[JOINT COMMITTEE PRINT]

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

Volume I

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

July 22, 1999

U.S. Government Printing Office
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JOINT COMMITTEE ON TAXATION

106th CONGRESS, 1ST SESSION

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CONTENTS

**Page numbers in contents do not necessarily reflect PDF format page numbers in text.
(Please excuse the inconvenience)

Page

VOLUME I

Page

Page

Page

Page

Page

Page

INTRODUCTION

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

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

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

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

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

I. EXECUTIVE SUMMARY

A. Overview

Under the IRS Reform Act, the Joint Committee on Taxation and the Secretary of the Treasury were each directed to conduct a study of the present-law interest and penalty provisions of the Internal Revenue Code of 1986 (the "Code") and to make any legislative or administrative recommendations that the Joint Committee or the Secretary deems appropriate to simplify penalty and interest administration or reduce taxpayer burden. The legislative mandate for this study directed the Joint Committee staff to examine whether the current penalty and interest provisions (1) encourage voluntary compliance, (2) operate fairly, (3) are effective deterrents to undesired behavior, and (4) are designed in a manner that promotes efficient and effective administration of the provisions by the Internal Revenue Service ("IRS"). These studies are required to be submitted to the House Committee on Ways and Means and the Senate Committee on Finance by July 22, 1999.

After extensive review of the present-law system of penalties and interest, including input from the public and analysis by the GAO and the Congressional Research Service, the Joint Committee staff study developed the legislative and administrative recommendations contained in this study with respect to the present-law penalty and interest system in general and specifically with respect to corporate tax shelters.

The Joint Committee staff believes that legislative changes to improve compliance and enhance the fairness and administrability of present law should not be undertaken without careful and deliberative review by the Congress and the opportunity for public input. Furthermore, the Joint Committee staff believes that careful consideration should be given to the views of the Administration, and particularly the IRS, with respect to these recommendations. Indeed, the legislative mandate contained in the IRS Reform Act requires the Treasury to provide legislative and administrative recommendations to the Congress.

The Joint Committee staff also believes that the need for deliberative review is particularly critical with respect to the recommendations relating to corporate tax shelters. There is evidence that the use of corporate tax shelters has grown significantly in recent years and the Joint Committee staff, in its study, has identified characteristics of present law that may be contributing to this growth. The number and complexity of the transactions that are used as corporate tax shelters suggests a need for a legislative solution that articulates broad and flexible principles that will address not only the current corporate tax shelter transactions being utilized, but will provide to the IRS the mechanism by which future corporate tax shelter transactions can be prevented. However, any legislative solution to the corporate tax shelter problem must balance this goal of articulating broad and flexible principles with present law's dependence on objective, rule-based criteria. Such a balanced approach will assure that the IRS is not granted open-ended authority that might be used to prevent transactions that the Congress did not intend to be considered corporate tax shelters. While the Joint Committee staff believes that its recommendations relating to corporate tax shelters will achieve the appropriate balance between

flexibility and certainty, the staff recognizes that others will hold alternative views and will favor alternative recommendations. The Joint Committee staff believes that deliberative review by the Congress of all points of view will strengthen the final legislative product.

On July 1, 1999, Treasury issued a White Paper relating to corporate tax shelters, titled The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals. In its White Paper, Treasury made a variety of legislative recommendations to address the corporate tax shelter issue. Because the Joint Committee staff completed its work on its recommendations before the issuance of the Treasury White Paper, the Treasury proposals were not considered in the preparation of the Joint Committee staff recommendations.

B. Joint Committee Staff Recommendations Relating to Penalties and Interest

In accordance with the findings of the Joint Committee staff throughout the study, the Joint Committee staff recommends the following with respect to penalties and interest.

Provisions of general applicability

- Provide one interest rate for both individual and corporate taxpayers. The rate, which would apply to both underpayments and overpayments of tax, would be the Applicable Federal Rate ("AFR") plus 5 percent.

- Exclude interest paid by the IRS from the income of individual taxpayers.

- Convert the present-law penalty for failure to pay estimated tax into an interest provision, increase the threshold at which taxpayers are subject to an interest charge for underpayment of estimated tax from $1,000 to $2,000, and allow both tax withheld and certain estimated tax paid throughout the year to be considered in determining whether the threshold has been met.

- Repeal the present-law penalty for failure to pay tax. If a taxpayer has not entered into an installment agreement with the IRS by the fourth month after assessment, then an annual 5-percent late payment service charge would apply. For those taxpayers who agree to an automated withdrawal of each installment payment directly from their bank account, the present-law $43 fee on installment agreements would be waived.

Interest

In addition to the recommendation to apply one interest rate contained in the provisions of general applicability, the Joint Committee staff recommends the following:

- Allow abatement of interest if gross injustice would otherwise result.

- Expand the circumstances in which interest may be abated to include periods attributable to any unreasonable IRS error or delay.

- Allow abatement of interest if the taxpayer is repaying an erroneous refund based on IRS calculations without regard to the size of the refund.

- Allow abatement of interest to the extent interest is attributable to the taxpayer's reliance on written statements by the IRS.

- Allow taxpayers to deposit amounts in a "dispute reserve account," a special interest-bearing account within the U.S. Treasury, which would stop the running of interest on tax underpayments and allow taxpayers to earn interest generally to the extent that a taxpayer's deposit is not applied to a tax underpayment.

Estimated tax

In addition to the recommendations to convert the present-law penalty for failure to pay estimated tax into an interest provision and to increase the threshold from $1,000 to $2,000, taking into account certain estimated tax payments, the Joint Committee staff recommends the following:

- Repeal the modified safe harbor that applies to individuals with AGI in the preceding taxable year in excess of $150,000. All taxpayers would be subject to the same safe harbor, which would require that estimated payments be made based on either 90 percent of current year's tax or 100 percent of prior year's tax.

- Provide only one interest rate per underpayment period.

- Change the definition of "underpayment" to allow existing underpayment balances to be used in underpayment calculations for succeeding estimated tax payment periods.

- Require taxpayers to use a 365-day year for all estimated tax underpayment calculations, regardless of whether the taxable year is a leap year.

Accuracy-related penalties

- Raise the minimum standards for undisclosed positions for both taxpayers and tax preparers such that, for each undisclosed position on a tax return, the taxpayer or tax preparer must reasonably believe that the tax treatment is "more likely than not" the correct tax treatment under the Code. Under present law, to avoid a penalty, taxpayers must have substantial authority for an undisclosed position, and, for tax preparers, the undisclosed position must have a realistic possibility of being sustained on the merits.

- Raise the minimum standards for disclosed positions for both taxpayers and tax preparers such that, for each disclosed position on a tax return, there must be at least substantial

authority. Under present law, to avoid a penalty, taxpayers must have a reasonable basis for a return position and disclose the position (and it must not relate to a tax shelter item), and, for tax preparers, the disclosed position must not have been frivolous (applies to tax shelter and non-tax shelter items).

- Change the preparer penalty from a flat $250 per occurrence to $250 or 50 percent of the tax preparer's fee, whichever is greater, for first-tier violations (i.e., preparation of a return with a position that does not meet the above-described recommended minimum preparer standards), and change the preparer penalty from a flat $1,000 per occurrence to $1,000 or 100 percent of the preparer's fee, whichever is greater, for second-tier violations (i.e., understatements that result from willful or reckless disregard of rules or regulations).

Pension penalty provisions

- Consolidate the Internal Revenue Code and ERISA penalties for failure to file Form 5500 series annual return/report, designate the IRS as the agency responsible for enforcement of reporting requirements, and reduce from three to one the number of government agencies authorized to assess, waive, and reduce penalties for failure to file Form 5500.

- Repeal the separate penalties for failure to file Schedules SSA and B and for failure to provide notification of plan status change; any such failure would constitute a failure to file a complete Form 5500.

Tax-exempt organization penalty provisions

- Clarify that the penalty imposed under section 6652(c)(2)(A), for failure to file annual trust information returns under section 6034, applies to a trust's failure to file Form 5227. Increase the penalty under section 6652(c)(2)(A), as applied to a trust's failure to file Form 5227, to that imposed by section 6652(c)(1)(A), which is $20 each day the failure continues, not to exceed the lesser of $10,000 or 5 percent of the organization's gross receipts.

- Recommend that the Congress consider whether it is appropriate to increase the penalty imposed under section 6652(c)(2)(A) for failure to file returns under section 6034 generally.

General administrative provisions

- Apply a higher standard of behavior to conduct by the IRS, similar to that which would be imposed on practitioners by the Joint Committee staff recommendations made elsewhere in this study.

- Require the IRS to publish, annually, statistics concerning the number of payments made and total amount paid out under section 7430 for taxpayers' reasonable administrative and litigation costs, as well as a summary of the administrative issues raised with respect to these payments and how these issues were resolved by the IRS.

- Require the IRS to improve the supervisory review of the imposition of penalties as well as their abatement in order to provide greater uniformity in penalty and interest administration and application.

- Require the IRS to develop better information systems in order to provide better statistical information on abatements and the reasons and criteria for abatements.

- Require the IRS to shorten significantly the current 45-day processing time for address changes.

- Require the IRS to establish administrative systems that assure that the proper representative of a taxpayer receives the proper notice directly from the IRS.

- Require the IRS to consider whether recent technological advances, such as e-mail and facsimile transmissions, permit the utilization of alternative means of communicating with taxpayers.

C. Joint Committee Staff Recommendations Relating to Corporate Tax Shelters

The Joint Committee staff recommends that a meaningful penalty structure be established to discourage corporate taxpayers from entering into corporate tax shelter transactions. Thus, the Joint Committee staff has developed a series of recommendations that would modify the penalties and standards of practice as they relate to corporate tax shelters. The recommendations fall into two categories: (1) those that affect corporations that participate in tax shelters, and (2) those that affect other parties involved in corporate tax shelters. In addition, the Joint Committee staff makes a number of recommendations regarding new disclosure and registration obligations with respect to corporate tax shelters. In accordance with its findings, the Joint committee staff recommends the following with respect to corporate tax shelters.

Recommendations that affect corporations which participate in corporate tax shelters

- Clarify the definition of a corporate tax shelter for purposes of the understatement penalty with the addition of several "tax shelter indicators." With respect to a corporate participant, a partnership, or other entity, plan, or arrangement will be considered to have a significant purpose of avoidance or evasion of Federal income tax if it is described by one (or more) of the following indicators:

  - The reasonably expected pre-tax profit from the arrangement is insignificant relative to the reasonably expected net tax benefits.

- The arrangement involves a tax-indifferent participant, and the arrangement (1) results in taxable income materially in excess of economic income to the tax-indifferent participant, (2) permits a corporate participant to characterize items of income, gain, loss, deductions, or credits in a more favorable manner than it otherwise could without the involvement of the tax-indifferent participant, or (3) results in a noneconomic increase, creation, multiplication, or shifting of basis for the benefit of the corporate participant, and results in the recognition of income or gain that is not subject to Federal income tax because the tax consequences are borne by the tax-indifferent participant.

- The reasonably expected net tax benefits from the arrangement are significant, and the arrangement involves a tax indemnity or similar agreement for the benefit of the corporate participant other than a customary indemnity agreement in an acquisition or other business transaction entered into with a principal in the transaction.

- The reasonably expected net tax benefits from the arrangement are significant, and the arrangement is reasonably expected to create a "permanent difference" for U.S. financial reporting purposes under generally accepted accounting principles.

- The reasonably expected net tax benefits from the arrangement are significant, and the arrangement is designed so that the corporate participant incurs little (if any) additional economic risk as a result of entering into the arrangement.

- An entity, plan, or arrangement can still be a tax shelter even though it does not display any of the tax shelter indicators, provided that a significant purpose is the avoidance or evasion of Federal income tax.
- Modify the penalty so that, with respect to a corporate tax shelter, there would be no requirement that the understatement be substantial.

- Increase the understatement penalty rate from 20 percent to 40 percent for any understatement that is attributable to a corporate tax shelter. The IRS would not have the discretion to waive the understatement penalty in settlement negotiations or otherwise for corporate tax shelters.

- Provide that the 40-percent penalty could be completely abated (i.e., no penalty would apply) if the corporate taxpayer establishes that it satisfies certain abatement requirements. Foremost among the abatement requirements is that the corporate participant believes there is at least a 75-percent likelihood that the tax treatment would be sustained on the merits. Another requirement for complete abatement involves disclosure of certain information that is certified by the chief financial officer or another senior corporate officer with knowledge of the facts.

- Provide that the 40-percent penalty would be reduced to 20 percent if certain required disclosures are made, provided that the understatement is attributable to a position with respect to the tax shelter for which the corporate participant has substantial authority in support of such position.

- Require a corporate participant that must pay an understatement penalty of at least $1 million in connection with a corporate tax shelter to disclose such fact to its shareholders. The disclosure would include the amount of the penalty and the factual setting under which the penalty was imposed.

Recommendations that affect other parties involved in corporate tax shelters

- Increase the penalty for aiding and abetting with respect to an understatement of a corporate tax liability attributable to a corporate tax shelter from $10,000 to the greater of $100,000 or one-half the fees related to the transaction.

- Expand the scope of the aiding and abetting penalty to apply to any person who assists or advises with respect to the creation, implementation, or reporting of a corporate tax shelter that results in an understatement penalty if (1) the person knew or had reason to believe that the corporate tax shelter could result in an understatement of tax, (2) the person opined or advised the corporate participant that there existed at least a 75-percent likelihood that the tax treatment would be sustained on the merits if challenged, and (3) a reasonable tax practitioner would not have believed that there existed at least a 75-percent likelihood that the tax treatment would be sustained on the merits if challenged.

- Require the publication of the names of any person penalized under the aiding and abetting provision and an automatic referral of the person to the IRS Director of Practice.

- Clarify the U.S. government's authority to bring injunctive actions against persons who promote or aid and abet in connection with corporate tax shelters.

- Include the explicit statutory authorization for Circular 230 in Title 26 of the United States Code and authorize the imposition of monetary sanctions.

- Recommend that, with respect to corporate tax shelters, Treasury amend Circular 230 generally to (1) revise its definitions, (2) expand its scope, and (3) provide more meaningful enforcement measures (such as the imposition of monetary sanctions, automatic referral to the Director of Practice upon the imposition of any practitioner penalty, publication of the names of practitioners that receive letters of reprimand, and automatic notification to state licensing authorities of any disciplinary actions taken by the Director of Practice).

Disclosure and registration obligations

Corporate taxpayer disclosure

- 30-day disclosure.--Arrangements that are described by a tax shelter indicator and in which the expected net tax benefits are at least $1 million would be required to satisfy certain disclosure requirements within 30-days of entering into the arrangement.

  - The 30-day disclosure would include a summary of the relevant facts and assumptions, the expected net tax benefits, each tax shelter indicator that describes the arrangement, the analysis and legal rationale, the business purpose, and the existence of any contingent fee arrangements.

  - The chief financial officer or another senior corporate officer with knowledge of the facts would be required to certify, under penalties of perjury, that the disclosure statements are true, accurate, and complete.

- Tax-return disclosure.--Arrangements that are described by a tax shelter indicator (regardless of the amount of net tax benefits) would be required to satisfy certain tax-return disclosure requirements.

  - The tax-return disclosure would include a copy of any required 30-day disclosure.

  - The tax-return disclosure also would identify which tax shelter indicators describe one or more arrangements reflected on the return.

Tax shelter registration

- Modify the present-law rules regarding the registration of corporate tax shelters by (1) deleting the confidentiality requirement, (2) increasing the fee threshold from $100,000 to $1 million, and (3) expanding the scope of the registration requirement to cover any corporate tax shelter that is reasonably expected to be presented to more than one participant.

- Require additional information reporting with respect to the registration of tax shelter arrangements that are described by a tax shelter indicator. The additional information would include the claimed tax treatment and summary of authorities, the tax shelter indicator(s) that describes the arrangement, and certain calculations relating to the arrangement.

II. LEGISLATIVE MANDATE AND METHODOLOGY

A. Mandate for Study

Under section 3801 of the IRS Reform Act, the Joint Committee on Taxation and the Secretary of the Treasury were each directed to conduct a study (1) reviewing the administration and implementation by the IRS of the penalty and interest provisions of the Code and (2) making any legislative or administrative recommendations the Joint Committee or the Secretary deems appropriate to simplify penalty or interest administration and to reduce taxpayer burden. These studies are required to be submitted to the House Committee on Ways and Means and the Senate Committee on Finance by July 22, 1999.

The legislative history for the IRS Reform Act indicates Congressional intent that these studies examine whether the current penalty and interest provisions (1) encourage voluntary compliance, (2) operate fairly, (3) are effective deterrents to undesired behavior, and (4) are designed in a manner that promotes efficient and effective administration of the provisions by the IRS. The legislative history also indicates Congressional intent that the Joint Committee on Taxation and the Secretary of the Treasury consider public comments in connection with their studies.

B. Study Methodology

In order to satisfy the legislative mandate, the Joint Committee staff undertook an extensive study of the present-law system of penalties and interest. The Joint Committee staff reviewed each of the penalty and interest provisions of the Code. (See the discussion below with respect to the Joint Committee staff's analysis of the scope of the study.) In addition, Joint Committee staff economists undertook an analysis of the economic considerations that determine, in part, taxpayers' decisions with regard to tax evasion or compliance, and the Federal Government's decisions in setting enforcement parameters, including penalties.

The Joint Committee staff met extensively with both the IRS and the Treasury Department to review the administration of the present-law system of penalties and interest. The Joint Committee staff reviewed stated IRS procedures and whether such procedures are consistently followed.

The Joint Committee staff requested that the General Accounting Office ("GAO") undertake a study of IRS administration with respect to the abatement of penalties and interest under present law. The GAO investigated IRS practices and procedures for abatement of penalties and interest. As part of its investigation, the GAO reviewed data provided by the IRS and reviewed the abatement processes in two IRS Service Centers and two District Offices. The

results of the GAO investigation were included in two reports prepared for the Joint Committee staff.[3]

The Joint Committee staff, with the assistance of the staff of the Library of Congress, reviewed the penalty and interest regimes of selected foreign countries.

On December 21, 1998, the Joint Committee staff issued a press release inviting interested parties to submit written comments and recommendations on matters relevant to the study. Specifically, the Joint Committee staff invited comments with respect to the following matters:

- The extent to which the present-law Federal penalty and interest provisions:
  - Encourage voluntary compliance (and the extent to which the administration of these provisions by the Internal Revenue Service encourages voluntary compliance).
  - Deter noncompliance, tax avoidance, and fraud.
  - Produce inequitable results or undue hardships for taxpayers.
  - Result in unequal treatment of similarly situated taxpayers.
  - Result in inequitable treatment of taxpayers and other third parties such as tax return preparers or providers of information returns.
  - Result in tax overpayments or underpayments because of disparities with commercial borrowing rates.
  - Result in inefficient or ineffective tax administration.
- Whether communications from the Internal Revenue Service to taxpayers provide an adequate explanation of why penalties and interest were imposed.
- With respect to the Commissioner's authority to waive penalties and abate interest:
  - The sources and scope of the Commissioner's authority to waive or not enforce penalties and whether such authority should be modified.
  - Whether the Commissioner's authority to abate interest should be modified.
  - Whether the administration of the penalty waiver and interest abatement authority is applied uniformly and fairly and the effect of such administration (including the effect on compliance).
- Whether certain provisions of the Internal Revenue Code should be clarified to identify whether they impose a penalty or a tax.
- How the Federal penalty and interest provisions compare to penalty and interest provisions of voluntary tax systems of other countries.
- Whether different entities should be subject to different penalty regimes and whether such different regimes should be determined by reference to the four operating units in the Commissioner's restructuring plan for the Internal Revenue Service.
- Specific recommendations on ways to:
  - Encourage voluntary compliance.
  - Deter noncompliance, tax avoidance, and fraud.

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[3] These reports are reprinted in Part III of Volume II of this study.

- C Align the structure of the penalty and interest provisions with the pending reorganization of the Internal Revenue Service.
- C Simplify the present-law penalty and interest provisions.
- C Make the administration of penalty and interest provisions more efficient and effective.
- C Reduce inequities and burdens of taxpayers who are (or may be) subject to the penalty and interest provisions.

C Any other matters that may be relevant to this study.

Interested parties were requested to submit comments in writing to the Joint Committee on Taxation by February 26, 1999. The Joint Committee staff received written submissions from more than 20 commentators. Summaries of the comments received are included in Appendix B of Volume I, below, and the texts of these comments are reproduced in Volume II. In addition, Joint Committee staff met with representatives of certain of the major taxpayer groups and professional organizations with respect to their written comments.

C. Scope of the Study

The Joint Committee staff study includes an analysis of each of the provisions of the Code that are statutorily called civil penalties. In addition, in preparing the study, the Joint Committee staff addressed the question of whether any provisions of the Code that are not called penalties, but that may function as penalties, should be included within the scope of the study.[4]

The decision whether or not to include any particular provision within the scope of the study is not intended to have any precedential value with respect to whether the provision is a penalty for any other purpose (such as for purposes of determining priority status in bankruptcy or for interest calculations). As described below, the Joint Committee staff limited the scope of the study in a manner intended to draw a logical distinction between provisions considered penalties and provisions that are more appropriately considered to be an inherent element of the tax benefit being conferred.[5] The Joint Committee staff recognized that different conclusions as to whether a provision is a "penalty" might be drawn in different contexts.

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[4] The Joint Committee staff did not include within the scope of its study penalties that are not specifically contained in the Code, such as certain penalties that can be imposed by the Tax Court, e.g., on taxpayers that maintain frivolous positions.

[5] Thus, the Joint Committee staff did not use the broadest possible definition of a penalty for purposes of the study. If a broad definition of penalty were used, then virtually any tax regime could be characterized as a penalty system. For example, the $500 child tax credit could be characterized as a penalty imposed on those taxpayers who do not have children, because taxpayers without children are "penalized" by not receiving the tax benefit conferred on taxpayers with children.

The scope of the study generally was limited to sanctions in the Code that relate to the collection of the proper amount of tax liability (such as penalties relating to payment of the proper amount of tax, reporting of income, or failure to provide information returns or reports). The scope of the study was not extended to provisions that address substantive Federal tax issues, including the adverse tax consequences that may result from the failure to meet requirements that are a condition of obtaining a particular tax benefit. For example, the Code imposes special substantiation requirements with respect to deductions for travel, gift, and entertainment expenses and expenses related to certain types of property.[6] Failure to comply with the substantiation requirements results in a loss of the deduction. The loss of the deduction is not considered a penalty, but merely the result of a failure to comply with the substantive tax rules. As another example, if capital assets are depreciated and then sold, the depreciation may be recaptured (i.e., a portion of any gain on the sale may be ordinary income rather than capital gain). Depreciation recapture is also not a penalty, but a normal function of the application of the substantive income tax rules--due to the sale of the asset, the taxpayer is not entitled to the benefit from the depreciation.

The so-called "marriage penalty" also was not considered a penalty for purposes of the Joint Committee staff study. The differences in tax liability that occur when two individual taxpayers marry result from the substantive operation of the present-law income tax system.

Certain of the provisions relating to tax-exempt organizations and tax-qualified pension plans raised questions as to whether they are properly considered penalties within the scope of the study. Section 501(c)(3) provides for 27 different categories of nonprofit organizations that are generally exempt from Federal income tax.[7] Similarly, pension plans that meet the requirements set forth in the Code[8] are generally exempt from tax.[9] In general, failure to satisfy the requirements applicable to the tax-exempt organization or pension plan results in loss of tax-exempt status (and

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[6] Sec. 274. References in this document to "section" or "sec." are references to the Internal Revenue Code of 1986 unless otherwise specified.

[7] Income derived from activities that are substantially related to the organization's exempt purposes and the organization's investment income are generally exempt from Federal income tax. Tax-exempt organizations are generally subject to tax on any income derived from business activities that are regularly carried on and that are not substantially related to their exempt purposes (called "unrelated business taxable income"). An additional tax benefit is associated with tax-exempt charitable organizations; subject to certain limits, contributions to such organizations are deductible.

[8] The qualification requirements are generally contained in Code section 401(a) and sections referred to therein.

[9] Additional tax benefits are associated with qualified pension plan benefits. For example, within limits, employers receive a current deduction for contributions to qualified plans, but employees are not required to include plan benefits in income until received.

any other associated tax benefits). In some cases, however, the Code imposes excise tax sanctions on certain activities in lieu of loss of tax-exempt status.[10] For example, separate excise taxes are imposed on the failure of an employer to meet the minimum funding requirements applicable to certain types of qualified pension plans;[11] nondeductible contributions to a qualified pension plan;[12] excess contributions to individual retirement plans and similar arrangements;[13] and failure of a qualified pension plan participant to receive minimum required distributions.[14] The Code also imposes excise taxes on prohibited transactions between a qualified pension plan and certain persons closely associated with the plan.[15] Similar excise tax sanctions apply with respect to various activities of private foundations.[16] Excise taxes are also imposed on excess benefit transactions and lobbying expenditures of certain tax-exempt organizations.[17] It was necessary to determine whether these and other provisions that impose sanctions in lieu of loss of favorable tax treatment were within the scope of the study.

The parameters for determining what should be included in the study, as described above, were applied to the various provisions relating to qualified plans and tax-exempt organizations. The Joint Committee staff determined that the loss of tax-exempt status is not a penalty, but a result of the failure to comply with the provisions granting tax-exempt status. The Joint Committee staff also determined that the excise tax sanctions imposed in lieu of loss of tax-exempt status generally should not be included in the study.[18] There were two primary reasons for this determination.

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[10] For a complete listing of these excise taxes, see Joint Committee on Taxation, *Schedule of Present Federal Excise Taxes (as of January 1, 1999)* (JCS-2-99), March 29, 1999.

[11] Sec. 4971.

[12] Sec. 4972.

[13] Sec. 4973.

[14] Sec. 4974.

[15] Sec. 4975.

[16] Secs. 4941-4945.

[17] Secs. 4911 and 4958.

[18] There is some case law with respect to whether certain of these excise tax provisions are "penalties." The Joint Committee staff did not find this case law to be dispositive of the issue. The cases deal with relatively narrow, technical issues, such as whether the taxes owed under the provisions receive favorable priority in bankruptcy. In addition, the cases do not reach a uniform result. Cf., Latterman v. United States, 872 F.2d 564 (3rd Cir. 1989) (holding that the first-tier prohibited transaction excise tax under sec. 4975(a) is a "tax" and not a "penalty" for purposes of determining when interest begins to accrue on amounts due) with Farrell v. United States, 484 F.

First, such provisions were determined to be closely linked with the provisions conferring the tax benefit–i.e., they are in lieu of loss of tax-exempt status. Because the loss of tax-exempt status was not considered a penalty, it was considered inappropriate to treat generally lesser, alternative sanctions as a penalty. Second, including such provisions as penalties could make it more difficult to draw a distinction between normal operation of the substantive rules of the Code and "penalty" provisions, and could result in the inappropriate expansion of the study to include almost any Code provision.

Another provision relating to qualified pension plans and similar arrangements is the 10-percent tax on early withdrawals (sec. 72(t)). The 10-percent early withdrawal tax is generally imposed on withdrawals from such plans prior to age 59-1/2, unless an exception to the tax applies.[19] While structured as an additional income tax, this provision is popularly referred to as a "penalty." For example, bills introduced in the Congress providing for additional exceptions to the early withdrawal tax frequently refer to the bill as providing for "penalty-free" withdrawals. This provision is not included in the study. The purpose of the early withdrawal tax is to recapture the tax benefits provided to qualified plan benefits in the event they are not used for their intended purpose, i.e., the provision of retirement income. The early withdrawal tax is thus part of the normal operation of the substantive provisions of the Code, much like depreciation recapture, and is not considered a penalty for purposes of this study.[20]

Similarly, the rule that subjects undistributed income of a charitable remainder trust to unrelated business income tax if the trust has any unrelated business taxable income in a particular year[21] is characterized on occasion as a "penalty," because other tax-exempt entities typically pay unrelated business income tax only on the portion of their income that constitutes unrelated business taxable income. As with the 10-percent early withdrawal tax, this provision is not included in the study. The unrelated business income tax rule of section 664(c) is intended to deny exemption from tax for any year in which a charitable remainder trust has unrelated business taxable income. Consequently, the Joint Committee staff viewed this provision as an adverse tax consequence that results from the failure to comply with the substantive tax rules applicable to charitable remainder trusts.

Supp. 1097 (E.D. Ark. 1980) (holding that the excise tax on self dealing under section 4941 is a "penalty" and not a "tax" for the same purpose).

[19] A similar tax is imposed on early withdrawals from annuity contracts (sec. 72(q)) and modified endowment contracts (sec. 72(u)).

[20] Similarly, the taxes under secs. 72(q) and 72(u) are not included in the study.

[21] Sec. 664(c).

The Joint Committee staff determined that provisions relating to the failure to comply with certain group health plan rules[22] should be included within the scope of the study. These provisions are not associated with any tax benefit. In some cases, the Congress could have structured such provisions to be tied to a tax benefit; in fact, the original penalty for failure to comply with the health care continuation rules was loss of the employer deduction for health care expenses. However, given that these provisions are not tied to a tax benefit, and that the primary purpose of these rules is to enforce requirements unrelated to the tax system, the Joint Committee staff determined that they should be included in the study.

[22] These rules include the excise taxes on the following: (1) failures to comply with the health care continuation rules (sec. 4980B); (2) noncomforming group health care plans (sec. 5000); (3) failures to comply with requirements relating to health care portability, renewability, and access (secs. 9801, 9802, and 9803); (4) discrimination against individuals based on health status (sec. 9802); and (5) failures to comply with requirements relating to coverage of mothers and newborns and mental health conditions (secs. 9811 and 9812).

III. OVERVIEW OF PRINCIPAL CIVIL PENALTY PROVISIONS

A. Delinquency Penalties

Failure to file

Under present law, a taxpayer who fails to file a tax return on a timely basis is subject to a penalty equal to 5 percent of the net amount of tax due for each month that the return is not filed, up to a maximum of 5 months or 25 percent.[23] An exception from the penalty applies if the failure is due to reasonable cause. The net amount of tax due is the excess of the amount of the tax required to be shown on the return over the amount of any tax paid on or before the due date prescribed for the payment of tax.[24]

The fraud and negligence penalties do not apply in the case of a negligent or fraudulent failure to file a return. Instead, in the case of a fraudulent failure to file a return, the failure to file penalty is increased to 15 percent of the net amount of tax due for each month that the return is not filed, up to a maximum of 5 months or 75 percent.[25]

Failure to pay

Taxpayers who fail to pay their taxes are subject to a penalty of 0.5 percent per month on the unpaid amount, up to a maximum of 25 percent.[26] If a penalty for failure to file and a penalty for failure to pay tax shown on a return both apply for the same month, the amount of the penalty for failure to file for such month is reduced by the amount of the penalty for failure to pay tax shown on a return. If a return is filed more than 60 days after its due date, then the penalty for failure to pay tax shown on a return may not reduce the penalty for failure to file below the lesser of $100 or 100 percent of the amount required to be shown on the return. For any month in which an installment payment agreement with the IRS is in effect, the rate of the penalty is half the usual rate (0.25 percent instead of 0.5 percent), provided that the taxpayer filed the tax return in a timely manner (including extensions).[27]

Failure to make timely deposits of tax

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[23] Sec. 6651(a)(1).

[24] Sec. 6651(b)(1).

[25] Sec. 6651(f).

[26] Sec. 6651(a)(2) and (3).

[27] Sec. 6651(h). This provision was added by section 3303 of the IRS Reform Act.

The penalty for the failure to make timely deposits of tax consists of a four-tiered structure in which the amount of the penalty varies with the length of time within which the taxpayer corrects the failure.[28] A depositor is subject to a penalty equal to 2 percent of the amount of the underpayment if the failure is corrected on or before the date that is 5 days after the prescribed due date. A depositor is subject to a penalty equal to 5 percent of the amount of the underpayment if the failure is corrected after the date that is 5 days after the prescribed due date but on or before the date that is 15 days after the prescribed due date. A depositor is subject to a penalty equal to 10 percent of the amount of the underpayment if the failure is corrected after the date that is 15 days after the due date but on or before the date that is 10 days after the date of the first delinquency notice to the taxpayer (under sec. 6303). Finally, a depositor is subject to a penalty equal to 15 percent of the amount of the underpayment if the failure is not corrected on or before the date that is 10 days after the date of the first delinquency notice to the taxpayer (under sec. 6303).[29]

An exception from the penalty applies if the failure is due to reasonable cause. In addition, the Secretary may waive the penalty for an inadvertent failure to deposit any employment tax by specified first-time depositors.[30]

The taxpayer may designate the period to which each deposit is applied. The designation must be made during the 90 days immediately following the sending of the related IRS penalty notice. For deposits required to be made after December 31, 2001, any deposit is to be applied to the most recent period to which the deposit relates, unless the taxpayer explicitly designates otherwise.[31]

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[28] Sec. 6656.

[29] In cases where the collection of the tax is in jeopardy, the 15-percent rate applies if the taxes are not deposited on or before the date on which notice and demand for immediate payment is given under section 6861, section 6862, or the last sentence of section 6331(a).

[30] Sec. 6656(c).

[31] This provision was added by section 3304 of the IRS Reform Act.

B. Accuracy-Related Penalties

Overview

All of the generally applicable penalties relating to the accuracy of tax returns are consolidated into one part[32] of the Code: the negligence penalty, the substantial understatement penalty, and the valuation penalties. These consolidated penalties are also coordinated with the fraud penalty. This statutory structure operates to eliminate any stacking of the penalties.

Accuracy-related penalty

The accuracy-related penalty[33] is imposed at a rate of 20 percent of the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation overstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. In addition, the penalty is doubled for certain gross valuation misstatements.

Negligence

If an underpayment of tax is attributable to negligence, the negligence penalty applies only to the portion of the underpayment that is attributable to negligence. Negligence includes any careless, reckless, or intentional disregard of rules or regulations, as well as any failure to make a reasonable attempt to comply with the provisions of the Code.

Substantial understatement of income tax

The accuracy-related penalty applies to the portion of an underpayment that is attributable to a substantial understatement of income tax. In determining whether a substantial understatement exists, the amount of the understatement is reduced by any portion attributable to an item if (1) the treatment of the item on the return is or was supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed on the return or on a statement attached to the return. Special rules apply to tax shelters.[34]

Substantial valuation overstatement

A penalty applies to the portion of an underpayment that is attributable to a substantial valuation overstatement. A substantial valuation overstatement exists if the value or adjusted basis

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[32] Part II of Subchapter A of Chapter 68 (secs. 6662, 6663, and 6664).

[33] Sec. 6662.

[34] See Part VIII, below, for a detailed discussion of this penalty.

of any property claimed on a return is 200 percent or more of the correct value or adjusted basis. The amount of the penalty for a substantial valuation overstatement is 20 percent of the amount of the underpayment if the value or adjusted basis claimed is 200 percent or more but less than 400 percent of the correct value or adjusted basis. If the value or adjusted basis claimed is 400 percent or more of the correct value or adjusted basis, then the overvaluation is a gross valuation misstatement.

Substantial overstatement of pension liabilities

The accuracy-related penalty applies to substantial overstatements of pension liabilities. The taxpayer is subject to this component of the accuracy-related penalty only if the actuarial determination of pension liabilities is 200 percent or more of the amount determined to be correct, but less than 400 percent of such amount. If the actuarial determination is 400 percent or more of the correct amount, then the overstatement is a gross valuation misstatement.

Substantial estate or gift tax valuation understatement

The accuracy-related penalty also applies to substantial estate or gift tax valuation understatements. The taxpayer is subject to this penalty only if the value of any property claimed on an estate or gift tax return is 50 percent or less of the amount determined to be correct. If the value claimed is 25 percent or less of the correct amount, then the understatement is a gross valuation misstatement.

Gross valuation misstatements

The rate of the accuracy-related penalty is doubled (to 40 percent) in the case of gross valuation misstatements. There are three types of gross valuation misstatements. The first is the same as the substantial valuation overstatement component of the accuracy-related penalty, except that the doubling is to apply only to valuation overstatements claimed on a return that are 400 percent or more of the amount determined to be the correct amount. The second is the same as the substantial overstatement of pension liabilities component of the accuracy-related penalty, except that the doubling is to apply only to overstatements of pension liabilities that are 400 percent or more of the correct amount. The third is the same as the substantial estate or gift tax valuation understatement component of the accuracy-related penalty, except that the doubling is to apply only to valuations claimed on the estate or gift tax return that are 25 percent or less of the amount determined to be the correct amount.

Fraud penalty

The fraud penalty is imposed at a rate of 75 percent of the portion of any underpayment that is attributable to fraud.[35] The accuracy-related penalty does not to apply to any portion of an underpayment on which the fraud penalty is imposed.

Reasonable cause and special rules

No penalty is to be imposed if it is shown that there was reasonable cause for an underpayment and the taxpayer acted in good faith.[36] An accuracy-related or fraud penalty is imposed only if a return has been filed.[37] This rule has the effect of coordinating the accuracy-related penalties with the failure to file penalties.

[35] Sec. 6663.

[36] Sec. 6664(c).

[37] Sec. 6664(b).

C. Information Reporting Penalties

Overview

The information return penalties are designed to encourage persons to file correct information returns even though such returns are filed after the prescribed filing date. There is a three-tier penalty structure in which the amount of the penalty varies with the length of time within which the taxpayer corrects the failure. Also, taxpayers may correct a de minimis number of errors and avoid penalties entirely.

Failure to file correct information returns

Any person that fails to file a correct information return with the Internal Revenue Service on or before the prescribed filing date is subject to a penalty that varies based on when, if at all, the correct information return is filed.[38] If a person files a correct information return after the prescribed filing date but on or before the date that is 30 days after the prescribed filing date, the amount of the penalty is $15 per return, with a maximum penalty of $75,000 per calendar year. If a person files a correct information return after the date that is after 30 days after the prescribed filing date but on or before August 1, the amount of the penalty is $30 per return, with a maximum penalty of $150,000 per calendar year. If a correct information return is not filed on or before August 1 of any year, the amount of the penalty is $50 per return, with a maximum penalty of $250,000 per calendar year.

There is a special rule for de minimis failures to include the required correct information. This exception applies to incorrect information returns that are corrected on or before August 1. Under the exception, if an information return is originally filed without all of the required information or with incorrect information and the return is corrected on or before August 1, then the original return is treated as having been filed with all of the correct required information. The number of information returns that may qualify for this exception for any calendar year is limited to the greater of (1) 10 returns or (2) one-half of one percent of the total number of information returns that are required to be filed by the person during the calendar year.[39]

Special lower maximum levels for this penalty apply to small businesses. Small businesses are defined as firms having average annual gross receipts for the most recent three taxable years that do not exceed $5 million. The maximum penalties for small businesses are: $25,000 (instead of $75,000) if the failures are corrected on or before 30 days after the prescribed filing date; $50,000 (instead of $150,000) if the failures are corrected on or before August 1; and $100,000 (instead of $250,000) if the failures are not corrected on or before August 1.

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[38] Sec. 6721.

[39] Sec. 6721(c)(2).

If the failure to file a correct information return is due to intentional disregard of the requirement, the penalty is $100 per information return or, if greater, 10 percent[40] of the amount required to be shown on the information return, with no limitation on the maximum penalty per calendar year.

Failure to furnish correct payee statements

Any person that fails to furnish a correct payee statement to a taxpayer on or before the prescribed due date is subject to a penalty of $50 per statement, with a maximum penalty of $100,000 per calendar year.[41] If the failure to furnish a correct payee statement to a taxpayer is due to intentional disregard of the requirement, the penalty is $100 per statement or, if greater, 10 percent[42] of the amount required to be shown on the statement, with no limitation on the maximum penalty per calendar year.

Failure to comply with other information reporting requirements

Any person that fails to comply with other specified information reporting requirements on or before the prescribed date is subject to a penalty of $50 for each failure, with a maximum penalty of $100,000 per calendar year.[43] The information reporting requirements specified for this purpose include any requirement to include a correct taxpayer identification number on a return or statement and any requirement to furnish a correct taxpayer identification number to another person.[44] This penalty is coordinated with the penalty for failure to file correct information returns and the penalty for failure to file correct payee statements by making this penalty inapplicable to failures penalized under those provisions.

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[40] Different rules are specified for certain types of payments. With respect to gross proceeds information reports, the percentage is 5 percent instead of 10 percent. With respect to information reports on cash received in a trade or business, the penalty is the greater of $25,000 or the amount of cash received in the transaction (up to $100,000).

[41] Sec. 6722.

[42] With respect to gross proceeds information reports, the percentage is 5 percent instead of 10 percent.

[43] Sec. 6723.

[44] Sec. 6724(d)(3).

Reasonable cause

Any of the information reporting penalties may be waived if it is shown that the failure to comply is due to reasonable cause and not to willful neglect.[45] For this purpose, reasonable cause exists if significant mitigating factors are present, such as the fact that a person has an established history of complying with the information reporting requirements.

[45] Sec. 6724(a).

D. Preparer, Promoter, and Protester Penalties

Return preparer penalties

If any part of an understatement of tax on a return or claim for refund is attributable to a position for which there was not a realistic possibility of being sustained on its merits, and if any person who is an income tax return preparer with respect to such return or claim for refund knew (or reasonably should have known) of such position and such position was not disclosed or was frivolous, then that return preparer is subject to a penalty of $250.[46] The penalty is not imposed if there is reasonable cause for the understatement and the return preparer acted in good faith.

If any part of an understatement of tax on a return or claim for refund is attributable to a willful attempt by an income tax return preparer to understate the tax liability of another person or to any reckless or intentional disregard of rules or regulations by an income tax return preparer, then the income tax return preparer is subject to a penalty of $1,000.[47]

Additional return preparer penalties apply to each failure to (1) furnish a copy of a return or claim for refund to the taxpayer, (2) sign the return or claim for refund, (3) furnish his or her identifying number, and (4) file a correct information return.[48] The penalty is $50 for each failure and the total penalties imposed for any single type of failure for any calendar year are limited to $25,000.

Penalty for promoting abusive tax shelters

The amount of the penalty imposed for promoting abusive tax shelters equals $1,000 (or, if the person establishes that it is less, 100 percent of the gross income derived or to be derived by the person from such activity).[49] In calculating the amount of the penalty, the organizing of an entity, plan, or arrangement and the sale of each interest in an entity, plan, or arrangement constitute separate activities.

Penalty for aiding and abetting the understatement of tax liability

The penalty for aiding and abetting the understatement of tax liability is imposed in cases where the person aids, assists, procures, or advises with respect to the preparation or presentation of any portion of a return or other document if (1) the person knows or has reason to believe that

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[46] Sec. 6694(a).

[47] Sec. 6694(b).

[48] Sec. 6695.

[49] Sec. 6700.

the return or other document will be used in connection with any material matter arising under the tax laws, and (2) the person knows that if the portion of the return or other document were so used, an understatement of the tax liability of another person would result. The penalty is $1,000, except that if the return or other document relates to the tax liability of a corporation, the penalty is $10,000.[50]

Frivolous income tax return penalty

Any individual who files a frivolous income tax return is subject to a penalty of $500.[51]

Sanctions and costs awarded by courts

The Tax Court may impose a penalty not to exceed $25,000 if a taxpayer (1) institutes or maintains a proceeding primarily for delay, (2) takes a position that is frivolous, or (3) unreasonably fails to pursue available administrative remedies.[52]

The Tax Court may require any attorney or other person permitted to practice before the Court to pay excess costs, expenses, and attorney's fees that are incurred because the attorney or other person unreasonably and vexatiously multiplied any proceeding before the Court.[53] If the attorney is appearing on behalf of the Commissioner of Internal Revenue, the United States is to pay these costs in the same manner as an award of these costs by a district court.

[50] Sec. 6701.

[51] Sec. 6702.

[52] Sec. 6673(a).

[53] Sec. 6673(b).

IV. OVERVIEW OF INTEREST PROVISIONS

In general

Taxpayers are required to pay interest to the IRS whenever there is an underpayment of tax. An underpayment of tax exists whenever the correct amount of tax is not paid by the last date prescribed for the payment of the tax.[54] The last date prescribed for the payment of the income tax is the original due date of the return.[55] The IRS is generally required to pay interest to a taxpayer whenever there is an overpayment of tax.[56] An overpayment of tax exists whenever more than the correct amount of tax is paid as of the last date prescribed for the payment of the tax. However, no interest is required to be paid by the IRS if it refunds or credits the amount due with 45 days of the filing of the return.[57]

Payment of tax

An amount is considered paid as tax on the last date prescribed for payment if it has been paid or credited to the appropriate tax on or before such date. An amount that is withheld, paid or credited as an estimate or deposit of tax does not count as the payment of tax until applied to the tax liability. Amounts that are refunded, credited to other periods, or offset against other liabilities are not considered as paid for this purpose.[58] An amount that was previously withheld, paid or credited as an estimate or deposit of tax is applied to the tax liability for the year as of the last day prescribed for payment of the tax.[59] Any amount that was previously paid but has been credited to a later year is considered credited on the last day prescribed for the payment of tax.[60]

For example, an individual taxpayer has withholding of $2,000 during 1999 and also pays $1,000 in estimated taxes during 1999. On April 15, 2000, the taxpayer forgets to file his return. On May 15, the taxpayer files a delinquent return, showing total income tax of $2,500 and a refund due of $500. Of this $500, the taxpayer requests that $300 be refunded to him and $200 credited to estimated taxes for the 2000 tax year. The IRS refunds the $300 and credits the $200 on June 10. No interest is owed by either the taxpayer or the IRS in this case. There is no underpayment,

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[54] Sec. 6601.

[55] Sec. 6601(b).

[56] Sec. 6611.

[57] Sec. 6611(e).

[58] Sec. 6513(d).

[59] Sec. 6513(b).

[60] Sec. 6513(d).

because an amount of estimated taxes and withholding that is not refunded or credited to a different year equals the liability and is considered paid on the original due date of the return, despite the return having been filed late. There is an overpayment, but no interest is due from the IRS since the amount requested to be refunded is paid within 45 days of the filing of the return.

Interest rates

Different interest rates are provided for the payment of interest depending upon the type of taxpayer, whether the interest relates to an underpayment or overpayment, and the size of the underpayment or overpayment. Interest on both underpayments and overpayments is compounded daily.[61] A special net interest rate of zero applies in situations where interest is both payable and allowable on offsetting amounts of overpayment and underpayment.[62]

For individuals, interest on both underpayments and overpayments accrues at a rate equal to the short term applicable Federal rate (AFR) plus three percentage points.[63]

For corporations, interest on an underpayment generally accrues at a rate equal to the short term AFR plus 3 percentage points, unless the overpayment is a "large corporate underpayment" (generally one in excess of $100,000) in which case interest accrues at a rate equal to the short term AFR plus 5 percentage points.[64] Interest on corporate overpayments generally accrues at rate equal to the short term AFR plus 2 percentage points, unless the overpayment exceeds $10,000 in which case interest accrues at a rate equal to the short term AFR plus one-half percentage point.

Abatement

Interest can be abated or suspended in certain situations. In general, the Secretary is authorized to abate interest that is not owed by the taxpayer, either because the interest was erroneously or illegally assessed, or was assessed after the expiration of the period of limitations. The Secretary also may abate interest that is attributable to unreasonable errors and delays by the IRS, as well as to erroneous written advice furnished by the IRS. The Secretary may abate interest if, in his judgement, the administration and collection costs involved do not warrant the collection of the amount due.

The Secretary is required to abate interest in the case of a declared disaster or certain erroneous refunds attributable solely to errors made by the IRS. The Secretary is required to

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[61] Sec. 6622.

[62] Sec. 6621(d).

[63] Sec. 6621.

[64] The higher interest rate on large corporate underpayments, also known as "hot interest," applies beginning 31 days after a letter or notice of proposed deficiency is sent (sec. 6621(c)).

suspend the accrual of interest if the IRS fails to contact the taxpayer in a timely manner and in the case of taxpayers serving in a combat zone.

Interest that is abated is not owed by the taxpayer and does not accrue additional interest through compounding or result in any additional penalties. If the accrual of interest is suspended for a period, then that period is not taken into account in determining the interest owed on an underpayment.

V. ECONOMICS OF TAX PENALTIES AND INTEREST

A. Penalties

Overview

Penalties for the failure to comply with tax laws are a necessary component of any system of tax laws if broad compliance with the tax laws is to be expected.[65] Penalties for the failure to comply with laws serve to establish and validate the standards of behavior set forth by the tax laws themselves, as well as to punish specific departures from such laws. Furthermore, the application of penalties in specific instances will help to promote the continued compliance with the tax laws by the currently law-abiding. In the absence of penalties, the tax laws would, at best, represent a suggested code of behavior. Anyone who disagreed with such code would be able to violate it without consequence.

Ideally, tax penalties would be set to achieve the goals mentioned at the outset of this study. That is, they should (1) encourage voluntary compliance, (2) operate fairly, (3) deter undesired behavior, and (4) be designed in a manner that promotes efficient and effective administration of the provisions by the IRS. In order to assess whether the current penalty regime meets these goals, and to form the basis for evaluating changes to this regime, it is necessary to have a framework to analyze the incentives for noncompliance and the role of penalties in a tax system.

A complete discussion of tax penalties must begin by addressing the related issue of tax evasion because tax noncompliance is a necessary precursor to the application of penalties. For Federal taxes, estimates of the size of the tax gap--the difference between the taxes that individuals and businesses legally owe and what they pay--vary widely.[66] Most estimates of the size of this gap are of a sufficient magnitude to require that tax rates be higher on compliant taxpayers in order to raise necessary revenue.

The following is a discussion of the economic considerations that determine, in part, taxpayers' decisions with regard to tax evasion or compliance. The government's decisions in setting enforcement parameters, including penalties, is then examined.

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[65] As the discussion shows in Part IX, below, tax penalties are used as a mechanism to improve tax compliance in most countries.

[66] For a discussion of issues involved in the measurement of tax noncompliance, see James Andreoni, Brian Erard, and Jonathan Feinstein, Tax Compliance, *Journal of Economic Literature*, Vol. XXXVI, June 1998, at 819.

Taxpayer's decision

Economists typically view the taxpayer's decision to comply fully or not to comply fully with the tax laws as a rational choice to maximize his or her expected "utility," or well-being. In this framework, the taxpayer chooses a level of compliance by weighing the tradeoff between compliance and evasion, choosing the level of compliance that will lead to the highest expected level of personal net benefits. The taxpayer's choice will depend on the various factors that affect the benefits and costs of tax evasion relative to complying with the tax laws. Among the factors that will influence the decision are the probability of the evasion being detected through audit, the back taxes, interest, and civil and criminal penalties that will be imposed if evasion is detected, the taxpayer's ethics or degree of honesty (alternatively, the expected level of guilt that would arise from evasion of taxes), damage to the reputation of the taxpayer if the evasion is detected, the taxpayer's level of "risk aversion," and the perceived benefits derived from a successful evasion of taxes.[67]

On the cost side, the audit probabilities and the penalties imposed are the principal determinants of the expected costs of tax evasion. The actual costs of undergoing an audit, regardless of the outcome, may also raise the expected cost of evasion. If audits were strictly random, such that a taxpayer's probability of being audited does not depend on whether he or she in fact cheated, the costs of undergoing an audit would not influence the decision to evade. If the taxpayer's cheating were to make an audit more likely, then the costs of undergoing an audit should be taken into account in the decision whether or not to cheat. Another cost factor is the guilt that one might feel after evading taxes. While guilt, or more broadly one's feelings about the morality of not paying one's taxes, is not often modeled in the economic analysis of tax evasion, it clearly is a factor that influences human behavior. If a taxpayer expects to feel guilty from tax evasion, the taxpayer is less likely to engage in tax evasion. Anything that would raise these expected costs, such as increased penalties for evasion, both civil and criminal, or an increased likelihood of evasion being detected due to increased audit rates, would generally be expected to decrease the amount of evasion undertaken.[68]

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[67] In theory, the net benefits should include consideration of the impact of one's tax evasion on the provision of public goods and services from which the taxpayer benefits. In a large community of taxpayers, the marginal personal benefit directly derived solely from one's own taxes is likely to be insignificant due to the diffuse benefits of the public good. Thus, in large communities, the potential tax evader can dismiss the effect that his evasion may have on his benefits from the provision of public goods and services.

[68] A government probably has little control over the guilt a taxpayer may experience from evasion. It is possible that penalties may reinforce guilt, and thus may reinforce compliant taxpayer behavior that is based on guilt avoidance.

The benefit from tax evasion is primarily the addition to after-tax income that results from such cheating, but also may include the avoidance of the costs of complying with the tax laws.[69] The monetary benefit of tax evasion in the form of underreporting income or overstating deductions will depend on the level of tax rates. For example, for each dollar of income that is not reported, the taxpayer will benefit by the amount of the taxes that would have been paid on that dollar of income, which is equal to the taxpayer's marginal tax rate multiplied by that dollar. Thus, if other factors are held constant, tax evasion would be expected to increase the higher the tax rate that one faces. While higher tax rates may provide an incentive for greater cheating, this incentive could well be offset by higher audit probabilities for persons in higher marginal tax brackets. If audit rates are correlated with higher tax rates, then it will not necessarily be the case that persons in higher tax brackets will have greater likelihood of cheating. Again, a taxpayer must weigh both the benefit side and the cost side of cheating before rationally determining a compliance level that maximizes one's expected net benefits.

Further, there is the taxpayer's "degree of risk aversion," or the extent to which the taxpayer likes or dislikes risk taking.[70] Taxpayers will vary in their attitudes towards risk taking: some will choose to cheat and others to comply, even though they might agree as to the potential costs and potential benefits of cheating. The less risk-averse taxpayer is more likely to risk the downside of cheating--getting caught--in order to reap the benefits of cheating--the addition to after-tax income. Essentially, the taxpayer's attitude toward risk is the final link in weighing the cost and benefits to determine whether to evade taxes. While the government can affect the benefits and costs of cheating, it basically has no control over the attitudes toward risk of a given taxpayer.

In sum, this basic model implies that the taxpayer will determine the benefits from evasion times the probability of achieving those benefits, and subtract from that the costs of evasion times the probability of those costs being imposed (i.e., being caught and having the penalties

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[69] While certain of the costs of tax compliance, such as record-keeping, may be incurred regardless of whether a taxpayer complies with the tax laws, there are nonetheless substantial stand-alone costs to complying with the tax laws. See, for example, Joel Slemrod and Nikki Sorum, The Compliance Cost of the U.S. Individual Income Tax System, *National Tax Journal*, Vol. XXXVII, No. 4, December 1984.

[70] A risk-averse individual is one who would not accept a gamble whose expected value is zero. Thus, if a gamble pays zero dollars with probability 0.5 or 1 dollar with probability 0.5, its expected value would be 50 cents. If it costs 50 cents to play the gamble, the gamble would have an expected value of zero. A risk-averse taxpayer would not pay 50 cents or more to play the gamble.

A risk-loving individual would be willing to pay more than 50 cents for the gamble. At a price of more than 50 cents, the expected value of the gamble is negative, but the prospect of winning a dollar motivates the risk lover. Just how much more than 50 cents an individual would be willing to pay would depend on just how risk loving they were, though the individual would not be willing to pay more than the possible winnings of 1 dollar.

assessed).[71] If the expected benefits exceed the expected costs, a taxpayer who is not risk-averse would choose to engage in tax evasion. A risk-averse taxpayer may choose not to engage in tax evasion under the same scenario, as such taxpayer gives more weight to the costs than to the benefits. Thus, as the penalties and probability of audit are raised, the costs of cheating are raised, and improved compliance will result.

Government's decision

Most of the above discussion has focused on the individual taxpayer's private benefit-maximizing choices with respect to compliance with the tax laws. The government's policy objective, on the other hand, is to maximize "social welfare." With respect to taxes, its objective is to design a tax system that raises the desired amount of revenues in an equitable and efficient manner, taking into consideration the likely response of the public to the policies it adopts. In this system, the government policy options include setting the enforcement parameters, i.e., the civil and criminal penalties and the resources devoted to audits. Like the rational taxpayer, the rational government should set these policy parameters with due consideration of the costs and benefits that result from the choices it makes. The government, unlike the individual taxpayer, must consider the costs and benefits of its policies on the myriad individual taxpayers that are affected.

With respect to the enforcement parameters, the government benefits from more stringent enforcement in several ways. First, more stringent enforcement in the form of higher audit rates will bring in increased revenues by identifying more tax delinquents and enabling the collection of back taxes, interest, and penalties. Similarly, more stringent enforcement in the form of increased monetary penalties from evasion will result in more revenues for each tax delinquent uncovered. Second, increasing the enforcement parameters will lead to greater voluntary compliance with the tax laws since this will raise the expected costs of evasion to the taxpayer, and such greater voluntary compliance results in greater tax revenues.[72] Furthermore, it is reasonable to expect that a given individual is more likely to comply with the tax laws if it is believed that others are generally in compliance as well. Such a taxpayer may be more motivated by a sense of collective

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[71] Costs such as the costs of "guilt" would not require getting caught in order to be imposed, but would be imposed with a 100-percent probability for those for whom guilt would be a factor.

[72] For discussion and analysis of the effects of enforcement on compliance, see Frank Malanga, The Relationship Between IRS Enforcement and Tax Yield, *National Tax Journal*, Vol. XXXIX, No. 3, September 1986; Ann Witte and Diane Woodbury, The Effect of Tax Laws and Tax Administration on Tax Compliance: The Case of the U.S. Individual Income Tax, *National Tax Journal*, Vol. XXXVIII, No. 1, March 1985; Jeffrey A. Dubin and Louis L. Wilde, An Empirical Analysis of Federal Income Tax Auditing and Compliance, *National Tax Journal*, Vol. XLI, No. 1, March 1988; and Jeffrey Dubin, Michael J. Graetz, and Louis Wilde, Are We a Nation of Tax Cheaters? New Econometric Evidence on Tax Compliance, *American Economic Review*, May 1987.

responsibility to pay taxes rather than the strict individualistic cost/benefit analysis previously outlined, and might willingly pay their tax obligation provided that others do so as well. However, in the face of widespread noncompliance, taxpayers may come to feel that the tax system is unjust to those who do pay the tax. If the government cannot achieve a reasonable level of compliance, a taxpayer's moral resolve to continue to pay the tax may erode. Such taxpayers might begin to rationalize cheating.[73] For these taxpayers, increased enforcement may not directly keep them in compliance out of fear of the consequences of cheating, but rather indirectly keep them in compliance by virtue of keeping other taxpayers in compliance whose motivations may differ.

There are costs to increased enforcement efforts as well. The most direct of these are the necessary resources devoted to audits. These resources clearly include the auditors' time, but also include the time of the law abiding taxpayers that are subject to audit. For cases that must be litigated, additional costs include those necessary to prepare one's case, both for the government and the taxpayer. Finally, where criminal penalties are imposed that result in jail time, the costs of incarceration must be considered.

Additionally, excessive enforcement efforts or unnecessarily harsh penalties could undermine compliance if such enforcement efforts and penalties lead to an unnecessarily adversarial relationship between the taxpayer and government. This adversarial relationship could foster disrespect for the tax laws and lead taxpayers to "get back" at the government by evading taxes. Enforcement efforts that seem harsh or arbitrary are also not likely to achieve the intended result of increasing compliance. As the link between offense and penalty becomes less clear, the taxpayer cannot rationally respond to the penalty regime.

The government needs to balance these costs and benefits in setting its enforcement and penalty policies in order to collect taxes most efficiently.

Optimal magnitude of penalties

As noted above, most economic research has found that taxpayer compliance rises with the probability of audit and the level of penalties. This implies that, in theory, from the simple economics of taxpayer behavior outlined above, the government could eliminate tax evasion with the appropriate choices of (sufficiently high) audit rates and penalties. If all noncompliance could be detected by audit, then a 100-percent audit rate would be sufficient to deter all tax evasion, assuming that the penalty for evasion in such a circumstance would consist of at least back taxes and interest charges so that the taxpayer is not made better off by evading taxes even though his or

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[73] For a discussion of these and similar social or moral factors possibly considered in the compliance decisions of individuals, see James Gordon, Individual Morality and Reputation Costs as Deterrents to Tax Evasion, *European Economic Review*, 1989, 33(4) at 797-805; Michael Spicer and Lee Becker, Fiscal Inequity and Tax Evasion: An Experimental Approach, *National Tax Journal*, 1980, 33(2) at 171-75; and Joel Slemrod, On Voluntary Compliance, Voluntary Taxes, and Social Capital, *National Tax Journal*, Vol. LI, No. 3, September 1998, at 485-491.

her tax evasion is detected. The economic costs of such an approach are not likely to be desirable, however. With a 100-percent audit rate, the resources devoted to audits, both on the part of the government and the taxpayer, would be quite substantial. Furthermore, such costs would fall disproportionately on law abiding taxpayers relative to a system of lower audit rates and higher penalties.[74]

Alternatively, a government could choose to devote fewer resources to audit, but could impose severe penalties on any taxpayer found to be cheating. For a typical, risk-averse, "utility-maximizing" taxpayer, as long as there is some positive probability of detection, there is a penalty level that can be set that would deter all tax evasion. The economic model posits that risk-averse taxpayers would not cheat so long as the expected value of their cheating was below zero. Since the gain from cheating can be made arbitrarily low by establishing a penalty that is sufficiently high, the expected value of the tax evasion can always be made to be less than zero, deterring all evasion, in theory.

For example, assume that a taxpayer chooses not to report income that saves him $1 in taxes. If he is caught, assume he will owe the taxes plus a penalty. One can think of this as the taxpayer taking a gamble. If his chance of being audited is 1 percent, the taxpayer will win the gamble 99 percent of the time. The expected value of the gamble depends, however, on the penalty if he is caught, and is given by

$$(1\text{-}p) \times \$1 + (p \times X)$$

where p is the probability of audit and X is the penalty if caught. In this case p equals 1 percent, and the expected value equals 99 cents plus 0.01X. Thus, the penalty would have to be set at $99 or greater for the expected value of the evasion to be $0 or less.

An advantage of a high-penalty, low-audit regime is that it would be administratively efficient. Fewer resources would be devoted to audit, and most costs of the enforcement regime would be borne by the tax evaders who are subject to penalties. However, such high-penalty regimes might be considered to be unfair if the penalty is not seen as fitting the crime. To the extent that the penalty is seen by the administrator of the penalty to be unfair, and thus not applied in practice, the deterrent effects of the penalty would not be realized.[75]

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[74] Strictly speaking, the given example of a 100-percent audit rate suggests that all taxpayers would be law abiding and thus costs could not fall disproportionately on the law abiding. However, audit rates that are high but less than 100 percent would presumably be accompanied by some level of cheating, and the statement that the costs of such a system would fall disproportionately on the law abiding holds true.

[75] For a discussion of this issue, see Department of the Treasury, Internal Revenue Service, Commissioner's Study of Civil Penalties, 1989, at III-9.

Government role in practice

In practice, the government faces difficult issues in setting its enforcement policies. While the economic theory can point to the likely effect of policies, there is, in general, insufficient data on the magnitude and nature of taxpayer noncompliance, and insufficient knowledge of the complex behavioral issues with respect to individual taxpayer behavior in the face of varying enforcement regimes. To complicate matters further, there can be long lead times before an optimal policy would have its proper effect. For example, an increase in enforcement levels might generate increased compliance in the short run only by actually catching and correcting individual acts of noncompliance, whereas in the long run, as knowledge of increased enforcement efforts spread, compliance would improve across the entire spectrum as taxpayers reduced cheating in recognition of the increased likelihood of being caught and penalized. Thus, it is possible that the short-run effects of a policy could seem cost-ineffective even if the long-run effects would justify the policy.[76] Similarly, it could be cost-effective in the short run to decrease enforcement levels once taxpayers are generally in compliance. By doing so, the government could save on its enforcement expenditures while for a time relying on the impression that it remains tough on enforcement. However, as knowledge spreads that enforcement efforts have waned, new taxpayers may become emboldened to cheat. In the face of budget pressures, there is likely to be a tendency toward decreased enforcement, whose harmful effects might not be felt for several years.

Politically, policy makers are also more likely to hear from taxpayers who are unhappy with enforcement actions, whether such actions were appropriate or inappropriate, and less likely to hear from compliant taxpayers upset that other taxpayers may be underpaying their taxes. As a result, policy-makers may face pressures to set enforcement at levels lower than would be most appropriate.

[76] As a result, it may be difficult to adopt the appropriate long-run policies in a political setting.

B. Interest

Overview

Interest payments (receipts) are the price paid (received) for the use (forbearance) of money for a period of time. The price paid, or interest, compensates the lender for the time- value of money and the risk of the loan. The time-value of money reflects the fact that, on average in the aggregate, a unit of consumption today is preferred to a unit of consumption tomorrow. In the market equilibrium, the time-value of money is reflected by a risk-free rate of return (as approximated by that of short-term Federal Government obligations, which carry negligible default and liquidity risk and little inflation risk). Loans that are risky will pay a premium to the risk-free rate to reflect the degree of risk undertaken in making the loan. Such risks include both credit risk, or the possibility that the borrower will not repay the loan, and inflation risk, the possibility that the nominal amount of the money, when paid back, will be worth less than it is today as a result of price inflation.

An underpayment of taxes is analogous to a loan from the government for the period of time between the time the payment was originally due and the time the underpayment was satisfied. Similarly, an overpayment of taxes is analogous to a loan to the government for the period of time between the time the payment was originally due and the time the government refunded the overpayment. An important difference between a Federal tax overpayment or underpayment and a typical loan agreement entered is that at least one of the parties to the underpayment or overpayment--the Federal Government--has no intention of entering into the loan. That is, the Federal Government does not wish to use the IRS as a vehicle to borrow from, or to lend to, taxpayers. Certain taxpayers, on the other hand, may deliberately underpay or overpay their tax obligations. One of the challenges in setting the overpayment and underpayment interest rates is to avoid incentives for taxpayers to overpay or underpay their tax obligations.

By convention, the price paid for the use of money is usually stated as an annual interest rate, regardless of the length of the loan. Thus, while mortgage loans are typically for 30 years and require monthly payments, the interest rate is specified as an annual rate. Similarly, a savings account will specify its dividend or interest payment as an annual rate, though it may credit and compound interest at periods of shorter duration.

Determination of interest rates

Market interest rates are those determined by market forces, i.e., by the interaction of the forces of supply (lenders) and demand (borrowers) for money. At any given time, market interest rates will vary based on the credit-worthiness of the borrower and the duration of the loan. The less credit-worthy the borrower, the more risky the loan, and thus the higher the interest rate will be to compensate for the possibility of default on the loan. The duration of the loan affects the market interest rate by introducing additional uncertainty in two ways. The primary uncertainty introduced by longer duration loans is that of inflation. Since loans are specified in nominal dollars, inflation will erode the value of the money that is ultimately repaid. The longer the period

of the loan, the greater the impact of inflation is on the value of the nominal loan repayments. Thus longer duration loans are generally expected to pay a premium to reflect this risk.[77] The second reason that duration affects the interest rate is that the longer is the loan repayment period, the more difficult it is to foresee the credit worthiness of the borrower at a future point in time, and thus the greater the likelihood of default occurring at some point during the loan repayment. Additionally, for illiquid loans (those that cannot be easily sold to a third party), a lender may require a higher interest rate to compensate for the uncertainty of his own future financial status, in which he or she might not wish to remain a lender but would be required to if the loan is not readily marketable.

Not all interest rates are determined in competitive markets. Certain interest rates are set by government fiat, rather than by market conditions. One example of such a rate is that for certain Federally guaranteed student loans, which have historically been set at levels lower than would prevail in a competitive market in order to subsidize the acquisition of education. Another example is the various interest rates charged for underpayments of tax obligations, or paid to taxpayers for certain overpayments of tax. Such rates are statutorily determined by reference to the applicable Federal rate (AFR) (see Part VII, below). To the extent that the rates charged or paid by the Federal Government approximate the rates that might prevail in the market, the government would neither be subsidizing nor penalizing taxpayers by virtue of the rates charged on underpayments. Similarly, taxpayers would neither subsidize, nor profit at the expense of, the government in the case of rates paid on overpayments. Rather, in both cases, the payments would merely compensate the lending party for the use of the funds.

In practice it is difficult to determine the appropriate interest rate in order to fairly compensate the taxpayer or the government for the use of funds. It could be argued that the AFR (without adjustments) is the appropriate rate for the government to pay on overpayments, as AFR is, in fact, a market determined rate for lending to the Federal Government, and overpayments are analogous to a loan to the government. Since the government is a net borrower, the use of the taxpayer's overpayment has saved the government its borrowing costs (AFR) over the interim in which it had use of the funds. Thus, returning these savings to the taxpayer would ensure that the government did not profit from the overpayment, and also provide compensation to the taxpayer. However, it could be argued that AFR is not likely to be the appropriate rate in all instances, as not all taxpayers take part in the market for government securities--that is, some taxpayers choose not to lend to the Federal Government at the market determined rate, and would perhaps do so only at much higher rates. For these taxpayers, some might argue that a higher rate of interest on overpayments would perhaps be more appropriate. For example, a taxpayer who is a net borrower may, at the margin, carry debt with much higher interest costs than AFR (such as credit card debt). The overpayment to the government means that higher cost debt could not be retired during the time that the government had the use of the funds. From this taxpayer's perspective, it

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[77] The "yield curve" is the graphic depiction of the relationship between the length of a loan (x-axis) and its yield (y-axis). The yield curve is normally upward sloping, reflecting that the rate rises with duration. This is not always the case, as at times of high temporary inflation when expectations are that inflation will decline.

might be argued that a higher interest rate is appropriate to compensate for his or her higher cost of funds. This, however, would mean that the government would incur a greater "borrowing" cost than it is able to achieve in the open market. The appropriate rate might then depend on who is at fault for the overpayment. If the taxpayer is at fault, a rate that resembles the government's opportunity cost[78] of funds (i.e., AFR) would be appropriate, while if the government is at fault, a rate that resembles the taxpayer's opportunity cost of funds would be appropriate (a rate possibly, but not necessarily, higher than AFR). Establishing who is at fault for an overpayment may be problematic, and not possible in many cases.

For underpayments of taxes, similar issues arise. While there is not a competitive market for government lending to private individuals similar to the market for private lending to government to serve as a proxy for a market rate, there is a private market for lending to individuals and businesses. In this market, the credit-worthiness of private individuals varies greatly (and is never as good as that of the Federal Government), and thus interest rates vary greatly to account for the specific characteristics of the borrower. To use such market proxies for underpayments means that interest rates would have to vary greatly to account for the specific characteristics of the "borrower" who has underpaid his or her taxes. For the individual that carries credit card balances from month to month, it could be argued that a rate as high as that typically charged by credit card companies would be the appropriate rate. For more credit-worthy individuals, lower rates might be appropriate, perhaps even as low as AFR for those who are net lenders to the Federal Government by virtue of their ownership of Federal debt securities. Again, however, it could be argued as above that if the underpayment were the fault of the government (such as if the taxpayer relied on erroneous advice provided by the government), an interest charge no greater than AFR would be appropriate. Such a charge would be sufficient to compensate the government for its opportunity cost of funds, while not unfairly harming those for whom a low rate closely reflects their opportunity cost of funds.[79] However, such a low rate would be a windfall to taxpayers with high opportunity cost of funds, and might encourage such taxpayers to forestall paying their tax obligations in order to pay off more high cost debt first. Ultimately, establishing the underpayment rate based on who is at fault for the underpayment is not likely to be practical owing to the difficulty of establishing who is at fault for the underpayment.

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[78] Opportunity cost refers to a method of valuation by reference to an alternative use to which one's money, time, etc. might otherwise have been put. Thus, for the Federal Government the opportunity cost of funds is the AFR--reflecting the fact that as an alternative to other uses of funds it can pay down government debt and save the borrowing costs (AFR). For a taxpayer with credit card debt, the opportunity cost of funds is at least that credit card rate, reflecting the fact that as an alternative to other uses of funds it can pay down the credit card debt and save the borrowing costs.

[79] Individuals with no debt and a conservative portfolio with a significant portion of its assets in short-term Federal securities, money market instruments, or cash would have a low opportunity cost of funds.

While in theory interest rates paid to and by the Federal Government for tax underpayments and overpayments should vary in order to fairly compensate (charge) the specific lender (borrower), such variety of rates is not manageable in practice. The rates charged by the Federal Government need to be chosen to balance concerns for fairness to specific taxpayers in underpayment situations (requiring that rates be kept low), while avoiding rates that would encourage certain taxpayers to underpay deliberately because they find the interest charge attractive (requiring that rates be kept high). Similarly, rates paid by the Federal Government should aim to fairly compensate taxpayers for the use of their funds (requiring that rates be kept high), while not encouraging taxpayers to overpay because the rate that is paid is attractive to them (requiring that rates be kept low).

Present-law interest rates thus represent a compromise between various objectives (see Parts IV and VII for a discussion of these rates). With respect to corporate interest rates, the disparity between overpayment and underpayment rates, particularly with respect to large corporate overpayments and underpayments, reflects a concern that overpayments to the IRS not be used
as a deliberate cash management device. The relatively low rate paid on overpayments discourages such use of overpayments, though the disparity in overpayment and underpayment rates then raises the complicated issues of interest netting (see Part VII, below, for a discussion of interest netting). The higher rate on underpayments is designed to encourage timely payment of tax obligations. With respect to individuals, the uniform overpayment and underpayment interest rate reflects a greater concern for equal treatment of individuals with respect to overpayments and underpayments. Individuals are less likely to deliberately underpay or overpay their tax obligations as a cash management device, and thus a higher underpayment rate relative to the overpayment rate may be less necessary. Additionally, the relatively low rate of AFR plus 3 suggests a bias towards limiting the number of individual taxpayers who would be charged a rate on underpayments too high for their particular circumstances (individuals with low opportunity costs of funds, as discussed above) at the expense of encouraging delayed payment of taxes for those with higher costs of funds.

Compound versus simple interest

The "simple" interest rate refers to the payment at a particular point in time (usually one year) of interest on a principal balance, expressed as a percentage of the original principal balance. It is thus the simple ratio of total interest paid at the end of a period to the original principal. Alternatively, the same interest payment could be expressed as a compound interest rate.

Compounding refers to the practice of periodically crediting interest earnings to the principal balance, such that these interest earnings themselves begin to accumulate interest. The more frequently interest is credited to the principal balance such that it begins to earn interest, the lower is the interest rate that is necessary to produce the same total annual interest payments as given by the simple interest rate. Thus, for example, if interest were credited to an account twice a year to achieve a 7-percent simple interest rate, the necessary compound interest rate *r* would be

given by $(1+ r/2) \times (1+r/2) = 1.07$. This reflects the fact that after the first six months the original principal P will have earned half of the annual rate r, or $P \times r/2$. When combined with the original principal P to reflect the crediting of the interest to the account at this point, this combined amount, $P \times (1+ r/2)$, now earns interest for the remaining six months at rate r/2. This gives us $P \times (1+ r/2) \times (1+ r/2)$ of combined interest and principal at year's end. To achieve the equivalent of a 7-percent simple interest rate, the above expression, $P \times (1+ r/2) \times (1+ r/2)$, must equal $P \times 1.07$ in order to yield the original principal P plus 7 percent of P. Since P drops out of both sides of the equality, $(1+ r/2) \times (1+ r/2)$, or $(1+ r/2)^2$, equals 1.07. Solving this expression for *r* yields a value of 6.88 percent. Thus, a 7-percent simple interest rate is equal to a 6.88 percent interest rate if interest is compounded every six months.

Compounding can occur at any frequency.[80] If it occurs monthly, then the interest rate that would be the equivalent of 7-percent simple interest would be given by the expression (1+r/12) raised to the twelfth power, or $(1+r/12)^{12}$, = 1.07. Solving for r, the monthly compound interest rate that is equivalent to 7-percent simple interest is 6.78 percent. In general, for compounding n times in a period, the equivalent interest rate is given by (1+r/n) raised to the nth power, or $(1+r/n)^n$, = 1.07. In the limit case, as n approaches infinity (known as continuous compounding), the continuously compounded interest rate equivalent to 7-percent simple interest can be shown to be 6.77 percent.

With respect to overpayments and underpayments of tax, present law requires daily compounding of the applicable annual interest rate. Thus, if the stated interest rate is 7 percent, the equivalent simple interest rate is (1 + .07/365) raised to the 365^{th} power, or $(1 + .07/365)^{365}$, which equals 7.25 percent. This simple interest rate is also known as the "annual percentage yield" (APY) to the lender of funds, and is known as the "annual percentage rate" (APR) to the borrower of funds.

The manner in which the interest rate is specified is immaterial to the economic substance of a lending or borrowing transaction. This is not to say that 7-percent simple interest is the same as 7-percent interest compounded daily, since, as shown above, a given interest rate that is compounded more frequently will yield a greater return--that is, it will produce more interest payments and hence yield a different economic result. Similarly, as also shown above, a lower interest rate can be the equivalent of a higher rate if the compounding is more frequent--that is, it can yield the same total interest payments and thus be the economic equivalent of the higher rate that is compounded less frequently. Thus, provided the total level of interest payments is

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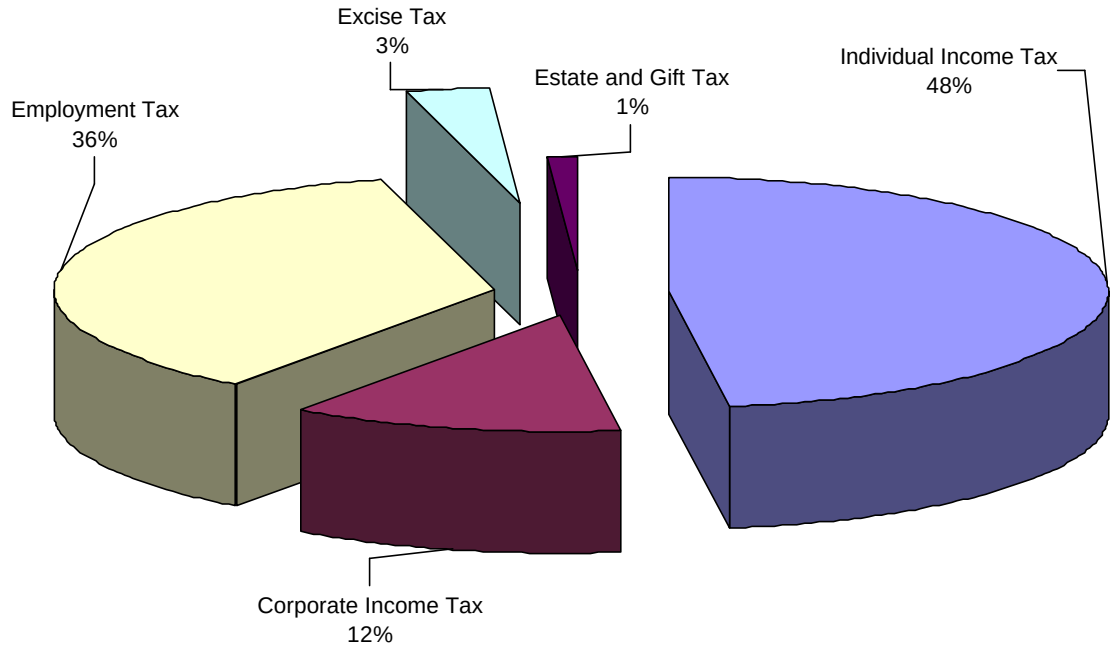
[80] While compounding can legally occur at any frequency, the Consumer Credit Protection Act requires that, for institutions covered by the Act (banks, credit unions, credit card companies, etc.), regardless of the institution's method of compounding, the effective "annual percentage yield" (APY), i.e., the simple interest rate, must be reported for borrowing, and an "annual percentage rate" (APR), also the equivalent of the simple interest rate, must be reported for lending.

equivalent, the specification of the rate as a simple interest rate or as a compound interest rate is economically immaterial.

VI. IRS ADMINISTRATION OF PENALTIES AND INTEREST

During Federal fiscal year 1996, the IRS collected $1.376 trillion in taxes, penalties, and interest (net of refunds). Figure 1 shows payments for individual income, corporate income, employment (including social security and unemployment taxes), estate and gift, and excise taxes were made in the following proportions:

Figure 1.--Source of $1.376 Trillion Paid in Federal Receipts in FY 1996



Source: Internal Revenue Service, *Fiscal Year 1996 Data Book*.

In fiscal year 1996, approximately $656 billion of tax, penalties, and interest was paid through individual income taxes, approximately $491 billion was paid through employment taxes, $171 billion was paid through corporate income taxes, $40 billion was paid through various excise taxes, and $17 billion was paid through estate and gift taxes.

This Part contains a discussion of the amounts of penalties and interest paid and abated for the three largest sources of Federal tax receipts in fiscal year 1996, which are the individual income tax, the corporate income tax, and employment taxes. Amounts paid and abated are arranged to show payment amounts and the timing of payments for taxes, penalties and interest. The main findings are as follows. IRS data show that, in dollar amounts and as a proportion of income taxes paid, corporations pay the least in penalties. With respect to the payments of interest, corporations pay the greatest dollar amount and proportion on corporate income tax liabilities, followed by individual taxpayer payments of interest for income taxes and business taxpayer payments of interest for employment taxes. IRS data also show that, with respect to the timing of payments, the greatest percentage of taxes paid on or before the due dates for tax returns was for employment taxes, followed by individual income taxes and corporate income taxes. IRS data compiled by the GAO show that abatements of taxes, penalties, and interest were greatest for corporate income taxes, followed by employment taxes and individual income taxes.[81]

Individual income taxes

Table 1, below, shows payments for individual income taxes by the amounts of tax, penalty, and interest paid and by when in the collections process the payments were made. All of the amounts shown are net of refunds.

Table 1.–Collection of Individual Income Tax During FY 1996
($ billions)

	Paid on original return	Paid at close of exam or first notice	Paid in collection	Totals
Tax	636.8	2.7	10.7	650.2
Penalty	0.9	0.5	1.5	2.9
Interest	(a)	0.8	2.1	2.9
Totals	637.7	4.0	14.4	656.0

Note: Details may not add to totals due to rounding.
(a) Less than 50 million.
Sources: Internal Revenue Service Data Book, Fiscal Year 1996; Tabulations of IRS Accounts Receivable Data; Tabulations of IRS Enforcement Revenue Information System Data; and Joint Committee on Taxation Staff tabulations.

[81] General Accounting Office, *Tax Administration: IRS' Abatements of Assessments in Fiscal Years 1995-98*, GAO/GGD-99-77.

The first column in Table 1 shows payments made from taxpayer self-assessments of taxes and penalties on or before the last date of the timely filing of individual returns. Penalty amounts shown in column 1 are mostly for the failure to pay estimated tax penalty. Columns 2 and 3 show all payments made after the due date for filing tax returns. Column 2 shows amounts paid promptly and in full at the time that a taxpayer's self-assessed liability was changed after a timely filed return. This could happen when a taxpayer paid the full amount upon (1) an examination or IRS appeals hearing recommendation; (2) a court decision; or (3) a notice from the IRS informing the taxpayer of an omitted or incorrect item or a mathematical error on the return. Column 3 shows amounts paid that are not included in columns 1 or 2. These amounts include periodic payments made under an installment agreement and payments made as the result of collections efforts by the IRS subsequent to a first notice of tax due to a taxpayer. All of the amounts shown in column 3 are generically referred to as paid in collections. The final column shows the total amounts of tax, penalty, and interest paid by individuals in fiscal year 1996.

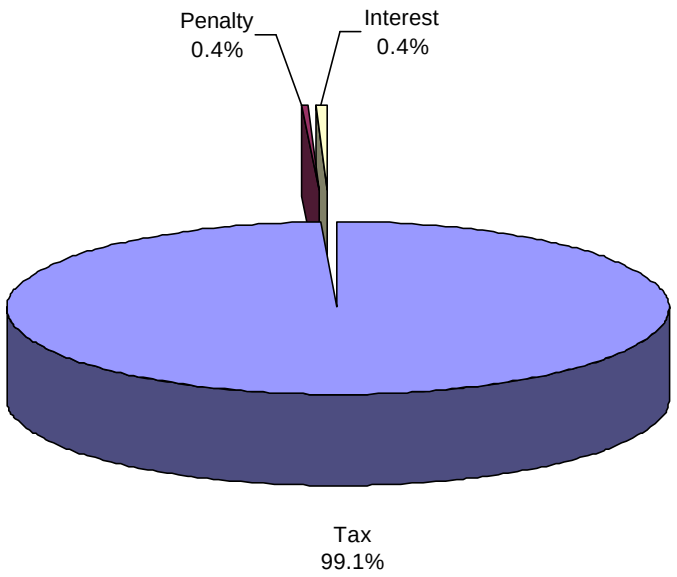
Figure 2 below shows the relative proportions of total individual payments for taxes, penalties and interest tabulated from the row totals in Table 1.

Sources: Internal Revenue Service *Data Book, Fiscal Year 1996*; Tabulations from the Internal Revenue Service Enforcement Revenue Information System File; Internal Revenue Service, *Statistics of Income.*

Although individual taxpayers paid almost $3 billion in penalties and $3 billion in interest, these amounts represent less than 1 percent of the total amount of payments made in fiscal year 1996. Table 1 also provides some perspective on the timing of payments of penalties and interest. Although the amounts paid through timely self-assessments are for tax year 1995 while the payments made subsequent to IRS contact are likely attributable to earlier tax years, Figure 3 below shows the high proportion of tax payments made through self assessment (column 1 of Table 1) relative to IRS enforcement actions (columns 2 and 3 of Table 1).

Figure 3, below, shows the percentage of individual payments of income tax, penalties, and interest that were paid on or before the filing date in fiscal year 1996.

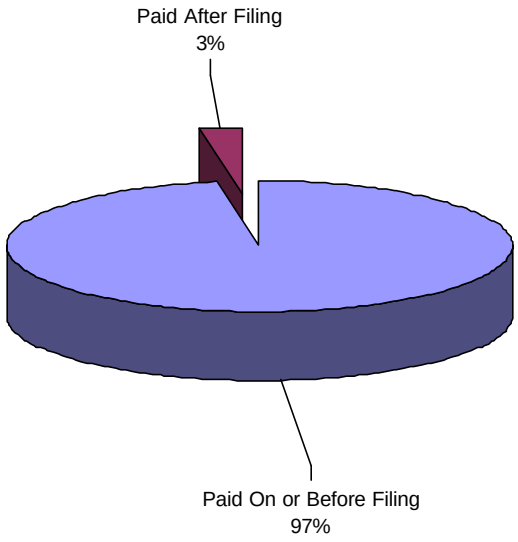
Figure 2.--Source of Individual Payments in Fiscal Year 1996



One feature of the present-law penalty and interest regime for individual taxpayers is that the interest rate charged by the Federal Government on underpayments of tax is below market rates for comparable debt, such as credit card debt on personal loans from commercial banks. In the absence of penalties, individual taxpayers would have an economic incentive to borrow from the government by delaying payments of tax and subsequently paying back the borrowing at a below-market interest rate. In the absence of penalties or under a reduced penalty regime, it would be expected that the percentage of payments made on or before filing would decrease.[82]

[82] Figures 2 and 3 depict payments made by the type of payment and by the time of payment. Because there is no measure of taxes that were not paid but should have been paid, it is difficult to determine the effectiveness of the current penalty and interest regime in inducing voluntary compliance. Because the IRS has not specifically measured noncompliance (with the exception of compliance with the Earned Income Tax Credit) during this decade, no useful measure of the extent of noncompliance during fiscal year 1996 is available.

Figure 3.--Individual Payments of Income Tax, Penalties, and Interest by Date of Payment in Fiscal Year 1996



Sources: Internal Revenue Service, *Data Book, Fiscal Year 1996*; Tabulations from the Internal Revenue Service Enforcement Revenue Information System File; Internal Revenue Service, *Statistics of Income*.

The 3 percent of receipts paid after the filing of the return as shown in Figure 3 corresponds to $18.3 billion in payments consisting of $2 billion of penalties, $2.9 billion of interest, and $13.3 billion of tax.[83] Approximately 22 percent of this amount, or $3.9 billion, was paid at the time that an assessment of additional tax was determined. These amounts are shown in column 2 of Table 1. The remaining approximately 78 percent, or $14.4 billion, was paid through IRS collection activities on approximately $90 billion of unpaid taxpayer liabilities. These amounts are shown in Table 2.

The rows of Table 2 are arranged by type of payment. The top half of Table 2 provides a breakdown of the $14.4 billion in receipts due to collections activities into payments of tax,

[83] These amounts are the sums of the respective items in columns 2 and 3 of Table 1.

penalty, and interest. Of the $14.4 billion collected, $10.7 billion represented actual tax liability, $1.5 billion was for penalties, and $2.1 billion was interest. These amounts are shown in the all years column of Table 2. The bottom half of Table 2 shows a similar breakdown for amounts abated in accounts receivable.

Table 2.–Individual Income Tax Accounts Receivable Balances, Payments, and Abatements by Age of Tax Return in Fiscal Year 1996
($ billions)

	Tax Year of Returns				
	1995 to 1994	**1993 to 1991**	**1990 to 1985**	**Prior to 1985**	**All years**
Total Balance	15.1	23.6	35.6	18.0	92.2
Payments					
Tax	5.7	3.7	1.2	0.1	10.7
Penalty	0.5	0.6	0.3	0.1	1.5
Interest	0.3	0.7	0.8	0.3	2.1
Total payments:	6.5	5.0	2.3	0.5	14.4
Abatements					
Tax	(a)	0.5	0.4	0.5	1.4
Penalty	0.1	0.5	0.3	0.4	1.3
Interest	(a)	0.3	0.3	0.8	1.4
Total abatements:	0.1	1.3	1.0	1.7	4.1
Ending Balance	8.6	17.2	32.3	15.7	73.8

Note: Details may not add to totals due to rounding.
(a) Less than 50 million.
Sources: Tabulations of the IRS Accounts Receivable File; General Accounting Office, *IRS' Abatements of Assessments in Fiscal Years 1995-98*; and Joint Committee on Taxation Staff tabulations.

The columns in Table 2 are organized to show the age profile of tax returns comprising individual accounts receivables during fiscal year 1996. The grouping of tax years illustrates important age dependent effects on the ability to collect delinquent taxes. The first column includes returns for tax years 1995 and 1994. Amounts paid (shown in rows 2, 3, and 4) on these returns show the greatest proportion of payments to liability (shown in row 1). The second column contains tax return years 1993, 1992, and 1991. The first two columns show that tax returns no older than 5 years pay the greatest amounts of taxes and penalties. The third column contains returns for tax years 1985 through 1990, and reflects liabilities with very low collection potential. The fourth column, which consists of returns for tax years prior to 1985, show the least collection

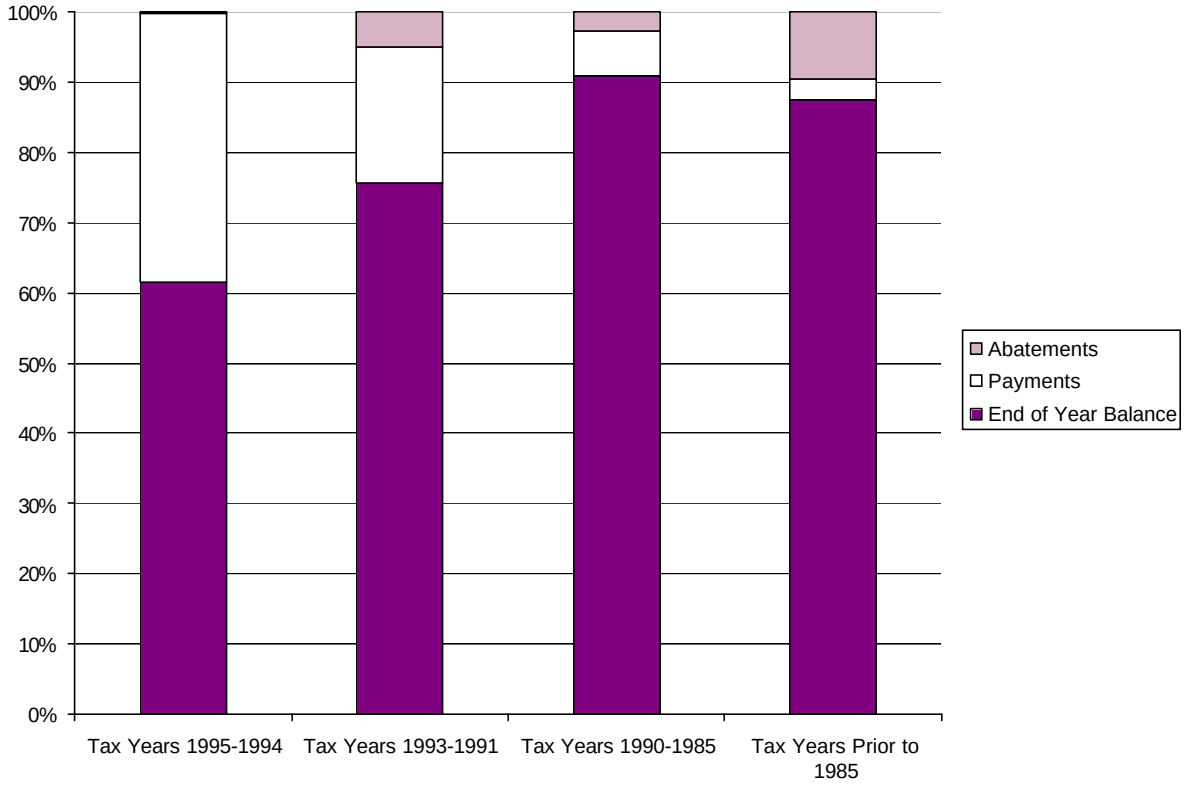
potential. In addition, payments on returns of this vintage show that the amounts of interest and penalties paid exceed the amount of taxes paid.

Reading across Table 2 from left to right, three patterns emerge. First, the amounts of interest and penalties paid relative to the amount of taxes paid increases with the age of the tax return. The first row of Table 2 shows the total amount of individual taxpayer liabilities in the IRS accounts receivable inventory during fiscal year 1996. These amounts represent the sum of payments (rows 2, 3 and 4), abatements (rows 5, 6 and 7), and unpaid balances (row 8) as of the final month of the Federal fiscal year in the individual accounts receivable inventory. The second pattern shows that the proportion of total payments (rows 2, 3 and 4) to total liability (row 1) decreases with the age of the tax return. Third, abatements of interest, shown in row 7, increase with the age of the return, although the pattern for abatements of taxes and penalties (shown in rows 5 and 6) is more constant across tax years.

Figure 4, below, shows the relative proportion of payments, abatements, and remaining balances for individual accounts receivable at the end of fiscal year 1996. The proportions shown for the various tax years refer to the dollar amounts in the accounts receivable inventory shown in Table 2. The bottom section of each bar refers to the amounts for ending year balances shown on the bottom row of Table 2 while the white section of each bar refers to the payment amounts shown in rows 2, 3, and 4 of Table 2. The top section of each bar refers to the abated amounts shown on rows 5, 6, and 7 of Table 2. Figure 4 shows that for tax return years 1995 and 1994, 60 percent of the accounts receivable inventory total balance of $15.1 billion had not been collected by the end of the fiscal year, while almost 40 percent of that amount was collected.[84] Reading Figure 4 from left to right shows the increase in unpaid account balances and abatements and decline in payments as a proportion of account balances, all reflecting the difficulty in collecting from older tax liabilities. For example, for tax years prior to 1985, less than 10 percent of the account balance was collected, while for tax year 1995 and 1994 returns, almost 40 percent was collected. The top section of each bar shows the generally increasing proportion of the accounts receivables that were abated each year.

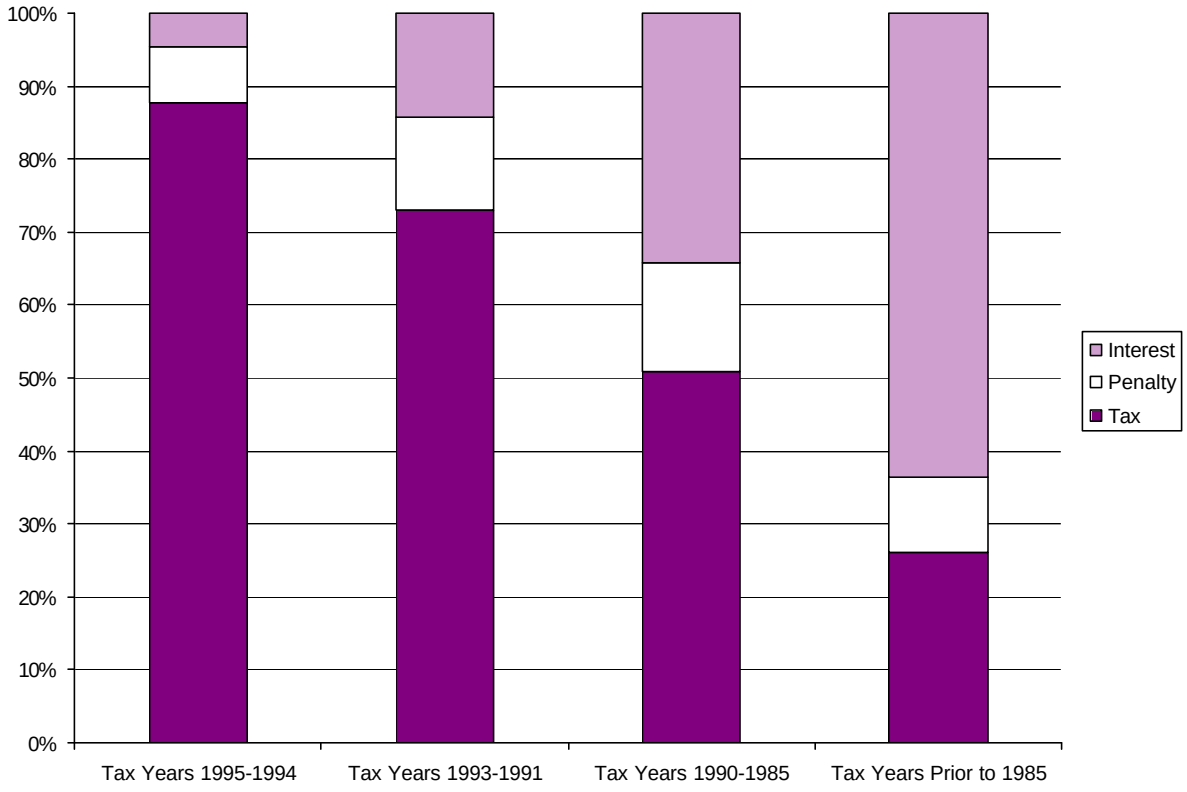
[84] The amounts abated for tax years 1995 and 1994 within the accounts receivable inventory were statistically insignificant.

Figure 4.--Proportion of Total Individual Accounts Receivable Paid, Abated, and End of Year Balance in Fiscal Year 1996



Sources: Tabulations of the IRS Accounts Receivable File; General Accounting Office, *IRS' Abatements of Assessments in Fiscal Years 1995-98*; and Joint Committee on Taxation Staff tabulations.

Figure 5.--Proportion of Payments in Individual Accounts Receivable by Tax, Penalty, and Interest in Fiscal Year 1996



Sources: Tabulations of the IRS Accounts Receivable File; and Joint Committee on Taxation Staff tabulations.

Figure 5 above disaggregates the proportion of payments (shown in white in each bar of Figure 4) into payments of tax, penalty and interest. The most visible trend is the large amount of interest paid on the oldest tax returns in the accounts receivable inventory. Note the fairly constant proportion of penalties paid across all of the tax years, ranging between 6 percent of payments made on tax years 1995 and 1996 returns to 15 percent on returns for tax years 1985 through 1990. This is because the two penalties that comprise most of the dollar amounts in the accounts receivable inventory (the section 6651 failure to pay and the failure to file penalties) have a coordinated penalty rate structure and a cap on the total penalty, so that the combined effect of the two never exceeds 25 percent of the outstanding tax liability.[85] The third most frequently assessed

[85] There are situations for which payment amounts are mostly for penalties. One situation occurs when payments are for the penalty for fraud, which is equal to 100 percent of the tax

and paid penalty for individuals, the section 6654 penalty for failure to pay estimated income tax, is assessed as an interest charge which tolls from the date of the underpayment to the date of payment. As a result, the amounts for this penalty will increase with the duration of time between the date the tax was payable and the date that the tax was ultimately paid. Most of the amounts for this penalty are self-assessed and paid on originally filed tax returns. These amounts are shown in column 1 of Table 2.

In fiscal year 1996, abatements of individual income tax, penalty and interest within the accounts receivable inventory totaled approximately $4.1 billion. Of this amount, $1.4 billion was for abatement of tax, $1.3 billion was for abatement of penalties, and $1.4 billion was for abatement of interest. Figure 4 shows the generally increasing proportion of abatements (shown as the gray areas atop each bar) by the tax year of the return. Figure 6, below, disaggregates these abatement amounts by tax year into taxes, penalties, and interest. The pattern of large proportions of penalty abatements is mainly due to the administration of the section 6672 penalty for failure to deposit taxes discussed below. The increasing proportions of abatements of interest on older returns is similar to the payment pattern of interest on returns shown in Figure 5.

Although there are many reasons for abatements they can generally be placed into three categories. The first type of abatement occurs when it is determined that the assessed liability never existed. This can occur for a variety of reasons, including IRS input processing errors and taxpayer reporting errors. This can also happen when an assessment under the substitute for return program is subsequently reversed as the result of additional information that establishes that no tax filing requirement was present.[86] Approximately $1.2 billion of abatements in fiscal year 1996 were for reversals of assessments on substitute for returns assessments. This type of abatement can also occur when a penalty assessment under section 6672 is made against a person who is responsible for making tax deposits. Because more than one person may be responsible for ensuring that these deposits are made, a penalty equal to 100 percent of the underdeposited amounts may be imposed on multiple persons for the same deposit delinquency. When the amount of tax is eventually deposited the penalty is abated on all persons who were deemed responsible

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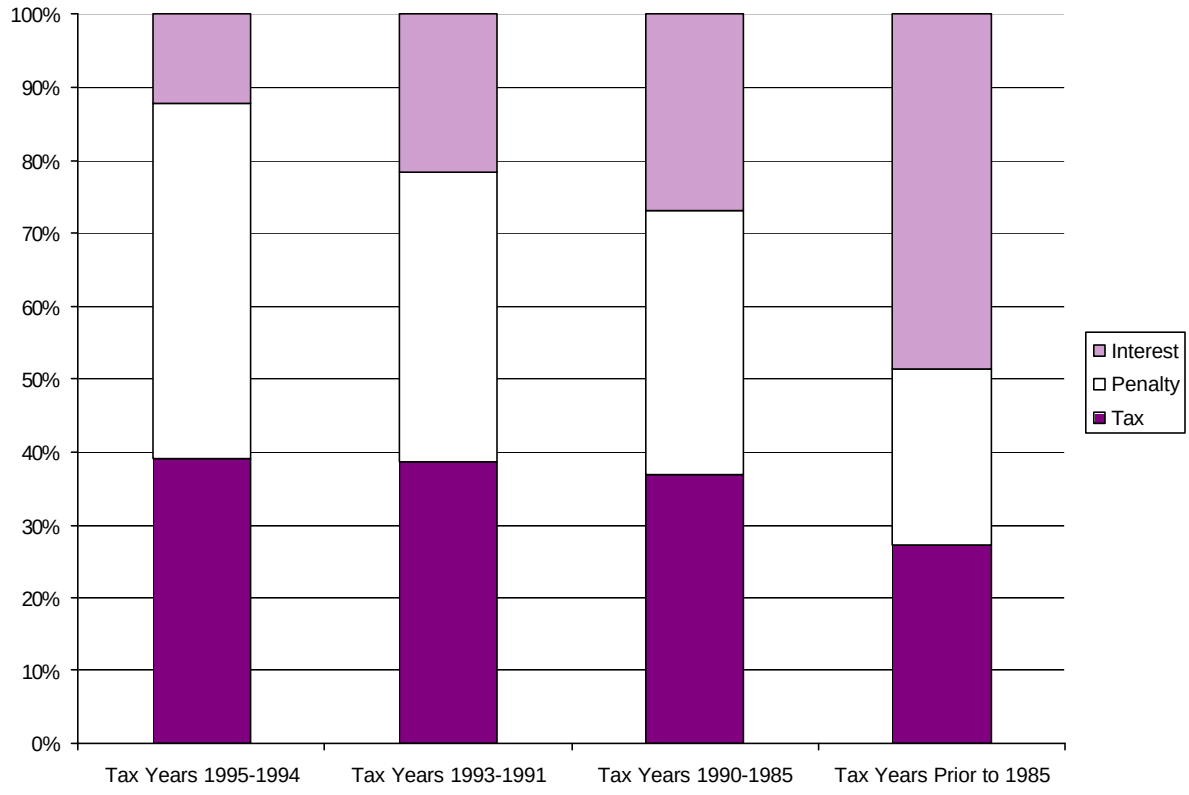
evaded. Another situation occurs as a result of the way the IRS attributes payments on unpaid liabilities. Payments are generally applied first against tax liabilities, second against penalties, and third against interest. Consequently, it is possible that for some taxpayers who make partial payments that are less than the amount due, or less than the required payment under an installment agreement, the remaining, unpaid liability could be substantially for penalties and interest. In this case, subsequent payments would be attributable mostly to penalties and interest.

[86] Under section 6020(b), the Secretary of the Treasury may make a return for a person who did not file a return, but with respect to whom the Secretary has sufficient information to prepare a return. Such a return is created under the substitute for return program. As the IRS locates these persons, it can be verified whether a return filing requirement existed or not. When it is determined that no filing of a return was necessary, any tax, penalty, and interest assessed is abated.

for making the payments. In fiscal year 1996, $0.6 billion of penalty abatements were for this penalty. In both situations, the assessments and abatements are mechanisms through which the tax administration system attempts to ensure that persons who are required to file tax returns and persons who have responsibilities to collect taxes file such returns and collect such taxes.

Figure 6.--Proportion of Abatements in Individual Accounts Receivable by Tax, Penalty, and Interest in Fiscal Year 1996



Sources: General Accounting Office, *IRS' Abatements of Assessments in Fiscal Years 1995-98*; and Joint Committee on Taxation Staff tabulations.

The second category of abatements is for actual tax liabilities whose chances of being collected have become so remote that the liability is abated. This type of abatement can occur because of (1) economic hardship, such as an accepted offer-in-compromise or a bankruptcy proceeding ($0.9 billion); (2) a determination by the IRS that the liability is uncollectible; or (3) the expiration of the 10-year statute of collections period ($1.3 billion).

The third category of abatements is for actual tax liabilities that subsequently become offset as the result of a carryback of a loss (such as a net operating loss) or a credit (such as foreign tax credits). Approximately $1.2 billion of abatements in fiscal year 1996 were for net operating loss carrybacks.

Corporate income taxes

Table 3, below, shows payments of tax, penalties, and interest as well as the timing of these payments for corporations in fiscal year 1996.

Table 3.–Collections of Corporate Income Tax During FY 1996
($ billions)

	Paid on original Return	Paid at close of exam or first notice	Paid in collection	Totals
Tax	162.1	3.4	1.8	167.3
Penalty	0.1	(a)	0.1	0.2
Interest	(a)	2.8	1.1	3.9
Totals	162.2	6.3	3.0	171.4

Note: Details may not add to totals due to rounding.
(a) Less than 50 million.
Sources: Internal Revenue Service, *Fiscal Year 1996 Data Book*; Tabulations of IRS Accounts Receivable Data; Tabulations of IRS Enforcement Revenue Information System Data; and Joint Committee on Taxation Staff tabulations.

The first column in Table 3 shows payments made from taxpayer self-assessments of taxes and penalties on or before the last date of the timely filing of corporate income tax returns. As with individual income tax returns, the penalty amounts shown in column 1 are mostly for the failure to pay estimated tax penalty. The second and third columns show payments of taxes, penalties, and interest after the filing of the return. In contrast with individual income taxes, a greater proportion of enforcement amounts are paid at the close of examination (or appeals, or upon a court decision, or upon a first notice) as shown in column 2 rather than through IRS collections efforts as shown by the amounts in column 3. The final column shows the total amounts of tax, penalty, and interest paid by individuals in fiscal year 1996.

The second and third rows show the timing and amounts of payments of penalties and interest. Corporate taxpayers pay greater amounts of interest than penalties, unlike individual taxpayers, who pay similar amounts of each as shown in Table 1.

Figure 7, below, shows the relative proportions of corporate payments of taxes, penalties and interest. It is clear that while corporations pay proportionately less in penalties than other taxpayers, they pay proportionately, and in absolute terms, more interest on underpayments of tax. Interest paid on underpayments of income tax amounted to almost 75 percent of the amount of tax underpayment, while for individual income taxes, interest paid on under payments of tax amount to 25 percent of the amount of tax underpayment.[87] In part, this reflects the higher interest rate that is generally attributable to corporate underpayments as compared with individual underpayments and the generally longer period of time between the filing of the original return and the determination of a corporate income tax underpayment.

[87] The 75 percent estimate is determined as the ratio of $3.9 billion of interest paid by corporations (row 3 of Table 3) to $5.2 billion of tax paid after the filing of the original return (the sum of columns 2 and 3 in row 1 of Table 3). The 25 percent estimate is made similarly for amounts shown on Table 2.

Sources: Internal Revenue Service, *Fiscal Year 1996 Data Book*; Tabulations from the Internal Revenue Service Enforcement Revenue Information System File; Internal Revenue Service, *Statistics of Income.*

Figure 7.--Source of Corporate Payments in Fiscal Year 1996

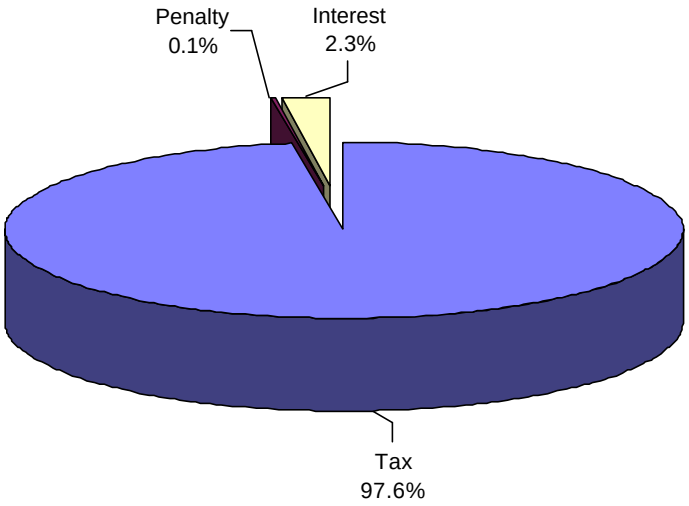
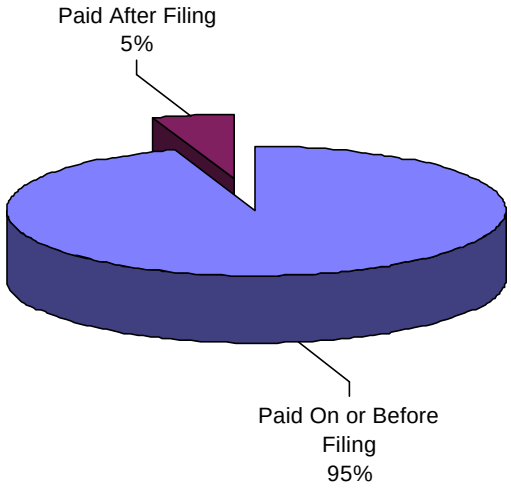


Figure 8.--Payments of Corporate Income Tax, Penalties, and Interest by Date of Payment in Fiscal Year 1996



Sources: Internal Revenue Service, *Fiscal Year 1996 Data Book*; Tabulations from the Internal Revenue Service Enforcement Revenue Information System File; Internal Revenue Service, *Statistics of Income*.

The 5 percent of receipts paid after the filing of the return as shown in Figure 8, above, is associated with $9.3 billion in payments, consisting of $5.2 billion of tax, $0.1 billion of penalty, and $3.9 billion of interest. Approximately 68 percent of this amount, or $6.3 billion, was paid at the time that an assessment of additional tax was determined. These amounts are shown in column 2 of Table 3. The remaining approximately 32 percent, or $3.0 billion, was paid through IRS collection activities on approximately $54 billion of unpaid taxpayer liabilities. These amounts are shown in Table 4, below.

Table 4.–Corporate Income Tax Accounts Receivables Balances, Payments, and Abatements by Age of Tax Return in Fiscal Year 1996
($ billions)

	Tax Year of Returns				
	1995 to 1994	**1993 to 1991**	**1990 to 1985**	**Prior to 1985**	**All years**
Total Balance	2.3	10.4	18.2	8.5	39.5
Payments					
Tax	0.7	0.4	0.6	0.1	1.7
Penalty	0.1	(a)	(a)	(a)	0.1
Interest	0.1	0.1	0.6	0.3	1.1
Total payments:	0.9	0.5	1.2	0.4	2.9
Abatements					
Tax	0.1	0.4	0.3	0.1	0.9
Penalty	(a)	(a)	(a)	(a)	0.1
Interest	(a)	(a)	0.1	(a)	0.1
Total abatements:	0.1	0.4	0.4	0.1	1.1
Ending Balance	1.4	9.4	16.6	8.0	35.5

Note: Details may not add to totals due to rounding.
(a) Less than 50 million.
Sources: Tabulations of the IRS Accounts Receivable File; General Accounting Office, *IRS' Abatements of Assessments in Fiscal Years 1995-98*; and Joint Committee on Taxation Staff tabulations.

The columns in Table 4 are organized to show the aging of tax returns comprising corporate accounts receivables during fiscal year 1996. The first column includes returns for tax years 1995 and 1994. As with individual income tax account receivables, collections on these returns show the greatest proportion of payments (rows 2, 3, and 4 amounts) to liability (row 1 amounts) compared with earlier returns. The second, third and fourth columns show collection amounts for earlier tax years. This age profile of the corporate account receivables inventory is notably different from the age profile of accounts receivables for individual taxpayers shown in Table 2. First, payments decline more rapidly in absolute amounts and as a proportion of outstanding accounts receivables total balances for corporate income taxes than for individual income taxes on returns earlier than tax year 1994. Second, while interest paid as a proportion of taxes increases with the age of the tax return, penalties do not. Third, abatements of taxes, penalties, and interest in collections for corporate income taxes (the bottom half of Table 4) are small relative to those for individual income taxes.

A comparison of abatement amounts shown on Table 2 for individuals with amounts shown on Table 4 for corporations shows that abatements of taxes, penalties, and interest are smaller during IRS collections actions for corporations than for individuals. However, in general, abatements of corporate income taxes are larger than for individual income taxes. According to GAO tabulations, abatements of taxes, penalties, and interest on corporate income taxes in fiscal year 1996 totaled approximately $17.7 billion compared with $10.3 billion for individual income taxes.[88] Table 4 does not reflect most of these amounts because they occur prior to IRS collections actions, generally as the result of an amended return filed by the taxpayer, or as the result of a refund generated during an IRS examination. The largest amounts of abatements for corporations were the result of net operating loss and foreign tax credit carrybacks totaling more than $7.7 billion. Refunds as the result of IRS examinations totaled $2.7 billion. These amounts compare with amounts for net operating loss carrybacks on individual returns totaling approximately $1.2 billion and refund amounts resulting from IRS examinations of approximately $0.5 billion.[89] The relatively small abatement amounts in IRS collections on corporate income tax account receivables shown in Table 4 are mainly the result of the expiration of the 10-year statute period of limitations for collections, bankruptcies, and the recovery of underdeposited amounts of payroll taxes.

Figure 9, below, shows the relative proportion of payments, abatements, and remaining balances for corporate accounts receivable at the end of fiscal year 1996. The proportions shown for the various tax years refer to the dollar amounts in the accounts receivable inventory shown in Table 4. For example, the first bar of Figure 9 shows that approximately 36 percent of the $2.3 billion of corporate accounts receivable for tax years 1995 and 1994 (column 1, row 1 of Table 4) had been paid by the end of the fiscal year, while approximately 4 percent of that amount was abated. Overall, it is clear from Figure 9 that the proportion of account balances that are paid is greatest for the most recent tax years but declines almost immediately to amounts in the vicinity of 5 percent for older tax years. Relative to individual returns, these data show that amounts in corporate accounts receivable have poor collection prospects beyond the most recent tax return years. The top section of each bar shows the proportion of the accounts receivable that were abated for each of the vintages of tax returns. Generally between 1 and 4 percent of accounts receivable liabilities are abated each year although no discernable pattern emerges.

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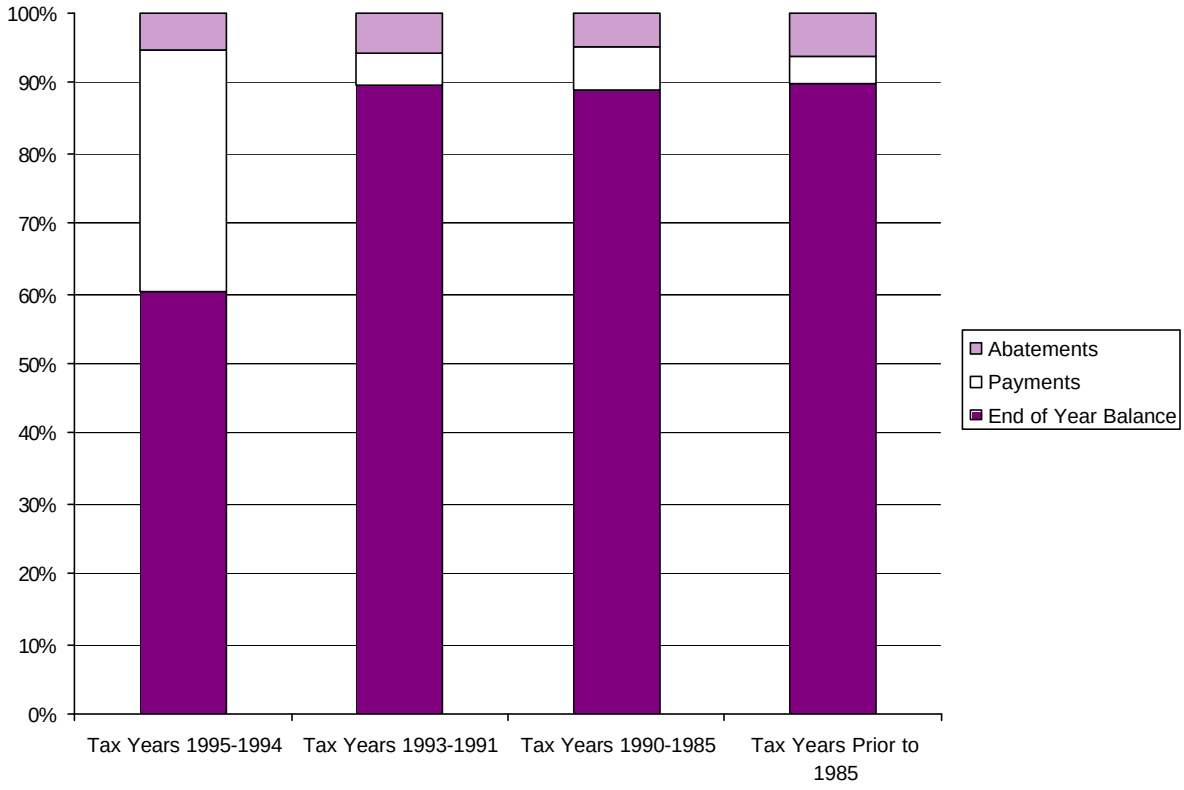
[88] General Accounting Office, *Tax Administration: IRS' Abatements of Assessments in Fiscal Years 1995-98*, GAO/GGD-99-77.

[89] It is not possible to "net" the GAO tabulations of abatements against enforcement revenues paid at the close of an examination or upon a first notice. To the extent that abatements occur at the close of an examination or with a first notice amount that was paid in full, enforcement revenues shown in column 2 of Table 3 may reflect the "net" effect of abatement amounts and enforcement revenue amounts. As a result, some amounts of the $17.7 billion in abatements of corporate income taxes, penalties, and interest, are included in the enforcement revenue data shown in column 2 of Table 3.

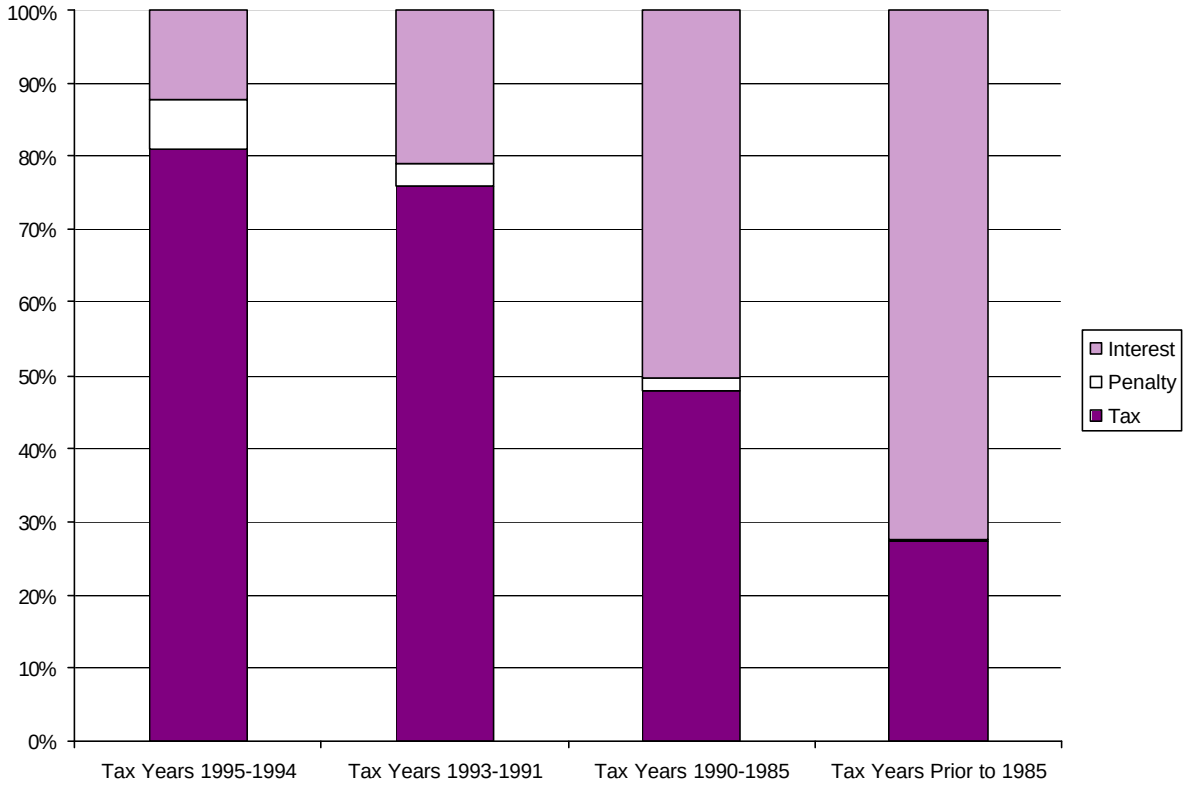
Figure 9.--Proportion of Total Corporate Accounts Receivable Paid, Abated, and End of Year Balance in Fiscal Year 1996



Sources: Tabulations of the IRS Accounts Receivable File; General Accounting Office, *IRS' Abatements of Assessments in Fiscal Years 1995-98*; and Joint Committee on Taxation Staff tabulations.

Figure 10, below, disaggregates the proportion of payments shown in white in each bar of Figure 9 into payments of taxes, penalties and interest. Figure 10 is notable for two reasons. First, although the pattern of an increasing proportion of payments of interest with the age of the tax returns is similar to the pattern of payments of interest in the individual accounts receivable inventory, a greater proportion of interest is paid on corporate income tax account receivables than on individual account receivables. Second, penalties paid are a smaller percentage and are declining with time as compared with penalty payments in individual account receivables (as shown in Figure 5).

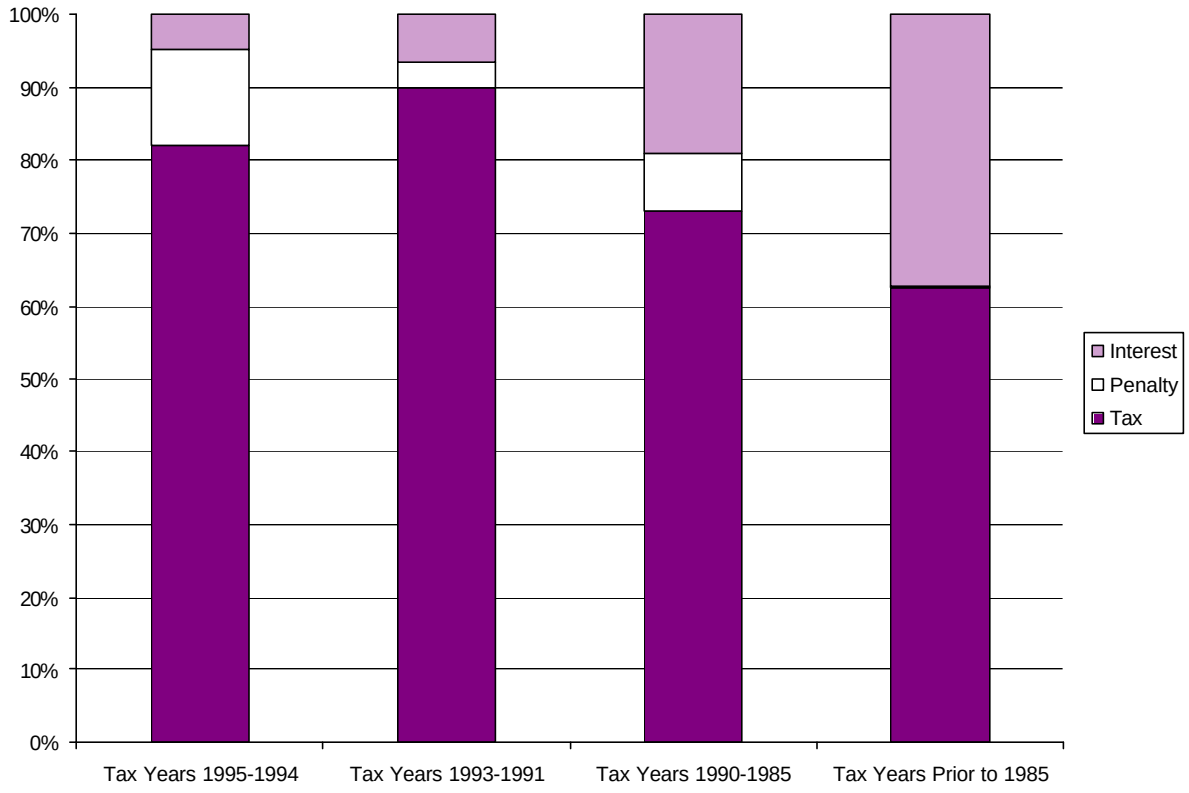
Figure 10.--Proportion of Payments in Corporate Accounts Receivable by Tax, Penalty, and Interest in Fiscal Year 1996



Sources: Tabulations of the IRS Accounts Receivable File; and Joint Committee on Taxation Staff tabulations

Figure 11, below, disaggregates the proportion of abatements in the corporate income tax accounts receivable inventory shown as white bars in Figure 9 into the proportions of taxes, penalties, and interest abated. The pattern of increasing abatements of interest and declining abatements of penalties is similar to the pattern for payments of interest and penalties shown in Figure 10.

Figure 11.--Proportion of Abatements in Corporate Accounts Receivable by Tax, Penalty, and Interest in Fiscal Year 1996



Sources: General Accounting Office, *IRS' Abatements of Assessments in Fiscal Years 1995-98*; and Joint Committee on Taxation Staff tabulations.

One possible explanation for the relatively small amount of corporate penalties paid and abated might be that corporations are more effective than individual taxpayers in preventing assessments of penalties through reliance on the reasonable cause standard for avoiding penalty assessments. In addition, if the determination of corporate income tax liability became more complicated, the effectiveness of the penalty regime would erode as it became easier to satisfy the reasonable cause standard for avoiding penalties.

Employment taxes

Table 5, below, shows payments of tax, penalties, and interest as well as the timing of these payments for employment taxes in fiscal year 1996. The first column shows payments that were made during fiscal year 1996 by employers on behalf of their employees for Federal social security taxes and unemployment taxes. Unlike individual and corporate income taxes, employers cannot self-assess penalties for failures to make timely deposits of employment taxes. As a result, no amounts are shown in rows 2 and 3 of column 1. As with individual income taxes, most of the amounts paid after the filing of original returns (which occurs quarterly for employment taxes) are paid through IRS collections efforts. This can be seen by comparing the $6.7 billion total of column 3 with the $1.5 billion shown in column 2.

Table 5.–Collections of Employment Taxes During Fiscal Year 1996
($ billions)

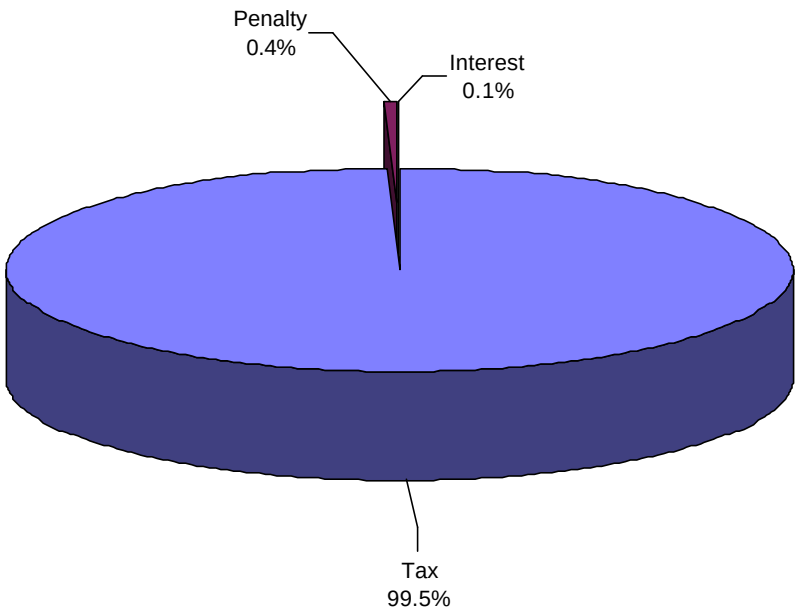
	Paid on original Return	Paid at close of exam or first notice	Paid in collection	Totals
Tax	483.1	0.9	5.00	489.0
Penalty	--	0.5	1.35	1.8
Interest	--	0.1	0.39	0.5
Totals	483.1	1.5	6.7	491.3

Note: Details may not add to totals due to rounding.
Sources: Internal Revenue Service, *Fiscal Year 1996 Data Book*; Tabulations of IRS Accounts Receivable Data, Tabulations of IRS Enforcement Revenue Information System Data; and Joint Committee on Taxation Staff tabulations.

In contrast with both individual and corporate income taxes, penalties for employment taxes exceed amounts paid for interest. One reason for the small proportion of interest payments for employment taxes is that underdeposits of employment taxes are detected and corrected much sooner than underdeposits of individual and corporate income taxes. This happens because employers file quarterly reports to the IRS showing payroll tax liabilities for the most recent quarter. These quarterly filings allow the IRS to compare the reported liability with the amounts deposited for each quarter and make assessments accordingly for underdeposited amounts on a quarterly basis, rather than on an annual basis as with income taxes.

Table 5 also shows that the proportion of payments made as penalties and interest are smaller for employment taxes than for either individual (Table 1, rows 2 and 3) or corporate (Table 3, rows 2 and 3) income taxes. Figure 12 below shows the relative proportions of payments of tax, penalties and interest made for employment tax liabilities. Employment taxes

Figure 12.--Source of Employment Tax Payments in Fiscal Year 1996

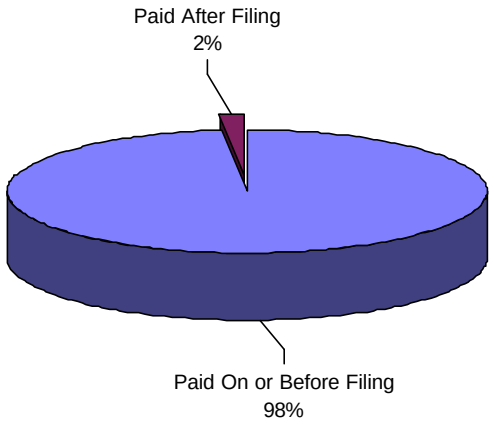


have a greater proportion of payments attributable to tax than either individual (99.1 percent shown in Figure 2) or corporate (97.6 percent shown in Figure 7) income taxes.

Sources: Internal Revenue Service, *Fiscal Year 1996 Data Book*; Tabulations from the Internal Revenue Service Enforcement Revenue Information System File; Internal Revenue Service, *Statistics of Income*.

Figure 13, below, shows that 98 percent of payments made for employment taxes are deposited on or before the filing of the original returns. This compares with 97 percent for individual income taxes (Figure 3) and 95 percent for corporate income taxes (Figure 8).

Figure 13.--Payments of Employment Tax, Penalties, and Interest by Date of Payment in Fiscal Year 1996



Sources: Internal Revenue Service, *Fiscal Year 1996 Data Book*; Tabulations from the Internal Revenue Service Enforcement Revenue Information System File; and Internal Revenue Service, *Statistics of Income*.

Compared with individual and corporate income tax systems, the employment tax system collects the greatest percentage of taxes on time. Three factors likely contribute to the prompt and accurate payment of employment taxes. First, employment tax liabilities are generally easier to determine than either individual or corporate income tax liabilities. Second, the quarterly filing of tax returns allows more timely notification by the tax administrator to the taxpayer of discrepancies between reported liabilities and amounts deposited for those liabilities than does annual filing of individual and corporate income tax returns. Third, two penalties promote timely and accurate deposits of employment taxes. The first penalty is imposed on persons who are responsible for collecting and paying taxes under section 6672. Referred to as the "responsible person penalty," this penalty is equal to 100 percent of the amount of taxes not deposited.[90] The second penalty is imposed on the taxpayer for failure to make deposits of taxes under section 6656. This penalty is a graduated percentage of the amount of tax underdeposited. The percentage penalty increases in increments from 2 to 15 percent as a function of the length of time that an underdeposit of tax persists.

The 2 percent of receipts paid after the filing of employment tax returns shown in Figure 13 represents $8.2 billion of payments comprising $5.9 billion of tax, $1.8 billion of penalties, and $0.5 billion of interest as shown on Table 5. Of these amounts, approximately 18 percent was paid at the time an assessment of tax was determined or at the close of an examination. The remaining 72 percent of these amounts, or $6.8 billion, was paid through IRS collection activities on approximately $54 billion of unpaid taxpayer liabilities, shown in Table 6, below.

Table 6.–Employment Tax Accounts Balances, Payments, and Abatements
By Age of Tax Return in Fiscal Year 1996
($ billions)

	Tax Year of Returns				
	1995 to 1994	**1993 to 1991**	**1990 to 1985**	**Prior to 1985**	**All years**
Total Balance	16.4	11.4	23.5	2.6	53.9
Payments					
Tax	4.1	0.7	0.1	(a)	5.0
Penalty	1.2	0.1	(a)	(a)	1.4
Interest	0.2	0.1	0.1	(a)	0.4
Total payments:	5.5	0.9	0.2	(a)	6.8

[90] One important feature of this penalty is the right of contribution by more than one person. This means that if more than one person is responsible for collecting and paying over taxes, then the penalty can be assessed against each responsible person for 100 percent of the underdeposited amounts.

Abatements					
Tax	2.1	0.8	0.2	(a)	3.0
Penalty	2.2	0.2	0.0	(a)	2.4
Interest	0.1	0.2	0.0	(a)	0.3
Total abatements:	4.4	1.0	0.2	(a)	5.7
Ending Balance	6.5	9.3	23.0	2.6	41.4

Note: Details may not add to totals due to rounding.
a) Less than 50 million.
Sources: Tabulations of the IRS Accounts Receivable File; General Accounting Office, *IRS' Abatements of Assessments in Fiscal Years 1995-98*, and Joint Committee on Taxation Staff tabulations.

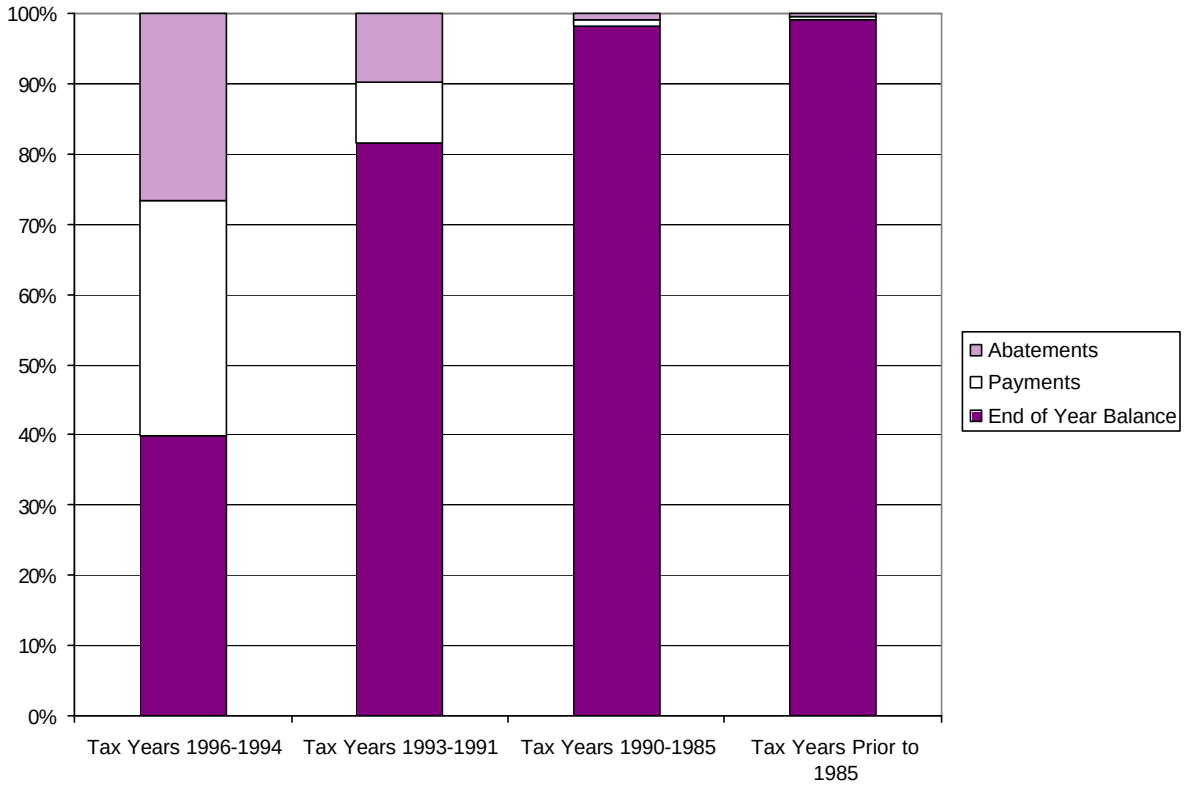
The top half of Table 6 shows a breakdown of the $6.8 billion in collection activity receipts into $5.0 billion of tax, $1.4 billion of penalties, and $0.4 billion of interest payments. These amounts are shown in the fifth column of the Table. The bottom half of Table 6 shows a similar breakdown for abated amounts in accounts receivable.

The columns in Table 6 are organized to show the aging of tax returns comprising employment tax accounts receivable during fiscal year 1996. Unlike Table 2 for individual income tax returns, and Table 4 for corporate income tax returns, some tax year 1996 returns are included in the first column of Table 6 because the first three quarterly filings of tax year 1996 employment tax returns are filed during fiscal year 1996. As with individual and corporate income tax accounts receivable, collections on these returns show the greatest proportion of payments (rows 2, 3, and 4 amounts) to liability (row 1 amounts) when compared with returns from earlier tax years. As for corporate taxes, employment tax payments that result from IRS collection actions on older tax returns are the exception rather than the rule, averaging less than 3 percent of outstanding liabilities. Table 6 shows two important results. First, payments decline rapidly in absolute amounts and as a proportion of accounts receivable total balances for employment taxes on returns prior to tax year 1994. Second, a large amount of tax and penalty abatements occur on the most recently filed returns. As discussed below, most of the penalty abatements are for the failure to deposit tax penalty.

Figure 14, below, shows the relative proportions of payments, abatements, and remaining balances for employment tax accounts receivables shown on Table 6 at the end of fiscal year 1996. The first bar shows that approximately 40 percent of the $16.4 billion of accounts receivable for tax years 1996, 1995 and 1993 employment tax returns was unpaid (row 8, column 1 of Table 6); approximately 32 percent of the $16.4 billion was paid (the sum of rows 2, 3, and 4 of column 1 of Table 6); and approximately 28 percent of the $16.4 billion was abated (the sum of rows 5, 6, and 7 of column 1 of Table 6) by the close of fiscal year 1996. As noted above, a relatively large amount of abatements occurred for tax year 1996, 1995, and 1994 employment tax returns. Another notable feature on Figure 14 is the near absence of payments or abatements on accounts receivable for tax years 1990 and earlier. The low level of payments and abatements for these tax returns reflects the difficulty in collecting delinquent taxes on business returns in general. A similar,

although not as dramatic, pattern of payments and abatements on tax year 1990 and earlier returns is shown on Figure 9 for corporate income tax accounts receivables.

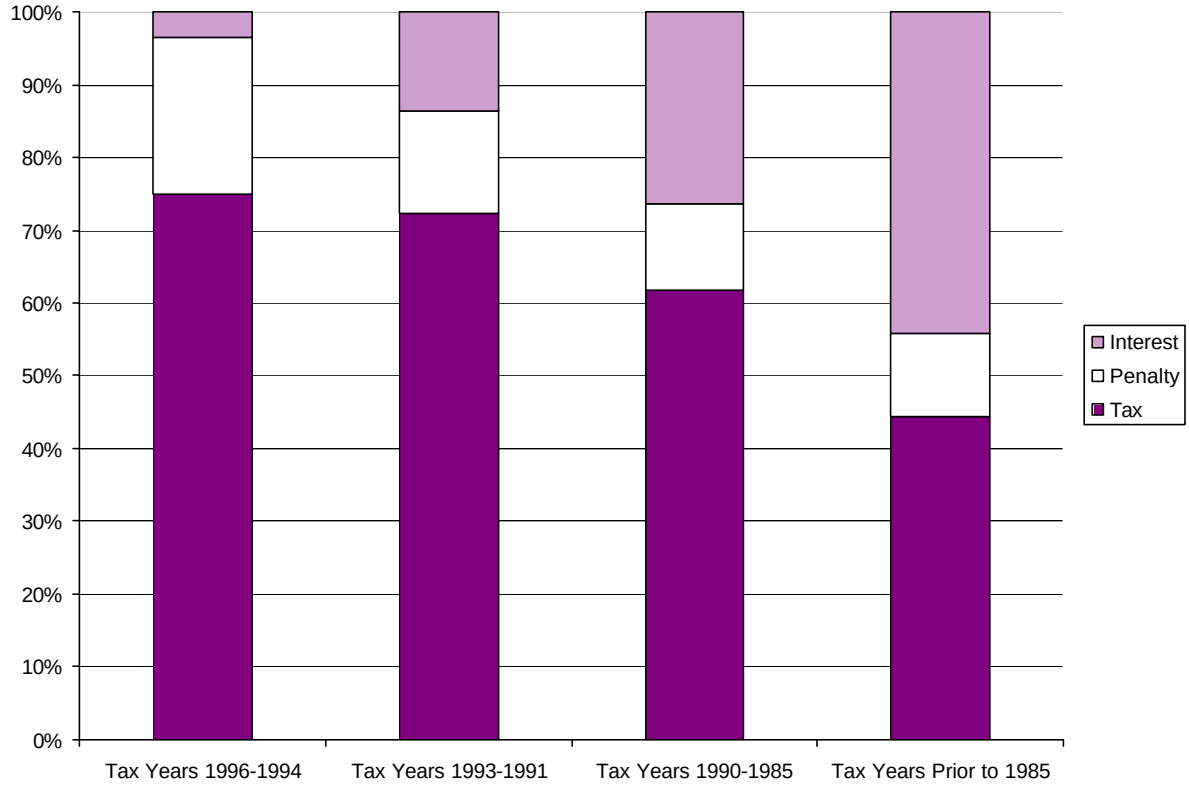
Figure 14.--Proportion of Total Employment Tax Accounts Receivable Paid, Abated, and End of Year Balance in Fiscal Year 1996



Sources: Tabulations of the IRS Accounts Receivable File; General Accounting Office, *IRS' Abatements of Assessments in Fiscal Years 1995-98*; and Joint Committee on Taxation Staff tabulations.

Figure 15, below, disaggregates the proportion of payments (shown in white in each bar of Figure 14) into payments of taxes, penalties, and interest. Two trends are depicted in Figure 15. First, payments of taxes are the largest proportion of total payments. Second, payments of penalties are a relatively constant 10 percent of total payments. The slightly larger proportion of penalties paid for the most recent tax years is the result of section 6656 failure to deposit ("FTD") penalty payments on current tax year quarterly employment tax returns.

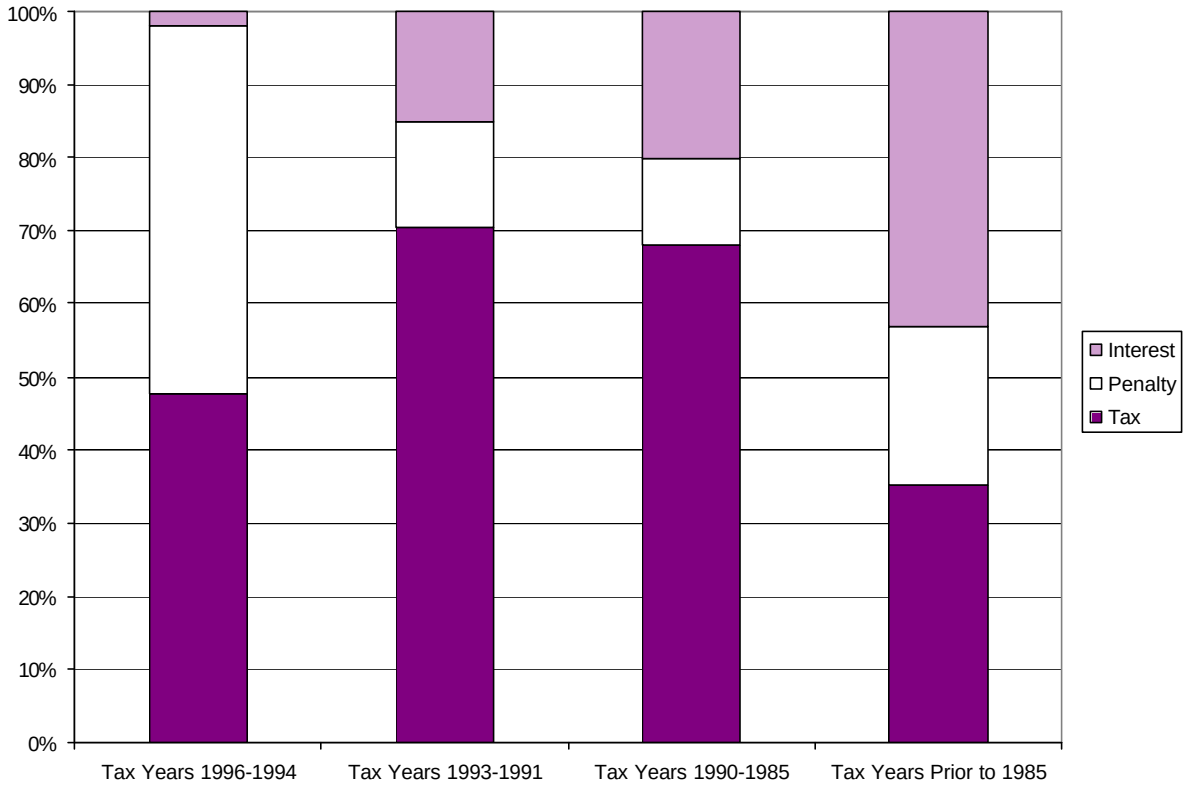
Figure 15. Proportion of Payments in Employment Tax Accounts Receivable by Tax, Penalty, and Interest in Fiscal Year 1996



Sources: Tabulations of the IRS Accounts Receivable File; and Joint Committee on Taxation Staff tabulations.

Figure 16, below, disaggregates the proportion of abatements of employment taxes shown in Figure 14 (as the gray section atop each bar) into the proportions of taxes, penalties, and, interest abated. The pattern of abatements is dominated by the $2.2 billion of abatements of penalties for the most recent tax years. As with payments of penalties shown in Figure 15, the large proportion of abatements is largely the result of abated FTD penalties associated with the current tax year. As the result of quarterly filing and reconciliation of employment tax return liabilities with tax deposits, this penalty can be assessed several times during the year if reported liabilities and deposited amounts do not agree for multiple quarters. Section 3304 of the IRS Reform Act provided changes to the administration of FTD penalties to reduce many of the penalty situations that result in abatements.

Figure 16.--Proportion of Abatements in Employment Tax Accounts Receivable by Tax, Penalty, and Interest in Fiscal Year 1996



Sources: General Accounting Office, *IRS' Abatements of Assessments in Fiscal Years 1995-98*, and Joint Committee on Taxation Staff tabulations.

VII. JOINT COMMITTEE ON TAXATION STAFF RECOMMENDATIONS RELATING TO PENALTIES AND INTEREST

In the course of its review of the present-law system of penalties and interest, the Joint Committee staff determined that certain modifications to the present-law system could improve the administration and equity of the penalty and interest rules. In certain instances, the Joint Committee staff in its research identified problems with the present-law system that the Joint Committee staff felt should be addressed. In other instances, commentators raised valid concerns about the operation of present law.

As a result of its review and to satisfy the explicit statutory mandate contained in the IRS Reform Act, the Joint Committee staff is making a variety of recommendations to modify the present-law system of penalties and interest. The Joint Committee staff is making certain recommendations of general applicability that are grouped together because of their close interrelationship; they are intended to complete policies articulated in the IRS Reform Act and to improve the substantive operation of certain rules. In addition, the Joint Committee staff is making recommendations for possible modifications to specific penalty and interest provisions to improve the overall administration of these provisions and to ensure consistency in the application of penalties with respect to similarly situated taxpayers. These general and specific recommendations relating to penalties and interest are contained in the following discussion. Finally, the Joint Committee staff is making specific recommendations to address issues relating to the proliferation of corporate tax shelters, which are contained in Part VIII., below.

A. Recommendations of General Applicability

Recommendations Relating to Interest, Estimated Tax Penalties, and Failure to Pay Penalty

Interest

The Joint Committee staff recommends providing one interest rate for both individuals and corporations applicable to both underpayments and overpayments.[91] The interest rate would be equal to the short-term AFR plus 5 percentage points ("AFR+5"). Accordingly, the Joint Committee staff recommends eliminating the so-called "hot interest" provision that applies a higher rate of interest to certain corporate underpayments, as well as the special rule that applies a lower interest rate to certain corporate overpayments. This would also limit the need for interest netting for corporations; the same principle was previously accomplished for non-corporate

[91] Sec. 6621.

taxpayers by the IRS Reform Act. The Joint Committee staff recommendation is also to make interest paid by the IRS to individual taxpayers totally excludable from income.[92]

Estimated tax penalties

The Joint Committee staff recommends making several changes to both the individual and corporate estimated tax penalties.[93] First, the Joint Committee staff recommends repealing the penalty and converting it into an interest provision. This new interest charge would be computed using the single rate of AFR+5 included in the recommendation, and with the simplifications proposed below.[94] The Joint Committee staff also recommends increasing to $2,000 the threshold below which individuals are not subject to the estimated tax penalty (currently $1,000). The calculation of this threshold would also be modified to take into account certain estimated tax payments.[95] Accordingly, for qualifying individual taxpayers, no interest on underdeposits of estimated tax would be required provided that the balance due shown on the return is less than $2,000.[96]

Penalty for failure to pay taxes

The Joint Committee staff recommends repealing the failure to pay taxes penalty.[97] Interest would continue to apply, at the single rate of AFR+5 discussed above. A late payment service charge would also apply to taxpayers that do not enter into installment agreements in a timely manner. This charge would operate in the following way. If a taxpayer has not entered into an installment agreement by the fourth month after assessment,[98] a 5-percent late payment service charge would be imposed on the balance remaining unpaid at the end of that four-month period. This 5-percent late payment service charge would also be imposed each year on the anniversary of

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[92] Interest paid to the IRS by individual taxpayers is nondeductible under present law. See Part VII.B.5, below.

[93] Secs. 6654 and 6655.

[94] See Part VII. C, below.

[95] This is in addition to consideration of amounts withheld (such as wage withholding), which is permitted under present law.

[96] No interest would be charged as a result of underpaid estimated taxes. However, if the full balance due shown on the return is not paid with the return, taxpayers would be charged interest from the due date of the return on the resulting underpayment.

[97] Sec. 6651(a)(2) and (3).

[98] This provision would apply to both self-assessments (amounts shown on an original return but not paid with that return) as well as assessments later made by the IRS.

its original imposition on the balance remaining unpaid at that anniversary date, unless the taxpayer has entered into an installment payment agreement with the IRS and has remained current on that agreement. For example, if an individual income tax return is filed on April 15, but the full amount shown as due on that return is not paid with that return, the taxpayer must enter into an installment agreement by August 15 to avoid paying the late payment service charge. A taxpayer could entirely avoid this service charge, however, by entering into an installment payment agreement with the IRS and remaining current on that agreement. Abrogation of the installment payment agreement by the taxpayer would result in the immediate[99] imposition of the 5-percent late payment service charge.

The Joint Committee staff also recommends that taxpayers who enter into installment agreements and who also agree to an automated withdrawal of each installment payment directly from their bank account would be entitled to the elimination of the present-law $43 fee for installment agreements.[100]

Effective date

The Joint Committee staff recommendation would be effective for periods beginning on or after January 1, 2000, except that the modifications relating to the failure to file penalty would be effective for tax returns the due date of which is on or after January 1, 2000. The exclusion from income for all interest payments by the IRS to individuals would be effective for payments of interest made after December 31, 1999.

Rationale

Interest

The recommended changes to the interest rate provisions would complete the policy begun by the IRS Reform Act of providing equivalent effective interest rates on underpayments and overpayments. The IRS Reform Act provided that the same statutory interest rate would apply to the underpayment and overpayment interest of individuals and other non-corporate taxpayers, but left in place the rules requiring overpayment interest paid to an individual to be included in income while denying a deduction for underpayment interest paid by an individual. The IRS Reform Act also provided for the application of a net zero interest rate where interest was both payable and allowable to the same taxpayer.

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[99] If a taxpayer abrogates an installment agreement within the four-month grace period, that taxpayer could avoid the 5-percent late payment service charge only be reentering into an installment agreement before the conclusion of the original four-month grace period and remaining current on that new installment agreement.

[100] The IRS charges a user fee of $43 upon approval of an application to enter into an installment agreement.

The recommendation that overpayment interest paid by the IRS to individuals be totally excludable from income is a necessary part of achieving the policy of providing equivalent effective interest rates on underpayments and overpayments for individuals. Equivalent effective rates can be achieved only if both the same rate and the same treatment for Federal income tax purposes applies to both types of interest; accordingly, to accomplish this goal, both types of interest must be either included or excluded from the determination of income. Because the nondeductibility of personal interest is central to the determination of the taxable income of an individual, the Joint Committee staff recommends that equivalency be achieved by excluding overpayment interest paid by the IRS from the income of an individual, despite the fact that it would otherwise be includible in income under Federal income tax principles.

The recommended changes to the interest rate provision would, on a prospective basis, provide a better mechanism for achieving the equivalent effective interest rate goal than the net zero interest rate approach of present law. This is because the proposed changes would, at least on a prospective basis, automatically achieve the desired result. On the other hand, the implementation of the net zero interest rate under present law requires the identification of the appropriate periods to which the net zero rate should apply and the recalculation of interest for those periods.[101] It is noteworthy that, while Congress expected the Secretary would ultimately implement the procedures necessary for the automatic application of the interest netting rules, it was understood that taxpayers would have to affirmatively request, and probably calculate, the adjustments needed to implement the zero net interest rate until such procedures could be implemented.[102] The recommended changes would make the benefits of equivalent effective interest rates available to all taxpayers on a prospective basis, not only to those taxpayers capable of preparing complex net zero rate calculations.

Another effect of the Joint Committee staff recommendation would be to make interest rates charged by and paid to the IRS more closely reflect market reality in that, under present law, corporations (particularly large corporations) pay a higher rate of interest to the IRS than do individuals, whereas in the market, this situation is generally inverted. For example, large financially secure corporations can currently borrow short-term at rates just under 5 percent in commercial paper markets, and can borrow long-term in the bond markets at rates in the vicinity of 7.25 percent.[103] Small business lending rates have been in the vicinity of 9 percent.[104] Individuals,

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[101] It is not yet clear how the recalculation of interest for the affected periods will be accomplished. Different results may occur depending on the methodology chosen. The Secretary is expected to issue regulations by the end of 1999 describing the acceptable methodologies.

[102] Joint Committee Taxation, *General Explanation of Tax Legislation Enacted in 1998*, (JCS-6-98), at 73-74.

[103] For updated information on rates cited in this paragraph, as well as more specific information on the types of loans referenced, see Board of Governors of the Federal Reserve System, *Survey of Terms of Bank Lending*, Statistical Release E.2; Board of Governors of the

on the other hand, face much higher borrowing costs. Recent rates on credit cards charged interest have been near 15 percent, rates on personal loans extended by commercial banks and finance companies have been over 13 percent, and those on used car loans have been 12 percent. Though individuals can borrow at lower rates for secured debt (for example, mortgages secured by the house have been in the vicinity of 7.5 percent, and new car loans secured by the value of the car have been around 6.5 percent), the debt that results from not timely paying the IRS is more akin to an unsecured loan. By raising the overpayment and underpayment rates to AFR+5, which would mean approximately a 10-percent rate at current market interest rates, the recommendation moves the rates closer to market rates for unsecured personal debt.

It is of course impossible to replicate the appropriate market rate of interest for each taxpayer; doing so would require an individualized assessment of each taxpayer's creditworthiness and would impose a multiplicity of different rates. This is administratively unfeasible.

The Joint Committee staff recommendation is designed to accommodate two policy goals simultaneously: the policy goal of applying one rate to all taxpayers and the policy goal of following market rates more closely. Accordingly, the recommendation necessarily entails blending the market rates otherwise applicable to the range of all taxpayers to produce one rate applicable to every taxpayer.

Estimated tax penalties

The conversion of both the individual and the corporate estimated tax penalties into interest charges more closely conforms the titles and descriptions of those provisions with their effect. Because these penalties in fact are computed as an interest charge, conforming their title to the substance of their functioning may improve taxpayers' perceptions of the fairness of the tax system. The present-law penalties are essentially a time value of money computation which is not punitive in nature, but rather compensatory. Calling them penalties may have a negative impact on taxpayers' perceptions of the fairness of the tax system and make the offense of underpaying estimated taxes seem greater than it really is.

The increase from $1,000 to $2,000 in the individual estimated tax payment threshold and the inclusion of certain estimated tax payments in its computation should simplify considerably the computation of estimated tax payments and interest for a number of individuals. Under present law, the computational difficulties of calculating estimated tax penalties can be considerable.

Federal Reserve System, *Selected Interest Rates*, Statistical Release H.15; and Board of Governors of the Federal Reserve System, *Finance Companies*, Statistical Release G.20.

[104] The Small Business Administration uses loans of under $100,000 as a proxy for small business lending, and quotes rates for such purposes from Board of Governors of the Federal Reserve System, *Survey of Terms of Bank Lending*, Statistical Release E.2.

Many taxpayers are forced by this complexity to leave this calculation to the IRS. Because the IRS may not possess sufficient information to determine the minimum penalty, overpayment may result. Limiting the circumstances where such computations are necessary should facilitate the payment of the proper liability.

Penalty for failure to pay taxes

The repeal of the penalty for failure to pay taxes also would complete a policy initiative begun by the IRS Reform Act, where this penalty was reduced for taxpayers who enter into installment agreements.[105] The recommendation is designed to give taxpayers several months after the original due date of their tax returns in which they can pay interest (but not a penalty) on amounts shown on their returns as owing but not paid. Paying only interest for that period may encourage taxpayers to report their income and liability in full even if they are unable to pay it in full immediately.

One of the most significant difficulties the IRS faces in collecting taxes owed but not paid is that a considerable period of time often passes before collection efforts are fully undertaken;[106] by contrast, in the private sector, collection efforts generally are begun as rapidly as possible. This is done because the likelihood of collecting amounts due diminishes significantly with the passage of time. One purpose of the Joint Committee staff's recommendations is to encourage more rapid commencement of the payment of amounts due. The advantage of encouraging taxpayers to utilize installment agreements is that taxpayers will continue to make periodic payments (generally monthly) to fulfill their obligations, rather than letting interest on an unpaid balance continue to mount with a concomitant decrease in the likelihood of eventual full payment.

Taxpayers would be given four months in which to pay their tax obligations and be charged interest only. This four-month period coincides with the four-month automatic extension of time to file individual tax returns that is made available to taxpayers who file Form 4868, Application for Automatic Extension of Time To File U.S. Individual Income Tax Return. At the end of that four-month period, if the taxpayer still has not fully paid the taxpayer's tax obligation, the taxpayer would have a significant incentive (avoidance of the late payment service charge) to enter into an installment agreement for payment with the IRS.

Taxpayers who do not enter into an installment agreement by four months after the due date of the return would be charged an annual 5-percent late payment service charge on the remaining outstanding balance. This service charge has several rationales. First, it is similar to late payment charges that are widely imposed in the private sector. Thus, taxpayers would have a better understanding of the purpose of the charge: to encourage timely payment. Second, it provides a

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[105] Sec. 6651(h).

[106] Statement of Charles O. Rossotti, IRS Commissioner, before the Joint Hearing on IRS Progress, May 25, 1999, at 4.

strong incentive to enter into an installment agreement in a relatively timely fashion, rather than waiting for a long period of time and letting interest continue to mount without making further payments. Third, it recognizes the increased burdens placed on the tax system (and therefore on compliant taxpayers) by those who do not fulfill their tax obligations in a relatively timely manner.

The elimination of the $43 user fee for installment agreements for taxpayers who both enter into installment agreements and who agree to use automated mechanisms, such as automated debits to a bank account, to pay their installment payments is designed to increase the certainty of timely payment, simplify the payment process for taxpayers, and decrease administrative costs of collection for the IRS.[107]

Effective date

The effective date recommended was chosen for several reasons. First, it is prospective, so that taxpayers and the IRS do not have to change prior actions. Second, it is the start of both a new year and a new calendar quarter, which are important dates in the structure of the operation of the affected provisions. Third, it should give the IRS time to adjust its forms and instructions so that taxpayers may become aware of the changes.

[107] The cost to the IRS of administering these automated payment mechanisms is less than a dollar a payment. See, Tax Notes, June 14, 1999, at 1544.

B. Interest Provisions

1. Calculation of interest

Background and Present Law

Overview

The payment of interest is required under the Code anytime a taxpayer or the IRS fails to satisfy an obligation by the required date. The IRS must pay interest to a taxpayer whenever it fails to return an overpayment of tax to the taxpayer in a timely manner. A taxpayer must pay interest to the United States whenever the taxpayer fails to pay the correct amount of tax by the legal due date.

The amount of interest required is determined by (1) the amount of the overpayment or underpayment, (2) the period of time that has elapsed between the time the tax was required to be paid (in the case of an underpayment) or returned (in the case of an overpayment) and the time the tax was actually paid or returned, and (3) the appropriate statutory interest rate, compounded daily.

Interest generally is not required to be paid, either by the IRS or by a taxpayer, if payment occurs within the time prescribed by law. This is true despite one party having held the other's funds for a period of time. The taxpayer has until the legal due date of its return[108] to determine its liability and remit any taxes owed.[109] The IRS is given 45 days after the later of the due date or the date the taxpayer files the return to make any refund shown on such return.

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[108] In the case of income taxes, the due date is the 15th day of the third month following year end for corporations and the 15th day of the fourth month following year end for other taxpayers.

[109] In many instances, taxpayers must make estimated tax payments (with respect to income taxes) or deposits (with respect to employment or excise taxes) in advance of the due date of the return or be subject to penalty. The estimated tax and deposit systems are separate systems. Failure to make a timely deposit or payment of estimated taxes may trigger a penalty in those systems without establishing the need to pay interest. The estimated tax and deposit systems are discussed more fully elsewhere in this study at Part VII.C., below.

Amount

Amount of overpayment.--The IRS is required to pay interest to a taxpayer if it does not timely refund an overpayment of any internal revenue tax.[110] Included in this definition is the portion of taxes paid that exceeds actual liability, refundable credits,[111] and any taxes that were assessed or collected after the expiration of the applicable statute of limitations. In addition, any interest and penalties that were previously paid by the taxpayer with respect to an underpayment of tax are treated as overpayments of tax to the extent the underpayment is later determined not to have existed.

For example, in 1998 an individual taxpayer files his or her return showing income tax of $10,000 and refundable credits of $1,000. On examination, the IRS disallows the refundable credits and proposes additional adjustments that would increase tax liability by $5,000. The IRS assesses interest and penalties of $500 on the resultant underpayment. The taxpayer pays these additional amounts and successfully sues for their refund. In this case, the total overpayment is $6,500 (the $1,000 of refundable credits plus the $5,000 additional tax liability plus the $500 in interest and penalties).

Amount of underpayment.--A taxpayer is required to pay interest to the government if it fails to pay the correct amount of any tax imposed under the Code by the statutory due date.[112] For this purpose, the amount of the underpayment may include penalties, additional amounts or additions to tax.[113] Underpayments of estimated taxes and deposits of employment and excise taxes are subject to a separate regime, discussed elsewhere in this study.

Period of time

Period of overpayment.--If the overpayment is to be refunded to the taxpayer, interest will accrue on the overpayment from the later of the due date of the return or the date the payment is made until a date that is not less than 30 days[114] before the date of the refund check. If the

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[110] Sec. 6611(a).

[111] See secs. 31-34.

[112] Sec. 6601(a).

[113] Sec. 6601(e)(2).

[114] The 30-day grace period afforded the government has not changed since its original inclusion as section 3771(b)(2) in the Internal Revenue Code of 1939. The 30-day period provides a period of time within which the IRS can transmit the refund information to the Financial Management Service of the Treasury Department, which is the agency that actually issues the refund checks.

overpayment is to be credited or offset against some other liability, interest will accrue until the date it is so credited or offset.

A payment is not be considered made by the taxpayer earlier than the time the taxpayer files a return showing the liability. Interest does not accrue on an amount that is submitted other than in payment of a specific liability. A taxpayer may not send money to the government as a deposit or prepayment of an undetermined liability and earn interest on such funds.

As noted above, no interest is accrued if the IRS makes the refund within 45 days of the later of the filing or the due date of the return showing the refund. If the IRS fails to make the refund within such 45-day period, interest is required to be paid for the entire period of the overpayment. For example, an individual taxpayer files his return on April 15, properly showing a refund due of $10,000. If the IRS pays the refund within 45 days, no interest on the overpayment will be required. However, if the IRS does not pay the refund until the 46th day, interest will be required from April 15.

If an overpayment is established by an amended return, interest is required to be paid from the original due date of the return (or the date the taxes were paid, if later) until the amended return is filed. Once the amended return is filed, the IRS is allowed a 45-day grace period to pay the refund without further interest, similar to the 45-day grace period provided for paying a refund shown on an original return. The IRS must still pay interest from the original due date of the return until the amended return is filed and, if the IRS does not pay the refund within the 45-day period, the IRS must pay interest until the refund is paid.

Period of underpayment.--Generally, interest accrues on an underpayment of tax from the last date prescribed for the payment of the tax (the original due date) until the tax is paid. In the case of taxes that must be paid with a return, the due date of the tax is generally the same as the due date of the return. However, an extension of time for the filing of a return does not extend the time for the payment of the tax. An underpayment may exist for the period between the original due date of the return and the date the return is filed and the tax liability paid, even if the full amount of any tax liability is paid by the extended due date. For example, on April 15 an individual taxpayer files a request for an automatic extension of time to file his Federal income tax return, showing an estimated liability of $10,000. As of that date, the taxpayer has withholding and estimated taxes equal to $10,000. On August 15, the taxpayer files his return showing a liability of $11,000 and encloses a check for the $1,000 balance due. The taxpayer will owe interest on the $1,000 underpayment from April 16 until August 15.

A 21-day grace period following the issuance of a notice and demand for payment (10 days if the underpayment is in excess of $100,000) is provided. No interest must be paid during such 21- or 10-day period, provided the payment is made within such period.

Suspension and abatement of interest accruals.--The Secretary is authorized or required to suspend or abate the accrual of interest in certain circumstances. These issues are discussed more fully elsewhere in this study.

Interaction with estimated taxes.--The underpayment or overpayment of estimated income taxes does not result in the payment of interest by or to the taxpayer. The requirement to pay estimated income taxes under section 6654 and 6655 is specifically excluded from the interest calculation under section 6601. Estimated income tax payments become payments of tax as of the original due date of the return for the taxable year for which the estimated payments were made and retain their status as payments of tax until they are credited to a different period or are required to be refunded. Estimated tax payments for a later year cannot be diverted to offset an underpayment in an earlier year.[115]

Statutory interest rate

The statutory interest rates on underpayments and overpayments are based on the short term applicable Federal rate (AFR). The short term AFR represents the average market yield on outstanding marketable obligations of the Federal government with remaining periods of three years or less.[116] Interest on both overpayments and underpayments is required to be compounded daily.[117]

For taxpayers other than corporations, the statutory interest rate on both overpayment and underpayment rates is the short-term AFR plus 3 percentage points. For interest periods beginning after 1986 and before July 28, 1999, the statutory interest rate on overpayments of taxpayers other than corporations was the short-term AFR plus 2 percentage points. This difference in statutory rates was eliminated for taxpayers other than corporations as part of the IRS Reform Act.

Different statutory interest rates apply to underpayments and overpayments of corporate taxpayers.[118] These rates are also adjusted depending on the size of the underpayment or overpayment. Corporate overpayments generally accrue interest at a rate equal to the short-term AFR plus 2 percentage points. Large corporate overpayments, those in excess of $100,000 for any taxable period, accrue interest at a rate equal to the short-term AFR plus 0.5 percentage point. Corporate underpayments generally accrue interest at a rate equal to the short-term AFR plus 3 percentage points. Large underpayments of corporations accrue interest at the "hot interest" rate equal to the short term AFR plus 5 percentage points.

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[115] The estimated tax system is discussed more completely in the next section of this study.

[116] Sec. 1274(d)(1)(C).

[117] Sec. 6622.

[118] Prior to 1987, the same interest rate applied to the overpayments and underpayments of all taxpayers. Section 1511 of the Tax Reform Act of 1986 established the rule that the Treasury will pay interest on overpayments at a rate one percentage point less than taxpayers are required to pay on underpayments, effective for periods beginning after 1986.

The short-term AFR is determined by the Secretary of the Treasury for the first month of each calendar quarter. The rate is then used to determine the statutory rate of interest in the following calendar quarter. For example, the Secretary of the Treasury determined that the average market yield on outstanding marketable obligations of the IRS with remaining periods of three years or less is 4.5 percent in January, 1999. The short-term AFR of 4.5 percent is then used to determine the statutory interest rate for the second calendar quarter of 1999.

Interest netting

A special net interest rate of zero applies to the extent that, for any period, interest is payable under subchapter A and allowable under subchapter B on equivalent underpayments and overpayments by the same taxpayer.[119] If both the underpayment and overpayment are unsatisfied, the interest rate applied to both will be zero. If either the underpayment or overpayment has previously been satisfied, the interest rate applicable to the unsatisfied amount will be equal to the interest rate applicable to the satisfied amount to the extent that interest was allowable or payable on both the underpayment and the overpayment for the same period. Interest must be both payable and allowable for interest netting to apply.

Overpayments attributable to the carryback of tax attributes

A change in the amount of an underpayment or overpayment that results from the carryback of a tax attribute (such as a net operating loss or a tax credit) is taken into consideration as of the due date (or date of filing, if later) of the return that includes the attribute. If an overpayment is attributable to the carryback of a tax attribute, the period of the overpayment does not begin until the due date (or date of filing, if later) of the return the includes the attribute that is being carried back.[120] If the availability of the attribute for carryback is itself created by the carryback of a separate item from a subsequent year, the period of overpayment does not begin until the due date (or date of filing, if later) for the subsequent year. For example, in 2002 a taxpayer incurs a net operating loss that is carried back and used in 2000. The use of the net operating loss in 2000 results in a carryback of general business credits arising to 1999 where they reduce the 1999 tax liability. Since the overpayments for both 1999 and 2000 are the result of the carryback of a tax attribute from 2002, the period of overpayment for 1999 and 2000 will not be considered to begin prior to the filing date of 2002 return.

If a change in the amount of an underpayment results from the carryback of a tax attribute, the change is not taken into account until the due date (or filing date if later) of the return that includes the tax attribute.[121] For example, a corporate taxpayer files its 1998 return on March 15,

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[119] This provision was enacted in section 3301 of the IRS Reform Act.

[120] Sec. 6611(f).

[121] Sec. 6601(d).

1999, showing a total liability of $20,000. The taxpayer has previously paid $20,000 in estimated taxes and balance is due with the return. On June 15, 2001, an examination of the 1998 return establishes an additional liability (and thus an underpayment) in the amount of $10,000. A notice and demand for the $10,000 underpayment is given the taxpayer that day. In the meantime, the taxpayer has filed its 2001 return on February 1, 2001, showing a net operating loss that, when carried back to 1999, reduces the liability in that year by $6,000. A refund is claimed through Form 4466. This refund is received on April 30, 2001. The taxpayer pays the $10,000 deficiency disclosed on the audit on July 2, 2001, within 30 days of receiving the notice and demand for payment.

The interest arising from this situation is determined as follows: The effect of the net operating loss cannot be taken into account until March 15, 2001, the due date of the return for the year in which the loss arose. Thus, interest is due on $10,000 of underpayment from March 15, 1999 until March 15, 2001. Interest is also due on the net underpayment of $4,000 from March 16, 2001 until June 15, 2001. No interest is due after June 15 because the underpayment is fully satisfied within the 30-day grace period following the issuance of the notice and demand for payment.

Similar rules apply in the case of carrybacks of foreign tax credits.

Overpayments attributable to adjustments initiated by the IRS

If an adjustment initiated by the Secretary results in a refund or credit of an overpayment, interest on such overpayment is computed by subtracting 45 days from the overpayment period.[122]

Method of paying refunds

Taxpayers may receive refunds due them in one of two ways. First, the taxpayer may be issued a check by the Financial Management Service division of the Department of the Treasury. For this to happen, the IRS must notify Financial Management Service, Financial Management Service must process and issue the check, and the U.S. Postal Service must deliver it. Alternatively, taxpayers may request that they receive their refunds electronically by direct deposit. This method is generally faster than payment by paper check.

Recommendations

The Joint Committee staff recommendations for legislative change in this area are incorporated in the Recommendations of General Applicability discussed in the previous section. Included in those recommendations is a proposal to establish a single interest rate equal to short-

[122] Sec. 6611(e)(3), added by section 13271(a) of the Omnibus Budget Reconciliation Act of 1993.

term AFR plus 5 percentage points that would be applicable to the underpayments and overpayments of all taxpayers.

2. Abatement and suspension of underpayment interest

Background and Present Law

In general

The Secretary of the Treasury can abate or suspend the accrual of interest in a number of situations. In general, the Secretary is authorized to abate interest that is not owed by the taxpayer, either because the interest was erroneously or illegally assessed, or was assessed after the expiration of the period of limitations. The Secretary also may abate interest that is attributable to unreasonable errors and delays by the Internal Revenue Service, as well as to erroneous written advice furnished by the Internal Revenue Service. The Secretary may abate interest where, in his judgement, that the administration and collection costs involved do not warrant the collection of the amount due.

The Secretary is required to abate interest in the case of a declared disaster or certain erroneous refunds attributable solely to errors made by the IRS. The Secretary is required to suspend the accrual of interest if the IRS fails to contact the taxpayer in a timely manner and in the case of taxpayers serving in a combat zone.

Interest that is abated is not owed by the taxpayer and does not accrue additional interest through compounding or result in any additional penalties. If the accrual of interest is suspended for a period, then that period is not taken into account in determining the interest owed on an underpayment.

Abatement of interest that is erroneously or illegally assessed

Most abatements of interest are a result of adjustments to the underlying tax liability. Underpayment interest is assessed any time an underpayment is assessed. If the underlying tax liability is later adjusted, resulting in a reduction in the amount of the underpayment, the portion of the interest attributable to such adjustment must be abated.

Abatements due to unreasonable error or delay by the IRS

If any part of an underpayment is attributable to an unreasonable error or delay by an officer or employee of the Internal Revenue Service, acting in his official capacity, in the performance of a ministerial or managerial act, the Secretary may abate all or a part of the interest on the underpayment. Similarly, if a delay in the payment of tax is attributable to such an officer or employee being erroneous or dilatory in performing a ministerial or managerial act, the Secretary may abate all the interest that would otherwise accrue for that period.

Prior to 1986, the IRS generally did not have the authority to abate interest charges that were properly calculated and based on a correctly determined underpayment. This was the case even if the IRS errors or delays had prevented the earlier satisfaction of the taxpayer's underpayment and resulted in the accrual of additional interest. The Tax Reform Act of 1986 provided the IRS the authority to abate interest where an IRS official fails either to perform a ministerial act in a timely manner or makes an error in performing a ministerial act. "Congress intended that the term 'ministerial act' be limited to a nondiscretionary act when all of the prerequisites to the (a)ct, such as fact gathering, analysis, decision-making, and conferencing and review by supervisors, have taken place."[123] Abatement is available under this authority only where "no significant aspect of the error or delay can be attributable to the taxpayer"[124] and relates only to periods after the taxpayer has been contacted for examination.[125] The rule authorizes, but does not require the abatement of interest. Abatement is at the discretion of the Secretary. "Congress did not intend that this provision be used routinely to avoid the payment of interest; rather, it intended that the provision be utilized in instances where failure to perform a ministerial act results in the imposition of interest, and the failure to abate the interest would be widely perceived as grossly unfair."[126]

In 1996, the authority to abate interest was expanded to permit the IRS to abate interest with respect to any unreasonable error or delay resulting from the managerial as well as ministerial acts. A managerial act is an administrative act that occurs during the processing of a taxpayer's case involving the temporary or permanent loss of records or the exercise of judgement or discretion relating to the management of personnel. This allows interest to be abated where extensive delays result from managerial acts such as the loss of records by the IRS, IRS personnel transfers, extended illnesses, extended personnel training, or extended leave. "For this purpose, delays resulting from managerial acts do not include delays resulting from general administrative decisions. For example, the taxpayer could not claim that the IRS's decision on how to organize the processing of tax returns or its delay in implementing an improved computer system resulted in an unreasonable delay in the Service's action on the taxpayer's tax return, and so the interest on any subsequent deficiency should be waived."[127]

The authority to abate interest under this rule does not apply where an underpayment or delay in payment of tax is attributable to an error or delay by an officer or employee of the IRS in

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[123] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* ("Bluebook") (JCS-10-87), at 1310.

[124] H.Rept. No. 99-841 (Conference Report on the Tax Reform Act of 1986), at II-811.

[125] *Id.*

[126] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* ("Bluebook") (JCS-10-87), at 1310.

[127] H.Rept. 104-506 (Taxpayer Bill of Rights 2).

the performance of an act that is not managerial or ministerial. Ministerial and managerial acts do not include a decision as to the application of any Federal or state law, including any Federal tax law.[128]

The proposed regulations provide a number of examples of situations in which abatement of interest under this rule would or would not be allowed. Abatement is generally limited to situations where resolution of the taxpayer's liability is delayed because the IRS has failed to assign appropriate personnel to a taxpayer's case (a managerial act), there is an unaccountable delay in the issuance of a notice by the IRS (a ministerial act), an IRS employee requests an insufficient amount of payment because he misreads the amount on the taxpayer's master file (a ministerial act), or the IRS loses or misplaces vital information (a managerial act). Abatement is not available where the delay in resolving the taxpayer's liability is attributable to excessive time spent by the IRS in interpreting the tax laws, to erroneous interpretations and calculations made by the IRS, to the IRS' decision to examine other returns prior to the examination of the taxpayer's return, or to other failures to resolve a taxpayer's liability in a timely manner.

Abatement of interest on erroneous refunds

The Secretary is required to abate interest on an erroneous refund for the period from the issuance of the refund until its return is demanded.[129] Since the taxpayer has 21 days from the date of demand to pay without interest,[130] no interest must be paid as the result of an erroneous refund if the taxpayer repays the refund within 21 days of the IRS asking for its return. If the taxpayer does not repay the refund within the 21 day grace period, interest must be paid from the date the return of the refund is demanded. The rule abating interest in the case of erroneous refunds does not apply if the taxpayer (or a related party) has in any way caused the erroneous refund or if the amount of the erroneous refund exceeds $50,000.

Abatement of penalties and additions to tax attributable to erroneous written advice given by the IRS

The Secretary is required to abate any portion of any penalty or addition to tax attributable to erroneous advice furnished to the taxpayer in writing by an officer or employee of the IRS acting in his or her official capacity. The abatement applies only if (1) the advice is given in response to a specific written request made by the taxpayer, (2) the taxpayer reasonably relied on the advice, and (3) the taxpayer provided adequate and accurate information.[131]

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[128] Treas. Reg. sec. 301.6404-2(b).

[129] Sec. 6404(e)(2).

[130] Sec. 6601(e)(3).

[131] Sec. 6404(f).

Only penalties and additions to tax that are attributable to erroneous written advice given by the IRS are abated under this rule. Interest is abated only to the extent that it is attributable to abated penalties and additions to tax. Interest attributable to an underpayment of tax, where such underpayment is the result of the taxpayer's proper reliance on written advice of the IRS, is not eligible for abatement.

Suspension of the accrual of interest for taxpayers serving in a combat zone[132]

Taxpayers serving in a combat zone generally are not required to file tax returns or pay taxes until 180 days after their service in the combat zone is completed. Accordingly, the accrual of interest on any underpayment is suspended during that period.[133] This suspension of interest applies to the underpayment of any tax, whether or not related to a return that would otherwise have been due while the taxpayer was serving in the combat zone.

A taxpayer is serving in a combat zone if serving in the Armed Forces of the United States in an area designated as a "combat zone" during the period of combatant activities. An individual who becomes a prisoner of war is considered to continue in such active service. An individual serving in support of the Armed Forces of the United States in the combat zone, such as Red Cross personnel, accredited correspondents, and civilian personnel acting under the direction of the Armed Forces, are also considered to be serving in the combat zone for this purpose. The designation of a combat zone may be made by the President in an Executive Order, or may be declared legislatively by the Congress. The President must also designate the period of combatant activities in the combat zone (the starting date and the termination date of combat).

The suspension of interest applies during the period of combatant activities in the combat zone, as well as (1) any time of continuous qualified hospitalization resulting from injury received in the combat zone or (2) time in missing in action status, plus the next 180 days.

Taxpayers located in a Presidentially declared disaster area

In the case of a Presidentially declared disaster, the Secretary of the Treasury has the authority to extend the filing date for returns of taxpayers that are located in the disaster area. The Secretary may also extend the payment date for any taxes shown on such an extended return. If the

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[132] The relief available to taxpayers serving in combat zones is discussed more fully in Joint Committee on Taxation, *Description of Present Law and a Proposal Relating to Tax Relief for Personnel in the Federal Republic of Yugoslavia (Serbia/Montenegro), Albania, the Adriatic Sea, and the Northern Ionian Sea* (JCX-18-99).

[133] Sec. 7508.

Secretary extends the filing and payment dates, any interest that would otherwise be accrued during the period of the extension must be abated.[134]

Suspension of interest where the Secretary fails to contact a taxpayer

For individual taxpayers who have filed a timely tax return, the accrual of interest is suspended after 1 year if the IRS has not sent the taxpayer a notice specifically stating the taxpayer's liability and the basis for the liability within the specified period. With respect to taxable years beginning before January 1, 2004, the 1-year period is increased to 18 months. Interest and penalties resume 21 days after the IRS sends the required notice to the taxpayer. The rule applies separately with respect to each item or adjustment[135] and does not apply where a taxpayer has self-assessed the tax. The suspension does not apply in the case of fraud.[136] Any interest that is assessed during the suspension period is required to be abated.

Procedures for the abatement of interest

Taxpayers may apply for the abatement of interest by filing a claim on Form 843 with the Internal Revenue Service Center that has assessed the interest the taxpayer seeks to have abated.[137]

Typically, interest is abated when the amount of tax assessed is reduced. Thus, any procedure that may result in the reduction of assessed tax may also result in an abatement of interest.

Where abatement of interest is sought separate from any redetermination of tax the availability of judicial review depends upon the basis on which abatement is sought. If the IRS is required to abate the interest, judicial review is available to determine if the facts exist that mandate abatement. Taxpayer Bill of Rights 2 specifically granted jurisdiction to the Tax Court to review for abuse of discretion any decision by the IRS not to abate interest that is attributable to unreasonable error or delay by Service employees in the performance of a ministerial or managerial act.[138] Otherwise, review of the Secretary's failure to use his or her discretion to abate interest may not be available. The courts have held that judicial review of the IRS' failure to use

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[134] Sec. 6404(h).

[135] For example, if the IRS sends a math error notice to a taxpayer 2 months after the return is filed and also sends a notice of deficiency related to a different item 2 years later, the suspension of interest applies to the item reflected on the second notice (notwithstanding that the first notice was sent within the applicable time period).

[136] Sec. 6404(g).

[137] Rev. Proc. 87-43, 1987-2 C.B. 590.

[138] Sec. 6404 (as amended by section 301 of the Taxpayer Bill of Rights 2).

its discretion to abate interest is generally not available, unless jurisdiction is specifically granted by statute or a standard for review has been established.[139]

Recommendations and Analysis

Allow the abatement of interest if a gross injustice would otherwise result if interest were to be charged

The Joint Committee staff recommends that the Secretary be granted the authority to abate interest if a gross injustice would otherwise result if interest were to be charged. It is anticipated that such authority will be used infrequently and will only be available in situations the taxpayer has not materially contributed to the accrual of the interest. Abatement under this authority would be solely within the discretion of the Secretary.

Present law does not grant authority to the Secretary to abate interest on general equitable grounds. The Secretary should have the authority to abate interest where necessary to avoid gross injustice.

Allow the abatement of interest for periods attributable to any unreasonable IRS error or delay

The Joint Committee staff recommends that the authority of the Secretary to abate interest be expanded to allow interest to be abated for any period that is attributable to unreasonable IRS errors or delays, whether or not related to managerial or ministerial acts. Such authority may be exercised with regard to errors and delays occurring in periods both before and after the taxpayer is contacted for examination, as well as situations where the error or delay occurs as a result of general administrative decisions. Abatement would not be available to the extent the taxpayer contributed to the delay by providing erroneous information or failing to provide required information.

It is not appropriate to require taxpayers to pay interest for periods where the sole reasons the taxpayer's case is not resolved relate to error or delay on the part of the IRS. Interest for such periods should be abated whether the error or delay relates to managerial, ministerial, or other acts.

It is not expected that this expansion of authority will result in an abatement of interest any time a taxpayer is not able to resolve its tax liability as quickly as the taxpayer would like. Interest owed by a taxpayer would not be abated solely because other taxpayers had their returns examined first, or because the determination of the taxpayer's liability proved difficult and required additional time. Abatement is expected to be available only where the additional time

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[139] Horton Homes, Inc. v. United States, 727 F. Supp. 1450 (M.D. Ga. 1990) aff'd., 936 F.2d 548 (11th Cir. 1991).

needed to resolve the taxpayer's liability is the result of unreasonable error or delay by the IRS, considering all the facts and circumstances applicable to the taxpayer's case.

Allow for the abatement of interest in situations where the taxpayer is repaying an excessive refund based on IRS calculations without regard to the size of the refund

The Joint Committee staff recommends that the $50,000 threshold for abatement of interest on erroneous refunds be repealed. The Secretary would be required to abate interest on any erroneous refund, provided the taxpayer has not in any way caused the erroneous refund to occur.

Allow the abatement of interest to the extent the interest is attributable to taxpayer reliance on written statements of the IRS

The Joint Committee staff recommends that the Secretary be allowed to abate interest on an underpayment where the underpayment is attributable to erroneous advice furnished to the taxpayer in writing by an officer or employee of the IRS acting in his or her official capacity. It is anticipated that, where such abatement is appropriate, it would apply to the period of time from the issuance of the erroneous advice through the day that is 21 days (10 days in the case of an underpayment in excess of $100,000) after the day the IRS gives written notice that its advice was erroneous. Under present law, penalties and additional tax must be abated if they are attributable to erroneous advice furnished to the taxpayer in writing by an officer or employee of the IRS acting in his or her official capacity. This does not eliminate the taxpayer's need to satisfy any underpayment of tax attributable to such erroneous advice, nor does it authorize the abatement of interest on such underpayment.

3. Interest netting

Background and Present Law

Overview

A net interest rate of zero applies to the extent that, for any period, interest is payable under subchapter A and allowable under subchapter B on equivalent underpayments and overpayments by the same taxpayer. The net interest rate of zero applies regardless of what type of tax is underpaid or overpaid for a period. However, each underpayment and overpayment is only to be taken into account once for this purpose.

A net interest rate of zero can be achieved in several ways. If the underpayment on which interest is payable and overpayment on which interest is allowable are both outstanding, the two amounts may be offset against each other. If the underpayment or overpayment has previously been satisfied and interest paid at the underpayment or overpayment rate, the net interest rate of zero can be achieved (1) by charging the same rate that was paid on the underpayment or overpayment to an equivalent amount of the overpayment or underpayment, or (2) by requiring repayment of the overpayment interest or refunding underpayment interest and then offsetting the underpayment and

overpayment. The Code does not specify the approach that is to be taken, so long as a net interest rate of zero is achieved. However, legislative history indicates that

> it is anticipated that the Secretary will take into account interest paid on previously determined deficiencies or refunds for the purpose of determining the rate of interest in periods for which this provision is effective without regard to whether the underpayments or overpayments are currently outstanding. It is also anticipated that where interest is both payable from and allowable to an individual taxpayer for the same period, the Secretary will take all reasonable efforts to offset the liabilities, rather than process them separately using the net interest rate of zero.[140]

The approach taken to implementing the net interest rate of zero may have a significant effect, particularly in the case of individual taxpayers. Because individuals are required to include overpayment interest in income, but are not allowed a deduction for underpayment interest, paying the same rate on an overpayment as was previously charged on an underpayment (or vice versa) does not produce as advantageous a result for the taxpayer as would offsetting.[141]

Where interest is payable and allowable on an equivalent amount of underpayment and overpayment that is attributable to a taxpayer's interest in a pass-thru entity (e.g., a partnership), the benefits of the net zero interest provision are intended to apply.

The legislative history of the IRS Reform Act indicates that Congress expects the Secretary to implement the procedures necessary to allow for the automatic application of this provision when practicable. Until such procedures are implemented, the Congress expects that the Secretary will promptly and carefully consider any taxpayer's request to have interest charges recalculated in accordance with this provision.[142]

Interest must be payable and allowable

The zero net interest rate is available to the extent the taxpayer both owes and is owed interest for the same period. This has the same effect as would the restoration of the pre-1987 rules requiring the IRS to pay the same rate on overpayments that it collects on underpayments.

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[140] H.Rept. 105-599 (Conference Report to the IRS Reform Act), at 257.

[141] For example, an individual taxpayer is assessed and pays interest on an underpayment. No deduction is allowed for the interest paid. Later, the taxpayer amends his return to show an overpayment. Any interest on this overpayment will be required to be included in income. If interest on the overpayment is determined at the same rate as interest was paid on the underpayment, the rates will be equivalent on a pre-tax, but not after-tax basis.

[142] H.Rept. 105-599 (Conference Report to the IRS Reform Act), at 257.

Underpayments and overpayments of tax are not taken into account to the extent interest does not accrue on them. For example, in September, 2000, a calendar year corporate taxpayer is determined to have underpaid its 1998 income tax. Interest is required to be accrued at the underpayment rate (short-term AFR+3 percentage points) from the original due date of the 1998 return (March 15, 1999) until it is paid. The taxpayer's timely filed returns for 1999, and 2000 showed refunds due the taxpayer. On its 1999 return, the taxpayer requested that the refund be paid in cash. The IRS pays this refund within 45 days. On its 2000 return, the taxpayer requested that its refund be credited to its estimated taxes for 2001. The amount is so credited by the IRS.

In this example, the zero net interest rate does not apply to the underpayment of 1998 taxes. Although there are overpayments outstanding for a portion of the time the underpayment is outstanding, interest does not accrue on those overpayments because they are credited or refunded during the statutory period.

If the zero net interest rate were allowed in this example, it would provide a benefit to the taxpayer contingent on the taxpayer underpaying tax. A taxpayer that has no underpayments would continue to receive its refund without the payment of interest. However, if the taxpayer were to first underpay a prior year's tax, it would benefit by being allowed to toll the interest on that underpayment while the IRS is processing its refund.

The rule limiting the zero net interest rate to situations in which the taxpayer both owes and is owed interest for the same period also serves to preserve the integrity of the rule requiring the suspension of interest where the IRS fails to contact an individual taxpayer. For example, an individual taxpayer always files his tax returns on April 15. On September 30, 2002, the IRS determines that an item of income was erroneously excluded from the taxpayer's 1998 return. Under present law, interest is only payable by the taxpayer on the understatement for the 18-month period beginning with the due date of the 1998 return and ending September 15, 2000.[143] The taxpayer also fails to claim an allowable deduction on his 1999 return. The taxpayer discovers this error and files an amended return on September 30, 2002. The IRS refunds the overpayment within 45 days. Thus interest is allowable on the overpayment from April 15, 2000 until September 30, 2002.

In this example, the zero net interest rate only applies for the period interest is allowable on the overpayment and payable on the underpayment, from April 15, 2000, through September 15, 2000. Interest will continue to be allowable on the overpayment after September 15, 2000. Were the zero net interest to apply to the entire period the underpayment and overpayment are outstanding would mean that this taxpayer would be subject to an interest cost through the loss of the interest that would otherwise be allowable on the overpayment for a period that is not

[143] The 18-month rule was added by section 3305 of the IRS Reform Act, effective for periods beginning after December 31, 1998. The 18-month period is reduced to 12 months, effective for periods beginning after 2003.

supposed to be subject to an interest cost because of the IRS' failure to assess the taxpayer's liability in a timely manner.

Related taxpayers

The zero net interest rate only applies where interest is payable by and allowable to the same taxpayer. The zero net interest rate does not apply where interest is payable by one taxpayer and allowable to a related taxpayer. However, if the related taxpayers joined in a consolidated return for the underpayment and overpayment years, they are presumably treated as a single taxpayer and may apply the zero net interest rate.

Certain taxpayers are prevented by the Code from joining in a consolidated return even though one taxpayer is the wholly owned subsidiary of the other. These taxpayers are prevented from using the net zero interest rate with respect to their underpayments and overpayments. Where the underpayment and overpayment are not related, this result may be appropriate.

However, many adjustments to the taxable income of one taxpayer (such as adjustments under section 482) will result in a correlation adjustment to the taxable income of the related taxpayer. Because interest netting is not available, the interest rate differential on the underpayment and overpayment may be greater than the net increase in taxes.

For example, a wholly owned foreign sales corporation (FSC) is prohibited from joining in a consolidated return with its parent. A United States parent will typically transfer property that will be exported to its FSC at one price, and the FSC will sell the property to the foreign purchaser at a higher price. The FSC is allowed to exclude a portion (15/23)[144] of its net income from Federal income tax, creating an incentive for the transfer from the parent to the FSC to take place at as low a price as possible. If the IRS successfully challenges the transfer price as tax law, the parent will be required to increase its income and a correlative adjustment will be made to the FSC decreasing its income by the same amount. This will generally result in an underpayment by the parent and an overpayment arising from the same adjustment. Interest payable on the underpayment may be accrued at a rate as high as short-term AFR plus 5 percentage points, while the interest on the overpayment is allowable at a rate as low as short-term AFR plus one-half percentage point.

Recommendation

The Joint Committee staff recommendations to provide a single interest rate applicable to the overpayments and underpayments of all taxpayers, and to exclude overpayment interest paid to

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[144] Section 923(a)(3) provides that if the income of the FSC is determined with regard to administrative pricing rules, 16/23 of such income is considered foreign source. Section 291(a)(4) reduces this amount to 15/23 if 100 percent of the stock of the FSC is held by C corporations for the entire taxable year.

an individual from income, are incorporated in the Recommendations of General Applicability discussed in the previous section.

Analysis

The changes included in the Recommendations of General Applicability would, on a prospective basis, provide a better mechanism for achieving equivalent net interest rates for all taxpayers than the net zero interest rate approach of present law. Use of a single statutory rates results in the same effect as a net zero interest rate without the requirement of special calculations. For individuals, the exclusion of overpayment interest from income parallels the nondeductible treatment of underpayment interest and allows an equivalent after-tax effective interest rate to apply. Finally, the use of a single statutory rate allows an equivalent effective interest rate to apply to adjustments that result in overpayments and underpayments occurring in different years, or with respect to different taxpayers.

4. Determination of interest during disputes between taxpayers and the IRS

Background and Present Law

Generally, interest on underpayments and overpayments continues to accrue during the period that a taxpayer and the IRS dispute a liability. The accrual of interest on an underpayment is suspended if the IRS fails to notify an individual taxpayer in a timely manner,[145] but interest will begin to accrue once the taxpayer is properly notified. No similar suspension is available for other taxpayers.

Taxpayers that, for whatever reason, are not able promptly to resolve their disputes with the IRS face limited choices. The taxpayer can continue to dispute the amount owed and risk paying a significant amount of interest, it can pay the disputed amount and claim a refund, or it can make a deposit in the nature of a bond.

If the taxpayer continues to dispute the amount and ultimately loses, it will be required to pay interest on the underpayment from the original due date of the return until the date of payment. Depending on the period of time it takes to resolve the dispute, and the interest rates applicable to the period of underpayment, this may result in a significant interest charge. Particularly where the final determination of the taxpayer's liability is dependent on the resolution of a dispute between the IRS and other parties, as is the case in TEFRA partnership proceedings, the underpayment period during which interest accrues may be substantial.

In order to avoid the accrual of underpayment interest, the taxpayer may choose to pay the disputed amount and immediately file a claim for refund. Payment of the disputed amount will prevent further interest from accruing if the taxpayer loses (since there is no longer any

[145] Sec. 6404(g).

underpayment) and the taxpayer will earn interest on the resultant overpayment if it wins. However, the taxpayer will generally lose access to the Tax Court if it follows this alternative. The taxpayer may, however, sue the IRS for the refund in either the U.S. District Court or the U.S. Court of Federal Claims. Amounts paid generally cannot be recovered by the taxpayer on demand, but must await final determination of the taxpayer's liability. Even if an overpayment is ultimately determined, overpaid amounts may not be refunded if they are eligible to be offset against other liabilities of the taxpayer.[146]

The third option available to the taxpayer is to make a deposit in the nature of a cash bond. A deposit in the nature of a cash bond will stop the running of interest on an amount of underpayment equal to the deposit, but the deposit does not itself earn interest. A deposit in the nature of a cash bond is not a payment of tax and is not subject to a claim for credit or refund. A deposit in the nature of a cash bond may be made for all or part of the disputed liability and may be recovered by the taxpayer prior to a final determination. However, if the taxpayer recovers the deposit prior to final determination and a deficiency is later determined, the taxpayer will not receive credit for the period in which the funds were held as a deposit. The procedures for making a deposits in the nature of a cash bond are provided in Rev. Proc. 84-58.[147]

Recommendation

The Joint Committee staff recommends that taxpayers be allowed to deposit amounts in a "dispute reserve account," a special interest-bearing account within the U.S. Treasury. A dispute reserve account could be established for any type of tax that is due for any period. The account could be established on the due date of the tax or at any time thereafter.

Any portion of the balance in a dispute reserve account would be eligible to be designated as a payment of the tax for which the account was established. If an amount from the account is designated as a payment of tax, it is treated as a payment of the tax as of the date it was originally deposited in the dispute reserve account for the purpose of determining the amount of underpayment interest owed by the taxpayer.

Amounts from a dispute reserve account would be treated as payments of tax as of their original deposit date only for the purpose of determining the amount of underpayment interest owed by the taxpayer. An amount from a dispute reserve account will not be considered as a payment of tax for the purpose of determining the amount of any penalty until it is actually

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[146] The amount of any overpayment, including interest thereon, may be credited against any other internal revenue tax liability of the taxpayer (sec. 6402(a)). In addition, the overpayment and any overpayment interest may be used to offset past due support payments (sec. 6402(c)), debts owed to other Federal agencies (sec. 6402(d)), and past due, legally enforceable State income tax obligations of residents of the same State (sec. 6402(e)).

[147] 1984-2 C.B. 501.

designated as a payment of tax. Amounts from a dispute reserve account could not be used to create or increase any overpayment of tax.

Deposits to dispute reserve accounts would be limited to amounts that the taxpayer indicates are the subject of a potential dispute.[148] Amounts shown on a notice of deficiency, plus potential penalties and interest determined as of the date of the deficiency, would automatically be considered the subject of a potential dispute. In addition, the taxpayer could designate additional amounts be the subject of a potential dispute if it discloses the items of potential dispute and the calculation of the amount to be deposited.[149]

Any balance in a dispute reserve account could be withdrawn by the taxpayer upon the giving of notice to the IRS. The IRS would be required to pay the withdrawal within 45 days.[150] If funds are withdrawn from a dispute reserve account, interest would be paid to the taxpayer at a rate equal to the short-term AFR.[151] Since the taxpayer is compensated for the use of its money by the payment of interest for the period of time the withdrawn amounts were on deposit in the account, withdrawn amounts are not eligible to be designated as payments of tax for any period that they were on deposit in the dispute reserve account.

> Example 1.--A calendar year corporate taxpayer based in the First Circuit files its 1999 income tax return on March 15, 2000. In that return it takes a position with regard to an item that is consistent with a decision in a case decided in the Second Circuit. Later, a decision is entered in a case in the Third Circuit that is contrary to the Second Circuit decision the taxpayer was relying on.
>
> In order to limit additional interest charges should the IRS ultimately prevail on the disputed issue, the taxpayer deposits $100,000 in a dispute reserve account for its 1999

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[148] For this purpose, an amount is the subject of a potential dispute only to the extent that there is substantial authority for the position taken on the tax return. Dispute reserve accounts may not be used in connection with fraudulent or unsupportable positions in any tax return.

[149] The taxpayer would be required to disclose the item or items of potential dispute, describe the approach or approaches taken in the return, and describe the alternative approach or approaches that (if applied) could result in an underpayment at least equal to the amount to be deposited in the dispute reserve account. It would not be the responsibility of the taxpayer to describe all possible treatments of the items potentially in dispute.

[150] The amount of the withdrawal would be treated as withdrawn on the date requested by the taxpayer. The Treasury would have 45 days to pay the withdrawal without incurring additional interest. If the Treasury failed to pay the withdrawal within the 45-day grace period, it would owe interest on the designated amount from the date of designation at the overpayment rate. This interest would be owed whether or not the taxpayer elected to make the withdrawal with interest.

[151] The short-term AFR rate would apply to all distributions from a dispute reserve fund.

income tax return on May 15, 2001. In support of the deposit, the taxpayer discloses the item of potential dispute, describes the approach taken in the return, and describes the alternative approach that would result if the decision in the Third Circuit were to apply.

On July 31, 2002 the IRS and the taxpayer agree on an adjustment to the taxpayer's 1999 income tax return resulting in an underpayment of $150,000 and enter into a closing agreement. At that time, the taxpayer designates the balance in the dispute reserve account as a payment of tax.

For the purpose of determining the amount of underpayment interest owed by the taxpayer with regard to the 1999 income tax return, the balance in the dispute reserve account ($100,000) is treated as payment of 1999 income taxes effective May 15, 2001 (the original date of the deposit). Underpayment interest would be owed on $150,000 for the period from the original due date of the return (March 15, 2000) to the date the moneys were deposited in the dispute reserve account (May 15, 2001). Underpayment interest would also be owed on $50,000 from May 15, 2001, until paid.

Example 2.--Assume the same facts as in Example 1, except the taxpayer deposits $200,000 on May 15, 2001. In this case, the taxpayer would owe interest on the $150,000 underpayment from March 15, 2000, until May 15, 2001. The remaining $50,000 in the account would be refunded to the taxpayer, along with interest from the date it was deposited at the short-term AFR.

Interest paid on amounts withdrawn from the a dispute resolution account would be includible in the income of the taxpayer. Deposits in a dispute resolution account are not eligible to be used to create on increase an overpayment and withdrawn amounts never become payments of tax. Thus, the recommendation that excludes overpayment interest received by an individual from tax would not apply.

A dispute reserve account may not be maintained beyond the period for which an underpayment of tax may be determined for the year the account was established. It is expected that procedures would be established for the automatic withdrawal of any balances remaining in a dispute reserve account when the statute of limitations on additional assessments of tax expires.

Analysis

The dispute reserve account would allow taxpayers to better manage their exposure to underpayment interest without requiring them to surrender access to their funds or requiring them to make a potentially indefinite-term investment in a non-interest bearing account. The dispute reserve account would also allow taxpayers to preserve access to the Tax Court. Taxpayers that might otherwise feel compelled to resolve their tax liabilities in a disadvantageous manner to prevent the potential accrual of additional underpayment interest would be better able to pursue to resolution their disputes with the IRS.

The availability of the dispute reserve account could also encourage more complete disclosure of issues in a taxpayer's return. Deposits to a dispute reserve account are limited to amounts the taxpayer indicates are the subject of a potential dispute. These potential disputes must be disclosed in order to use the dispute reserve account.

The interest rate on dispute reserve accounts would be set at a rate that can provide reasonable compensation to the taxpayer for the use of its money, but should not encourage the use of dispute reserve accounts as an alternative to investment in other short-term instruments.

5. Federal income tax treatment of underpayment and overpayment interest

Background and Present Law

Underpayment interest

No specific rules are provided by the Code for the Federal income tax treatment of underpayment interest. Thus, underpayment interest is treated in the same manner as other interest expenditures. If other interest would be currently deductible, the interest on an underpayment is generally deductible as well. If the current deduction of other interest would not be allowed, whether as a result of capitalization or disallowance, then the interest on an underpayment will similarly not be allowed.

The time that underpayment interest is taken into account depends upon the taxpayer's method of accounting. If the taxpayer uses the cash method of accounting, underpayment interest is taken into account when paid. If the taxpayer uses the accrual method of accounting, underpayment interest is taken into account when the amount of the underpayment interest becomes fixed and determinable.[152]

A corporate taxpayer is generally allowed to deduct its interest expense currently under section 163 as an ordinary and necessary business expense. However, current deduction is not assured. Underpayment interest is combined with other unallocated interest expenditures of the taxpayer. If current deduction is not allowed with regard to some portion of the taxpayer's unallocated interest expenditures, as may be the case if interest must be capitalized under section 263A or disallowed as a cost of earning tax exempt income under section 265, some portion of the underpayment interest will be nondeductible as well.

Noncorporate taxpayers, including individuals, generally are not allowed to deduct interest on the underpayment of Federal income taxes. Section 163(h) of the Code prohibits the deduction of personal interest by taxpayers other than corporations. Temporary regulations provide that personal interest includes interest paid on underpayments of Federal income tax, regardless of the

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[152] Economic performance is also required and occurs as the interest accrues. Payment is not required for the economic performance of interest. (See Treas. Reg. sec. 1.461-4(e).)

source of the income generating the tax liability.[153] This is consistent with the statement in the General Explanation of the Tax Reform Act of 1986 that "(p)ersonal interest also includes interest on underpayments of individual Federal, State, or local income taxes notwithstanding that all or a portion of the income may have arisen in a trade or business, because such taxes are not considered derived from conduct of a trade or business."[154] The validity of the temporary regulation has been upheld in those Circuits that have considered the issue, including the Fourth,[155] Sixth,[156] Eighth,[157] and Ninth Circuits.[158]

Overpayment interest

No specific rules are provided by the Code for the Federal income tax treatment of overpayment interest. Thus, overpayment interest is treated in the same manner as any other interest that is received by the taxpayer and is includible in income under section 61(a)(4).

Cash basis taxpayers are required to report overpayment interest as income in the period the interest is received. Accrual basis taxpayers are required to report overpayment interest as income when all events fixing the right to the receipt of the overpayment interest have occurred and the amount can be estimated with reasonable accuracy.[159] Generally, this occurs on the date the appropriate IRS official signs the pertinent schedule of overassessments.[160]

Recommendations

The Joint Committee staff recommendations for changes in this area are incorporated in the Recommendations of General Applicability discussed in the previous section. Included in those recommendations is a proposal to make overpayment interest paid to individual taxpayers excludable from income, effective for amounts paid in calendar years beginning after the date of enactment.

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[153] Treas. Reg. sec. 1.163-9T(b)(2).

[154] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), at 66.

[155] Allen v. U.S., 173 F.3d 533 (1999).

[156] McDonnell v. U.S., 1999 U.S. App. LEXIS 10842 (1999).

[157] Miller v. U.S., 65 F.3d 687 (1995).

[158] Redlark v. U.S., 141 F.3d 936 (1998).

[159] Treas. Reg. sec. 1.451-1(a).

[160] Rev. Rul. 62-160, 1962-2 C.B. 451.

6. Use of interest rates in other Code sections

Background and Present Law

In general

Generally, taxpayers are required to determine their income tax liability as of the due date of their return. As noted elsewhere in this document, interest is typically calculated on any underpayment or overpayment from the original due date of the return and a taxpayer may be subject to failure to pay and other penalties if sufficient payments of tax are not made by the due date, as well as a failure to file penalty if the return is not filed in a timely manner.

If a taxpayer files an amended return in order to correct its tax liability, overpayment or underpayment interest is typically calculated from the original due date of the return being amended. Several Code sections allow taxpayers to redetermine their tax liability based on facts determined after the filing date of the return without requiring an amended return to be filed. These provisions typically require interest to be paid by the taxpayer on any additional tax at the underpayment rate. Some provisions also allow interest to be received by the taxpayer.

Lookback provisions

In general.--In some cases, proper matching of income and expense involves the use of estimates of either (1) future revenues to be derived from a transaction (or series of related transactions) or (2) future costs to be incurred but which costs were necessary to generate an item of current income. Estimates, by their very nature, can be (and often are) inexact. As a result, tax rules have been adopted, generically referred to as "lookback" rules, that apply (1) to the recognition of income from "long-term contracts" or (2) to compute the amount of allowable depreciation deduction allocable to certain future streams of forecasted income (i.e., the "income forecast method"). The income forecast method initially uses estimates to determine income, but later compensates for inaccuracies in the estimates through interest payments to or from the IRS and the taxpayer if the actual facts develop that are different than the estimated facts.

Income from long-term contracts.--Taxpayers engaged in the production of property under a long-term contract generally must compute income from the contract under the percentage of completion method. Under the percentage of completion method, a taxpayer must include in gross income for any taxable year an amount that is based on the product of (1) the gross contract price and (2) the percentage of the contract completed as of the end of the year. The percentage of the contract completed as of the end of the year is determined by comparing costs incurred with respect to the contract as of the end of the year with estimated total contract costs.

Because the percentage of completion method relies upon estimated, rather than actual, contract price and costs to determine gross income for any taxable year, a "look-back method" is applied in the year a contract is completed in order to compensate the taxpayer (or the Treasury Department) for the acceleration (or deferral) of taxes paid over the contract term. The first step of

the look-back method is to reapply the percentage of completion method using actual contract price and costs rather than estimated contract price and costs. The second step generally requires the taxpayer to recompute its tax liability for each year of the contract using gross income as reallocated under the look-back method. If there is any difference between the recomputed tax liability and the tax liability as previously determined for a year, such difference is treated as a hypothetical underpayment or overpayment of tax to which the taxpayer applies a rate of interest equal to the overpayment rate, compounded daily.[161] The taxpayer receives (or pays) interest if the net amount of interest applicable to hypothetical overpayments exceeds (or is less than) the amount of interest applicable to hypothetical underpayments.

The look-back method must be reapplied for any item of income or cost that is properly taken into account after the completion of the contract. The look-back method does not apply to any contract that is completed within two taxable years of the contract commencement date if the gross contract price does not exceed the lesser of (1) $1 million or (2) 1 percent of the average gross receipts of the taxpayer for the preceding three taxable years. In addition, a simplified look-back method is available to certain pass-through entities and, pursuant to Treasury regulations, to certain other taxpayers. Under the simplified look-back method, the hypothetical underpayment or overpayment of tax for a contract year generally is determined by applying the highest rate of tax applicable to such taxpayer to the change in gross income as recomputed under the look-back method. For purposes of the look-back method, only one rate of interest applies for each accrual period. An accrual period with respect to a taxable year begins on the day after the return due date (determined without regard to extensions) for the taxable year and ends on such return due date for the following taxable year. The applicable rate of interest is the overpayment rate in effect for the calendar quarter in which the accrual period begins.

Taxpayers may elect not to apply the look-back method with respect to a long-term contract if for each prior contract year, the cumulative taxable income (or loss) under the contract as determined using estimated contract price and costs is within 10 percent of the cumulative taxable income (or loss) as determined using actual contract price and costs. Thus, under the election, upon completion of a long-term contract, a taxpayer would be required to apply the first step of the look-back method (the reallocation of gross income using actual, rather than estimated, contract price and costs), but is not required to apply the additional steps of the look-back method if the application of the first step resulted in de minimis changes to the amount of income previously taken into account for each prior contract year. The election applies to all long-term contracts completed during the taxable year for which the election is made and to all long-term contracts completed during subsequent taxable years, unless the election is revoked with the consent of the Secretary of the Treasury.

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[161] The overpayment rate equals the applicable Federal short-term rate plus two percentage points. This rate is adjusted quarterly by the IRS. Thus, in applying the look-back method for a contract year, a taxpayer may be required to use five different interest rates.

In addition, taxpayers may elect to not reapply the look-back method with respect to a contract if, as of the close of any taxable year after the year the contract is completed, the cumulative taxable income (or loss) under the contract is within 10 percent of the cumulative look-back income (or loss) as of the close of the most recent year in which the look-back method was applied (or would have applied but for the other de minimis exception described above). In applying this rule, amounts that are taken into account after completion of the contract are not discounted. Thus, an electing taxpayer need not apply or reapply the look-back method if amounts that are taken into account after the completion of the contract are de minimis. The election applies to all long-term contracts completed during the taxable year for which the election is made and to all long-term contracts completed during subsequent taxable years, unless the election is revoked with the consent of the Secretary of the Treasury.

Income forecast method of computing depreciation.--As stated above, a taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through allowances for depreciation or amortization. The cost of a film, video tape, or similar property that is produced by the taxpayer or is acquired on a "stand-alone" basis by the taxpayer may not be recovered pursuant to either the general depreciation provisions of section 168 or the intangible amortization provisions of section 197. The cost of such property may be depreciated under the "income forecast" method. The income forecast method also has been held to be applicable for computing depreciation deductions for television shows, books, patents, master sound recordings and video games.

Under the income forecast method, the depreciation deduction for a taxable year for a property is determined by multiplying the cost of the property (less estimated salvage value) by a fraction, the numerator of which is the income generated by the property during the year and the denominator of which is the total forecasted or estimated income to be derived from the property during its useful life. The total forecasted or estimated income to be derived from a property is to be based on the conditions known to exist at the end of the period for which depreciation is claimed. This estimate can be revised upward or downward at the end of a subsequent taxable period based on additional information that becomes available after the last prior estimate. These revisions, however, do not affect the amount of depreciation claimed in a prior taxable year.

Taxpayers that claim depreciation deductions under the income forecast method are required to pay (or would receive) interest based on the recalculation of deprecation under a "look-back" method. The "look-back" method is applied in any "recomputation year" by: (1) comparing depreciation deductions that had been claimed in prior periods to depreciation deductions that would have been claimed had the taxpayer used actual, rather than estimated, total income from the property; (2) determining the hypothetical overpayment or underpayment of tax based on this recalculated depreciation; and (3) applying the overpayment rate of section 6621. Except as provided in Treasury regulations, a "recomputation year" is the third through and tenth taxable year after the taxable year the property was placed in service unless the actual income from the property for each taxable year ending with or before the close of such years was within 10 percent of the estimated income from the property for such years. The Treasury Secretary has the authority to allow a taxpayer to delay the initial application of the look-back method where the

taxpayer may be expected to have significant income from the property after the third taxable year after the taxable year the property was placed in service (e.g., the Treasury Secretary may exercise such authority where the depreciable life of the property is expected to be longer than three years). In applying the look-back method, any cost that is taken into account after the property was placed in service may be taken into account by discounting (using the Federal mid-term rate determined under section 1274(d) as of the time the costs were taken into account) such cost to its value as of the date the property was placed in service. Property with an adjusted basis of $100,000 or less when the property was placed in service is not subject to the look-back method.

Foreign tax provisions

Several provisions applicable to the determination of the Federal income tax liability of foreign corporations include the interest effects of redetermined taxes. These provisions include the redetermination of cost sharing payments,[162] reasonable cause failures to make distributions to meet DISC qualification requirements,[163] the calculation of the deferred tax amount of a passive foreign investment company,[164] and the elective deferral of tax on current inclusion of undistributed income by qualified electing funds.[165]

Recommendations

The Joint Committee staff has recommended changes that would provide a single interest rate applicable to the underpayment and overpayment of tax by all taxpayers. This recommendation is discussed as part of the Recommendations of General Applicability discussed in the previous section of this document. The Joint Committee staff recommends that the change to the single interest rate also apply to those Code sections that reference the underpayment or overpayment rate under present law.

Analysis

The Code sections that include the underpayment or overpayment rates by reference are intended to allow taxpayers to redetermine their tax liability based on facts determined after the filing date of the return without requiring an amended return to be filed. These sections charge or allow interest in order to achieve a result equivalent to the result that could be achieved by filing an amended return, without imposing the burdens associated with the amended return process. It is

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[162] Sec. 936(h)(5).

[163] Sec. 992(c)(2).

[164] Sec. 1291(c)(2)(B).

[165] Treas. Reg. sec. 1.1294-1T(b)(1).

therefore appropriate that the same interest rate apply under these sections as would apply if an amended return were filed.

C. Failure to Pay Estimated Tax Penalties

1. Background and present law

The Federal income tax system is designed to ensure that taxpayers pay taxes throughout the year based on their income earned and expenses. To the extent that tax is not collected through withholding, taxpayers are required to make quarterly estimated payments of tax. The task of calculating estimated tax becomes more complex as projected income throughout the year becomes less determinable, as it might be for a taxpayer engaged in a business. The estimated tax payment rules generally allow taxpayers to calculate estimated tax based on their prior year's tax liability or their current year's liability.[166]

a. Individuals

Estimated tax-individuals

Prior to 1994, individuals were required to make timely estimated tax payments at least equal to (1) 90 percent of the tax shown on the return for the current year or (2) 100 percent of the tax shown on the return for the prior year.[167] In addition, for taxable years beginning after 1991 and before 1997, a special rule denied the second prong of the safe harbor, "100 percent of last year's tax liability," to a taxpayer who (1) had modified adjusted gross income (AGI) in the current year that exceeded the taxpayer's AGI in the preceding year by more than $40,000 ($20,000 in the case of a married taxpayer filing a separate return) and (2) had a modified AGI in excess of $75,000 in the pertinent current year ($37,500 in the case of a married taxpayer filing a separate return).[168]

The Congress believed that the application of the special rule denying the "100 percent of last year's tax liability" safe harbor was unduly burdensome. Thus, to provide simplification in the calculation of estimated taxes for individuals, the special rule was replaced with a permanent safe harbor that applies to individuals with a prior year AGI above a certain threshold.[169] For tax years beginning after December 31, 1993, individuals must make four estimated tax payments equal to at least 25 percent of the lesser of (1) 90 percent of the tax shown on the current year's return or (2) 100 percent of last year's tax; however, if an individual taxpayer's adjusted gross

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[166] The prior year's tax safe harbor does not apply to large corporations, which are corporations with taxable income of $1 million or more during any of the three taxable years immediately preceding the taxable year involved.

[167] H.Rept. 103-213, at 593 (1993).

[168] *Id.*

[169] P.L. 103-66 (Aug. 10, 1993).

income shown on the return for the prior taxable year exceeds $150,000, then the "100 percent of last year's tax liability" safe harbor is replaced by a "110 percent of last year's liability" safe harbor. The "100 percent of last year's tax liability" safe harbor does not apply if (1) the prior year was a taxable year of less than 12 months or (2) if the individual did not file a return for the prior year.[170]

The Taxpayer Relief Act of 1997 established new safe-harbor percentages for taxpayers with an adjusted gross income over $150,000. Regarding any installment payment for taxable years beginning before January 1, 2000, the "110 percent of last year's tax liability" safe harbor is replaced by 105 percent if the prior taxable year begins in 1998, 1999, and 2000, and 112 percent if the prior taxable year begins in 2001. The 110 percent safe harbor resumes when the prior taxable year begins in 2002 or thereafter.[171] These safe-harbor percentages were again amended in 1998 for any installment payment for tax years beginning after December 31, 1999, by the Tax and Trade Relief Extension Act of 1998, which changed the percentage from 105 to 106 if the prior taxable year begins in 1999 or 2000.[172]

Generally, for calendar-year taxpayers, installments must be paid on or before April 15, June 15, September 15, and January 15 of the next taxable year.[173] If the payment due date falls on a Saturday, Sunday, or holiday, then the payment will be timely if made on the next day which is not a Saturday, Sunday, or holiday.[174]

A taxpayer who receives income unevenly throughout the taxable year may reduce their required estimated tax installments if the taxpayer's annualized income installment is less than the installment otherwise payable under the rules. An annualized installment is the excess of (1) an amount equal to the applicable percentage of the tax for the year calculated by placing on an annualized basis the taxable income, alternative minimum taxable income, and adjusted self-employment income for months in the taxable year ending before the due date of the installment, over (2) the aggregate amount of any prior required installments for the taxable year.[175]

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[170] *Id.*

[171] P.L. 105-34 (Aug. 5, 1997).

[172] P.L. 105-277 (Oct. 21, 1998).

[173] Sec. 6654(c)(2). If, on or before January 31 of the following taxable year, the taxpayer files a return for the taxable year and pays in full the amount computed on the return as payable, then no addition to tax is imposed with respect to any underpayment of the fourth required installment for the taxable year. Sec. 6654(h).

[174] Sec. 7503.

[175] The applicable percentages are: installment 1, 22.5 percent; installment 2, 45 percent; installment 3, 67.5 percent, and installment 4, 90 percent. Sec. 6654(d)(2)(C)(ii).

The estimated tax rules provide that farmers and fisherman are required to pay only one installment of tax for any taxable year.[176] The due date of such installment is January 15 of the following taxable year, and the amount of the installment is equal to 66-2/3 percent of the tax shown on the return for the taxable year.[177] A taxpayer who qualifies under this rule may skip the January 15 estimated payment of 66-2/3 percent of the tax and, instead, pay the entire tax on or before March 1 of the following taxable year.[178] Nonresident aliens are required to pay estimated tax in three installments, June 15, September 15, and January 15 of the following year.[179] In such case, a nonresident alien's June 15 installment must be equal to 50 percent of the required annual payment.[180]

Failure to pay estimated tax-individuals

If an individual fails to make the required estimated tax payments under these rules, a penalty is imposed under section 6654. The amount of the penalty is determined by applying the underpayment interest rate to the amount of the underpayment for the period of the underpayment.[181] The amount of the underpayment is the excess of the required payment over the amount (if any) of the installment paid on or before the due date of the installment.[182] The period of the underpayment runs from the due date of the installment to the earlier of (1) the 15th day of the fourth month following the close of the taxable year, or (2) the date on which each portion of any underpayment is made.[183] A payment of estimated tax is credited against unpaid required installments in the order in which such installments are required to be paid.[184]

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[176] Sec. 6654(i)(1)(A). An individual is a farmer or fisherman if the individual's gross income from farming or fishing (including oyster farming) for the current taxable year and prior taxable year is at least 66 2/3 percent of the total gross income from all sources in such taxable years. Sec. 6654(i)(2).

[177] Sec. 6654(i)(1).

[178] Sec. 6654(i)(1)(D)(i).

[179] Sec. 6654(j).

[180] Sec. 6654(j)(3).

[181] Sec. 6654(a).

[182] Sec. 6654(b)(1).

[183] Sec. 6654(b)(2).

[184] Sec. 6654(b)(3).

Example 1.--Assume a calendar-year taxpayer is required to pay estimated tax of $10,000 during 1999. Under section 6654, the taxpayer should pay $2,500 estimated tax per quarter. However, the taxpayer only paid a total of $8,000: $1,500 on April 15, 1998, $1,500 on June 15, 1998, $4,500 on September 15, 1998, and $500 on January 15, 1999. The taxpayer's $1,000 underpayment on the first installment runs from April 15, 1998, to June 15, 1998, the date when the underpayment is satisfied by the first $1,000 of the June 15, 1998, payment. The $500 balance of the June payment is applied as the second installment, leaving a $2,000 underpayment. The taxpayer's $2,000 underpayment on the second installment runs from June 15, 1998, to September 15, 1998, the date when the underpayment is satisfied by the first $2,000 of the September, 15, 1998, payment. The $2,500 balance of the September payment is applied to the third installment in full. The January 15, 1999, payment of $500 left a remaining underpayment of $2,000 which ran until the earlier of the date is was paid or April 15, 1999. Assuming it was not paid until April 15, 1999, then it ran until April 15, 1999.

The underpayment rate under section 6621(a)(2) is AFR plus 3 percentage points, which is the average market yield on outstanding marketable obligations of the United States with remaining periods of 3 years or less.

There are exceptions to the penalty for failure to pay estimated tax. First, there is no penalty if the tax shown on the return for the taxable year (or, if no return is filed, the tax), reduced by federal income tax withholding, is less than $1,000.[185] Second, the penalty does not apply when there is no tax liability for the prior taxable year, provided that the prior year was a taxable year of 12 months, the individual had no liability for tax for such year, and the individual was a citizen or resident of the United States throughout the prior taxable year.[186]

The estimated tax rules also provide for a waiver of the penalty in certain cases. To the extent the Secretary determines that a taxpayer suffered a casualty (e.g., a fire which destroys the taxpayer's books and records), disaster, or other unusual circumstance where imposition of the penalty would be against equity and good conscience, then the penalty will not apply.[187] Furthermore, there is no penalty if an underpayment is due to reasonable cause and not willful neglect when the Secretary determines that the taxpayer (1) retired after attaining age 62 or (2) became disabled in the current or prior taxable year.[188] There are no other reasonable cause exceptions.[189]

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[185] Sec. 6654(e)(1).

[186] Sec. 6654(e)(2).

[187] Sec. 6654(e)(3)(A).

[188] Sec. 6654(e)(3)(B).

[189] In the case of an individual serving in the Armed Forces of the United States in an area designated as a "combat zone" during the period of combatant activities, the period of time for

Changes in the Federal tax laws have frequently provided relief from the penalty for failure to pay estimated tax where tax increases have been caused by such changes in the law. For example, section 1 of the Taxpayer Relief Act of 1997 provides that "[n]o addition to tax shall be made under section 6654 or 6655 of the Internal Revenue Code of 1986 for any period before January 1, 1998, for any payment the due date of which is before January 16, 1998, with respect to any underpayment attributable to such period to the extent such underpayment was created or increased by any provision of this Act."[190]

Generally, estates and trusts are subject to the same rules and penalties for failure to pay estimated tax that apply to individuals under section 6654.[191] For any taxable year ending before the date two years after the date of decedent's death, the estimated tax rules and penalties do not apply to (1) the estate of such decedent, or (2) any trust all of which was treated as owned by the decedent and to which the residue of the decedent's estate will pass (or is primarily responsible for paying debts, taxes, and administration expenses).[192]

b. Corporations

Estimated tax-corporations

Prior to 1994, corporations were required to make estimated tax payments of at least 25 percent of the lesser of (1) 100 percent of the tax shown on the prior year's return or (2) for taxable years beginning after June 30, 1992, and before 1997, 97 percent of the tax shown on the current year's return.

The "97 percent of current year's tax" safe harbor was scheduled to become a "91 percent of current year's tax" safe harbor, beginning after 1996.[193] The Omnibus Budget Reconciliation Act of 1993, however, amended the provision. For taxable years beginning after December 31, 1993, a corporation is required to make four estimated tax payments of at least 25 percent of the lesser of (1) 100 percent of the tax shown on the prior year's return or (2) 100 percent of the tax

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performance of various acts under the Code are suspended. The suspension of time encompasses the period of service in the combat zone during the period of combatant activities in the zone, as well as (1) continuous qualified hospitalization resulting from injury received in the combat zone or (2) time in missing in action status, plus the next 180 days. Estimated tax is included in the acts that are suspended under the Code. Sec. 7508.

[190] H.R. 2014, 105th Cong., sec. 1(d) (1997).

[191] Sec. 6654(l)(1).

[192] Sec. 6654(l)(2).

[193] H.Rept. 103-213, at 618-19 (1993).

shown on its return for the current taxable year.[194] The "100 percent of prior year's tax liability" safe harbor does not apply (1) if the prior year was a taxable year of less than 12 months, (2) if the corporation did not file a tax return for the prior year showing a tax liability,[195] or (3) to large corporations, which are corporations with taxable income of $1 million or more during any of the 3 taxable years immediately preceding the taxable year involved.[196] These corporations must make estimated payments of 100 percent of the tax shown on their current year's return.[197] Large corporations may, however, use the prior year's tax as the basis for calculating their first installment.[198] Any reduction in the first installment must be recaptured by increasing the amount of the second required installment.[199] For calendar-year taxpayers, installments must be paid on or before April 15, June 15, September 15, and December 15 of the current taxable year.[200] If the payment due date falls on a Saturday, Sunday, or holiday, then the payment will be timely if made on the next day which is not a Saturday, Sunday, or holiday.[201]

A corporate taxpayer that receives income unevenly throughout the taxable year may reduce its required estimated tax installment. If a corporation establishes that its "annualized income installment" or its "adjusted seasonal installment" is less than the 25-percent payment amount, then the amount of the required installment shall be the annualized income installment or, if less, the adjusted seasonal installment.[202] Any reduction in an installment resulting from this rule must be recaptured by increasing the amount of the next required installment by the amount of such reduction, and by increasing subsequent required installments to the extent that the reduction has not previously been recaptured.[203]

Failure to pay estimated tax-corporations

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[194] H.R. 2264, 103rd Cong., sec. 13225 (1993).

[195] Sec. 6655(d)(1).

[196] Sec. 6655(d)(2), (g)(2).

[197] Sec. 6655(d)(2)(A).

[198] Sec. 6655(d)(2)(B).

[199] *Id.*

[200] Sec. 6655(c)(2).

[201] Sec. 7503.

[202] Sec. 6655(e).

[203] Sec. 6655(e)(1)(B).

If a corporation fails to make the required estimated tax payments under the rules, then a penalty is imposed under section 6655. The amount of the penalty is determined by applying the underpayment interest rate to the amount of the underpayment for the period of the underpayment.[204] The amount of the underpayment is the excess of the required payment over the amount (if any) of the installment paid on or before the due date of the installment.[205] The period of the underpayment runs from the due date of the installment to the earlier of (1) the 15th day of the third month following the close of the taxable year, or (2) the date on which each portion of any underpayment is made.[206] A payment of estimated tax is credited against unpaid required installments in the order in which such installments are required to be paid.[207]

The penalty for failure to pay estimated tax is not imposed if the tax shown on the return for such taxable year (or, if no return is filed, the tax) is less than $500.[208]

c. Criminal penalty for willful failure to pay estimated tax

In addition to the civil penalties for failure to pay estimated tax, section 7203 provides that any person who willfully fails to pay estimated tax shall be guilty of a misdemeanor and, upon conviction thereof, shall be fined not more than $25,000 ($100,000 in the case of a corporation), or imprisoned not more than 1 year, or both. The taxpayer must also bear the costs of prosecution.[209] In the case of a person with respect to whom there is a failure to pay estimated tax, this provision shall not apply if there is no addition to tax under sections 6654 or 6655 with respect to such failure.[210]

2. Administration of the penalty for failure to pay estimated tax and recommendations for legislative change

a. Convert estimated tax penalty into an interest provision

Present Law

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[204] Sec. 6655(a).

[205] Sec. 6655(b)(1).

[206] Sec. 6655(b)(2).

[207] Sec. 6655(c).

[208] Sec. 6655(f).

[209] Sec. 7203.

[210] *Id.*

Sections 6654(a) and 6655(a) provide that, in the case of any underpayment of estimated tax, there is an "addition to the tax" which is determined by applying the underpayment interest rate of section 6621 to the amount of the underpayment for the period of the underpayment. For individual and corporate taxpayers, the "addition to the tax" for failure to pay estimated tax is literally interest, which is calculated based on the time value of money.

Taxpayers are not permitted to deduct penalties, including penalties for failure to pay estimated tax.[211]

Recommendation

As described in the general recommendations, above, the Joint Committee staff recommends converting the existing penalty for failure to pay estimated tax into an interest provision.

Analysis

Interest would be computed at the rate provided in section 6621 (as amended by rate-change proposals contained within this study). The estimated tax interest provisions would otherwise operate as under present law, subject to the simplification proposals detailed below. For example, there would be no interest due where the tax shown on the return, reduced by withholding, is less than $1,000 (subject to simplification proposals detailed below). Moreover, interest would not apply to taxpayers who had no tax liability for the preceding taxable year.

The present-law waivers also would continue to apply. For instance, no interest would apply with respect to any underpayment to the extent the Secretary of the Treasury determines that, by reason of casualty, disaster, or other unusual circumstances, the imposition of interest would be against equity and good conscience, and the reasonable cause exception would apply to newly retired or disabled individuals.

Individuals are not permitted to deduct personal interest.[212] For this purpose, personal interest includes interest on underpayments of the individual's income taxes. In accordance with the recommendations contained within this study, interest paid by individuals on underpayments of income taxes would remain nondeductible. Because the penalty for failure to pay estimated tax would be converted into a provision for interest on underpayments of estimated tax, any such interest paid by individual taxpayers would be nondeductible. For individual taxpayers, this would be consistent with the result under present law, where penalties for failure to pay estimated tax are not deductible.

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[211] Sec. 162(f).

[212] Sec. 163(h).

Corporations are allowed an income tax deduction for interest paid on underpayments of income tax. Pursuant to the recommendations included within this study, such interest would continue to be deductible by corporations. Thus, interest paid by corporate taxpayers on underpayments of estimated tax would be deductible. For corporate taxpayers, this would differ from the result under present law, where penalties for failure to pay estimated tax are not deductible.

b. Increase and revise estimated tax threshold for individuals

Present Law

Individual taxpayers are not liable for a penalty for the failure to pay estimated tax where the tax shown on the return for the taxable year (or, if no return is filed, the tax), reduced by withholding, is less than $1,000.[213] This safe harbor does not apply, however, where a taxpayer has paid throughout the year solely through estimated tax. For such taxpayers, any tax shown on the return for the taxable year, net of estimated tax paid, could subject the taxpayer to the penalty for failure to pay estimated (unless a safe harbor applies).

Recommendation

As described in the general recommendations, above, the Joint Committee staff recommends that there be no penalty for failure to pay estimated tax if the tax shown on the return for the taxable year (or, if no return is filed, the tax), reduced by both withholding and estimated tax paid by qualifying individuals during the taxable year, is less than $2,000.

Qualifying individuals would be those individual taxpayers who pay estimated tax in four equal installments on or before the due date of each installment.

Analysis

The proposal would recognize both withholding and estimated tax paid in four equal installments in determining whether an individual taxpayer satisfies the safe harbor. Estimated tax paid in unequal installments would not be considered in calculating whether an individual satisfies this safe harbor.

By increasing the threshold from $1,000 to $2,000, fewer taxpayers will need to make estimated tax payments throughout the year. Amending the safe harbor to consider both withholding and estimated tax paid in four equal installments throughout the year will reduce the number of taxpayers who file Form 2210, because more individuals will have satisfied the safe harbor by having a balance due with their return, net of withholding and estimated tax, of less than $2,000.

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[213] Sec. 6654(e)(1).

c. Repeal the modified safe harbor, which applies to taxpayers whose AGI for the preceding taxable year exceeded $150,000.

Present Law

Individual taxpayers generally must make quarterly estimated tax payments equal to at least 25 percent of (1) 90 percent of the tax shown on the current year's return or (2) 100 percent of the prior year's tax. Income tax withholding is treated as a payment of estimated tax. For taxpayers whose AGI for the preceding taxable year exceeded $150,000, the rule that allows payment based on 100 percent of the prior year's tax is modified. For taxpayers making estimated tax payments based on prior year's tax, if the prior year begins in 1998, then payments must be based on 105 percent of the prior year's tax. If the prior year begins in 1999 or 2000, then payments must be made based on 106 percent of the prior year's tax. If the prior year begins in 2001, then payments must be made based on 112 percent of the prior year's tax. If the prior year begins in 2002 or thereafter, then payments must be based on 110 percent of the prior year's tax. The modified safe harbor applies to married taxpayers filing a separate return whose AGI for the preceding taxable year exceeded $75,000.

The safe harbor was originally modified by the Omnibus Budget Reconciliation Act of 1993. Under that rule, taxpayers with prior year's AGI over $150,000 were required to make estimated payments equal to at least 25 percent of the lesser of (1) 90 percent of the tax shown on the current year's return or (2) 110 percent of the prior year's tax.

The Taxpayer Relief Act of 1997 established new safe-harbor percentages for taxpayers with AGI over $150,000. For any installment of estimated tax for taxable years beginning before January 1, 2000, 110 percent was replaced by 105 percent if the prior taxable year begins in 1998, 1999, and 2000, and becomes 112 percent if the prior taxable year begins in 2001. The 110 percent resumes when the prior taxable year begins in 2002 or thereafter.

These percentages were, again, amended in 1998 for any installment payment for tax years beginning after December 31, 1999. The Tax and Trade Relief Extension Act of 1998 changed the percentage from 105 to 106 if the prior taxable year begins in 1999 or 2000.

Recommendation

The Joint Committee staff recommends repealing the modified safe harbor, which applies to individuals whose AGI for the preceding taxable year exceeded $150,000.

Analysis

By repealing the modified safe harbor rule, the same estimated tax safe harbor would apply to all individual taxpayers. Moreover, to the extent that this special rule is eliminated, the estimated tax rules will be simplified. Every taxpayer would meet the estimated tax safe harbor

provided that they made quarterly estimated tax payments equal to at least 25 percent of (1) 90 percent of the tax shown on the current year's return or (2) 100 percent of the prior year's tax.

d. Apply one interest rate per underpayment period

Present Law

Individual taxpayers who are affected by the estimated tax system may either have the Internal Revenue Service calculate any penalty owed, or they may self assess their own penalty on Form 2210. According to the latest information available to the GAO at the time of its study in May 1998, four million taxpayers self assessed their estimated tax penalties in 1994.[214] Taxpayers may use either the short or regular method to calculate their estimated tax penalties.[215] Although the IRS did not collect the data necessary for the GAO to determine how many of these taxpayers used the short or regular method, the GAO found that over half of those taxpayers who self assessed estimated tax penalties in 1994 used the regular method.

The penalty is equal to the interest rate multiplied by the number of days the underpayment is outstanding, which is the number of days between when the taxpayer should have made the estimated payment and the earlier of (1) the actual date of payment or (2) April 15th of the following year (assuming a calendar-year taxpayer). The interest rate, which equals the Federal short-term rate plus 3 percentage points, is subject to change on the first day of each quarter, which

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[214] General Accounting Office, *Tax Administration: Ways to Simplify the Estimated Tax Penalty Calculation* (GAO/GGD-98-96), May 27, 1998, at 2 (hereinafter, Tax Administration: Ways to Simplify the Estimated Tax Penalty Calculation).

[215] The instructions to Form 2210 provide that only taxpayers who either made no estimated payments or made four equal, timely estimated payments may use the short method to calculate their penalties. The short method requires taxpayers to simply apply a percentage rate to their estimated tax underpayments to calculate any penalty due.

The short method is unavailable to those taxpayers who made any estimated tax payment late, used the annualized income installment method, treated tax withheld as paid on the dates it was actually withheld, or filed as a nonresident alien and did not receive wages as an employee subject to U.S. withholding. Taxpayers who use the regular method must make additional calculations. Taxpayers using the regular method on Form 2210 must calculate an underpayment for each of the four estimated tax payment periods. A separate estimated tax penalty is ultimately calculated for each period in which there is an underpayment. See also *Tax Administration: Ways to Simplify the Estimated Tax Penalty Calculation*, supra note 214, at 2.

is January 1,[216] April 1, July 1, and October 1. The IRS updates Form 2210 annually to reflect changes in the Federal short-term interest rate.

If interest rates change while an underpayment is outstanding, then taxpayers are required to make separate calculations for the periods before and after the interest rate change. Such calculations generally are needed to cover 15-day periods. For example, the July 1 interest rate change occurs 15 days after the June 15 payment date. A change in interest rates, which occurs on the first day of each quarter, would require the use of different interest rates during one estimated tax period and would increase the number of calculations that a taxpayer must make in completing Form 2210.

Example 2.--Assume an individual taxpayer has an estimated tax underpayment outstanding from June 15, 1998, until it is paid on September 15, 1998. Further assume that the estimated tax interest rate changed at the beginning of each quarter. Under present law, two interest calculations would be required. The first calculation is needed to cover the period from June 16, 1998, through June 30, 1998 (at the rate applicable to April 1, 1998). The second calculation would cover the period from July 1, 1998, through September 15, 1998 (at the rate applicable to July 1, 1998). Thus, there would be two interest calculations for one underpayment period.

Recommendation

The Joint Committee staff recommends aligning the interest rates that apply to underpayment of estimated tax so that, for any given estimated tax underpayment period, only one interest rate would apply. For this purpose, the recommendation would adopt the interest rate applicable to the first day of the quarter in which the pertinent estimated payment due date arises.[217]

Analysis

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[216] Sec. 6621(b)(2)(B) provides that the interest rate that applies during the third month following the taxable year shall also apply during the first 15 days of the fourth month following such taxable year. Thus, the rate in effect January 1 is used from January 1 through the following April 15.

[217] Another option would be to apply the interest rate which would be in effect during most of the estimated tax underpayment period. Under this approach, however, taxpayers might still be faced with uncertainty and, thus, greater complexity. Assume a taxpayer makes a June 15 payment on July 5. Under this example, the taxpayer would be charged interest during this 15-day period at the April 1 rate because most of the underpayment period occurred during the April 1 quarter. However, if that taxpayer had waited until, for example, July 20 to make this payment, then the July 1 rate would apply because most of the underpayment period would have fallen in the July 1 quarter.

The recommendation would apply one interest rate per underpayment period. Therefore, in Example 2, above, there would be only one interest calculation required for the underpayment outstanding from June 15, 1998, through September 15, 1998. Under these facts, the April 1, 1998, interest rate would be the exclusive rate that would apply to the underpayment outstanding from June 15, 1998, through September 15, 1998.[218]

Providing taxpayers with one interest rate per underpayment period would reduce complexity in preparing Form 2210.[219] If only one interest rate applies, it would end the potential for multiple interest calculations occurring within one estimated tax underpayment period. However, adopting such a change would prevent the estimated tax calculation from taking into account changes in the interest rate which may occur during an underpayment period. Thus, especially in times of changing interest rates, taxpayers might not calculate interest based on the actual rates in effect during the entire underpayment period.

e. Provide that underpayment balances are cumulative

Present Law

Section 6654(b)(1) defines "underpayment" as the amount of an installment due over the amount of any installment paid (including withholding) on or before the due date of the installment. In determining an underpayment penalty for a calendar year taxpayer, the period of underpayment runs for each underpayment from the payment's due date through the earlier of the date on which any portion of the payment is made or the following April 15th.[220] Underpayment balances are not cumulative must be tracked separately for each estimated tax underpayment period. As the GAO reported in its May 1998 study, "[t]he definition precludes existing underpayment balances from being used in underpayment calculations for succeeding [estimated] payment periods."[221] Consequently, individual underpayments must be tracked when completing Form 2210.

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[218] Because April 1 is the start of the quarter in which both the April 15 and June 15 estimated payment due dates fall, the interest rate in effect on April 1 would apply to underpayments which relate to both the April 15 and June 15 estimated payments for calendar-year taxpayers.

[219] The GAO included a similar recommendation in its report *Tax Administration: Ways to Simplify the Estimated Tax Penalty Calculation*, supra note 214, at 6.

[220] When a payment of estimated tax is made, it is credited against unpaid required installments in the order in which such installments are required to be paid. Sec. 6654(a)(3). Overpayment balances are cumulative and are applied to successive estimated tax payments.

[221] *Tax Administration: Ways to Simplify the Estimated Tax Penalty Calculation*, supra note 214, at 5.

Example 3.--An individual taxpayer made no estimated tax payments for 1998. However, the taxpayer should have made four estimated payments, each in the amount of $2,000. The total of all underpayments for calendar-year 1998 is $8,000.

Under present law, each separate underpayment balance runs from its respective estimated payment due date through the earlier of the date it is paid or the following April 15th. Assuming that no payments were made until the tax return was filed on the following April 15, interest on each underpayment of estimated tax ran separately from its due date to the following April 15.[222] During periods of changing interest rates, this would require multiple interest calculations for each underpayment.

Recommendation

The Joint Committee staff recommends changing definition of "underpayment" to allow existing underpayment balances to be used in underpayment calculations for succeeding estimated payment periods.

Analysis

If such a change were made, taxpayers would no longer track each outstanding underpayment balance until the earlier of the date they were paid or the following April 15th (assuming a calendar-year taxpayer). Rather, taxpayers would calculate their cumulative estimated tax underpayment for each period or quarter and apply the appropriate interest rate as of that date. This change would not effect estimated penalty amounts.[223] It would simply reduce complexity in completing Form 2210.

The recommendation would simplify the estimated tax penalty calculation by providing that underpayment balances would roll into the next estimated tax period so that the penalty would be calculated once per underpayment, per period. Assuming the facts in Example 3, above, the $2,000 underpayment outstanding since April 15, 1998, would roll into the underpayment that started on June 15, 1998. Thus, the $2,000 underpayment would run from April 15, 1998, through June 15, 1998 (instead of through April 15, 1999). The June 15, 1998, underpayment of $2,000 would be added to the $2,000 underpayment from April 15, 1998, for a cumulative total underpayment of $4,000 as of June 15, 1998. The $4,000 cumulative underpayment as of June 15, 1998, would be added to the $2,000 underpayment which arose September 15, 1998. Thus, as of September 15, 1998, the cumulative outstanding underpayment would be $6,000. The $6,000

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[222] If any estimated tax payments were made, they would be credited to any outstanding underpayments in the order in which such installments were required to have been paid. Secs. 6654(b)(3), 6655(c). For an illustration of this rule, see Example 1, above.

[223] The GAO included an identical recommendation in its report *Tax Administration: Ways to Simplify the Estimated Tax Penalty Calculation*, supra note 214, at 4-5.

cumulative underpayment as of September 15, 1998, would be added to the $2,000 underpayment outstanding as of January 15, 1999, for a total cumulative underpayment of $8,000, outstanding from January 15, 1999, through April 15, 1999.

If the definition of "underpayment" were changed, and if the recommendation that would apply only one interest rate were adopted (see "c." above), taxpayers would need to make fewer calculations when determining their estimated tax penalties. For example, taxpayers would determine what their cumulative underpayment balances were for a particular period and apply the interest rate that was in effect at the beginning of the underpayment period. The result: one interest calculation per underpayment period. For example, assuming the facts in Example 3, above, taxpayers would perform one interest calculation for the underpayment which remained outstanding from April 15, 1998, through June 15, 1998, and again for each subsequent outstanding underpayment. Unless the taxpayer were to make multiple estimated tax payments during a period or pay mid period, there could be a maximum of four estimated tax calculations required for any taxable year in completing Form 2210.

f. Require 365-day year for all estimated tax penalty calculations

Present Law

Under current IRS procedures, taxpayers with outstanding underpayment balances that extend from a leap year through a non-leap year are required to make separate calculations solely to account for the different numbers of days in the two different years.[224] For example, if a taxpayer has an underpayment outstanding from September 15, 2000, through January 15, 2001, the taxpayer must account for the period from September 15, 2000, through December 31, 2000, by using a 366-day formula. The taxpayer must then account for the period from January 1, 2001, through January 15, 2001, under a 365-day formula. This calculation is necessary regardless of whether the interest rate changes on January 1, 2001.

For example, for 1995 underpayments, two penalty rates applied: 10 percent for the period from April 15, 1995, through June 30, 1995, and 9 percent for the period from July 1, 1995, through April 15, 1996. However, even through only two penalty rates applied to 1995 underpayments, Part IV of Form 2210 had three rate periods. A separate rate period was needed from January 1, 1996, through April 15, 1996, because 1996 was a leap year.[225]

Recommendation

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[224] Two calculations would also be required for underpayment balances which extend from a non-leap year to a leap year.

[225] See IRS Publication 505, "Tax Withholding and Estimated Tax" for the 1996 tax year (release date: December 1, 1995).

The Joint Committee staff recommends that taxpayers use a 365-day year for all estimated tax penalty calculations.[226]

Analysis

Under the proposal, for the 1995 underpayments described above, only two rates would have applied: 10 percent for the period from April 15, 1995, through June 30, 1995, and 9 percent for the period from July 1, 1995, through April 15, 1996. A 365-day year would have been used for both 1995 and 1996, regardless of the fact that 1996 was a leap year. Complexity would be eliminated by dispensing with the extra calculation that is required for underpayment balances that extend from a leap year to a non-leap year or from a non-leap year to a leap year.

3. Effective date

The Joint Committee staff recommends that the changes to the provisions relating to underpayments of estimated tax be effective for periods beginning on or after January 1, 2000.

[226] The GAO included an identical recommendation in its report *Tax Administration: Ways to Simplify the Estimated Tax Penalty Calculation*, supra note 214, at 9.

D. Failure to File Penalties

Background and Present Law

The United States tax system is one of "self-assessment," i.e., taxpayers are required to declare their income, expenses, and ultimate tax due, while the IRS has the ability to propose subsequent changes. This voluntary system requires that taxpayers comply with deadlines and adhere to the filing requirements. While taxpayers may obtain extensions of time in which to file their returns, the Federal tax system consists of specific due dates of returns. In order to foster compliance in meeting these deadlines, Congress has enacted a penalty for the failure to timely file tax returns.[227]

A taxpayer who fails to file a tax return on or before its due date is subject to a penalty equal to 5 percent of the net amount of tax due for each month the return is not filed, up to a maximum of 25 percent of the net amount.[228] If the failure to file a return is fraudulent, then the taxpayer is subject to a penalty equal to 15 percent of the net amount of tax due for each month the return is not filed, up to a maximum of 75 percent of the net amount.[229] For purposes of the failure to file penalty, the "net amount due" is the amount of tax required to be shown on the return reduced by the amount of any part of the tax which is paid on or before the date prescribed for payment of the tax and by the amount of any credits against tax which may be claimed on the return.[230] The penalty will not apply if it is shown that the failure to file was due to reasonable cause and not willful neglect.[231]

If a return is filed more than 60 days after its due date, then the failure to file penalty may not be less than the lesser of $100 or 100 percent of the amount required to be shown as tax on the return.[232] If a penalty for failure to file and a penalty for failure to pay tax shown on a return both apply for the same month, the amount of the penalty for failure to file for such month is reduced by the amount of the penalty for failure to pay tax shown on a return.[233] If a return is filed more than 60 days after its due date, then the penalty for failure to pay tax shown on a return may not reduce

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[227] See United States v. Boyle, 469 U.S. 241, 245 (1985).

[228] Sec. 6651(a)(1).

[229] Sec. 6651(f).

[230] Sec. 6651(b)(1).

[231] Sec. 6651(a)(1).

[232] Sec. 6651(a).

[233] Sec. 6651(c)(1).

the penalty for failure to file below the lesser of $100 or 100 percent of the amount required to be shown on the return.[234]

The failure to file penalty applies to all returns required to be filed under subchapter A of Chapter 61 (relating to income tax returns of an individual, fiduciary of an estate or trust, or corporation; self employment tax returns; and estate and gift tax returns), subchapter A of chapter 51 (relating to distilled spirits, wines, and beer), subchapter A of chapter 52 (relating to tobacco, cigars, cigarettes, and cigarette papers and tubes), and subchapter A of chapter 53 (relating to machine guns and certain other firearms).[235] The failure to file penalty does not apply to any failure to pay estimated tax required to be paid by sections 6654 or 6655.[236]

Analysis

It can be argued that taxpayers who fail to file timely returns impose a burden on the tax administration and processing system by depriving the government of the taxpayer's information and balance due. The penalty for failure to file is calculated as a percentage of the net amount of tax due with the return. The gravity of the penalty is directly proportional to the net amount of tax due, because the penalty is based on a percentage of tax; the penalty increases as the net amount of tax due increases. Because the penalty is based on a percentage of tax, taxpayers with no net amount of tax due on their returns or taxpayers who claim refunds are not subject to the penalty, regardless of whether their returns are filed late.

The present-law penalty for failure to file rationally discourages the late filing of tax returns. The time-sensitive nature of this penalty is designed to advance prompt corrective action by taxpayers. For example, taxpayers are encouraged to file as early as possible to avoid a month-to-month increase in the penalty. For taxpayers who are due a refund, they are denied the use of or earnings on their overpayment until they file a return and receive their refund. Conversely, a penalty that would impose a flat amount from the first day of delinquency would likely not promote remedial action after the initial late filing. Such a penalty would provide little incentive for taxpayers subject to the penalty to file as early as possible. Consequently, the Joint Committee staff recommends that no new legislation be enacted in this area.[237]

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[234] *Id.*

[235] Sec. 6651(a)(1). Section 6698 provides a penalty for failure to file a partnership return. The penalty is $50 times the number of persons who were partners in the partnership during any part of the taxable year, for each month (or a fraction thereof) during which such failure continues (not to exceed five months), unless the failure is due to reasonable cause. There is no maximum penalty, and a penalty under this provision is assessed against the partnership.

[236] Sec. 6651(e).

[237] Under section 6651(c)(1), the penalty for failure to file is reduced by the present-law penalty for failure to pay. If the Joint Committee staff recommendation to repeal the penalty for

E. Failure to Pay Penalties

Present Law

In general

The failure-to-pay penalty rate is .5 percent per month. The penalty may be invoked in two cases.

First, the penalty may be imposed in the case of a failure to pay tax shown on a return.[238] This penalty is calculated from the original due date of the return.[239] If a taxpayer fails to file a return and the IRS prepares a substitute, the substitute return is treated as though it were prepared by the taxpayer.[240] This means the penalty is assessed from the original due date of the return. If the tax shown on a return is overstated, only the amount actually due is subject to the penalty.[241]

Second the penalty may be imposed in the case of a failure to pay tax required to be shown on a return (but not, in fact, shown), for which IRS has issued a notice and demand.[242] This penalty is calculated from the date the tax is assessed.[243] This penalty applies only if the amount shown in the notice and demand is not paid within 21 days (or within 10 business days if the amount shown on the notice and demand is $100,000 or more).[244] A business day is any day that is not a Saturday, Sunday, or legal holiday in Washington, DC, or a statewide legal holiday in the taxpayer's home state.[245] The penalty applies in cases where a taxpayer understates the tax as a result of a math error.[246]

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failure to pay is enacted, then this rule will no longer apply.

[238] Sec. 6651(a)(2).

[239] IRM (20)242.2.

[240] Sec. 6651(g).

[241] Sec. 6651(c)(2).

[242] Sec. 6651(a)(3).

[243] IRM (20)251(2)(b).

[244] Sec. 6651(a)(3).

[245] Treas. Reg. secs. 301.6651-1(a)(3), 301.6601-1(f)(5).

[246] Sec. 6651(a)(3).

The failure-to-pay penalties were added to the Code in 1969.[247] In discussing the need for this legislation, Congress noted that interest on tax deficiencies was then set at a fixed 6 percent rate. This was often substantially less than the cost of borrowing from commercial lenders. That gave some taxpayers an incentive to use the IRS as an inexpensive source of borrowed funds by filing balance due returns without paying the balance. The failure-to-pay penalties were enacted to reduce this incentive.

Maximum penalty

The maximum penalty under either provision (failure to pay tax shown or failure to pay after notice) is 25 percent. The two penalties should never apply to the same amounts, since one applies only to tax shown on the return, the other only to tax that should have been shown but was not.

Coordination of failure-to-pay penalties with failure-to-file penalties

The 5 percent-per-month failure-to-file penalty is reduced to 4.5 percent per month whenever the penalty for failure to pay tax shown on a return applies to the same month. Thus, the combined rate for both penalties in any given month is 5 percent. Since the failure-to-file penalty is never assessed for more than 5 months, if both penalties continue for the full five month period, the maximum failure-to-file penalty is reduced to 22.5 percent.[248] However, this coordination provision can never cause the failure-to-file penalty to be reduced below $100 or, if lower, the tax required to be shown on the return for returns that are filed over 60 days past their due date.[249]

The penalty for failure to pay after notice does not affect, and is not affected by, the penalty for failure to file.

Penalty rate increase

Both penalty rates (for failure to pay tax shown on return and for failure to pay after notice) increase to 1 percent once IRS proceeds to collect either by way of a levy or by issuing a jeopardy assessment.[250] The effective date of the rate increase is either (1) the first day of the month that begins at least 10 days after the levy date for taxes subject to levy,[251] or (2) the first day of the

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[247] P.L. 91-172.

[248] IRM (20)232.4(a)(1)(b).

[249] Sec. 6651(c)(1).

[250] Sec. 6651(d).

[251] Sec. 6651(d)(2)(A).

month that begins after the jeopardy assessment date for taxes subject to jeopardy assessment.[252] Congress added this provision in 1986 [253] in response to the fact that certain taxpayers ignore multiple payment requests and force the IRS to undertake more costly collection methods, such as liens, levies, and attachment. The increased penalty rate is meant to compensate in part for the increased costs these taxpayers impose on the system.

Amount subject to penalty

The amount subject to penalty is subject to recalculation each month. The starting point is the amount of tax shown on the return or the amount of tax assessed. This amount is reduced by payments made before the month for which the penalty is imposed (including withholding and estimated tax payments) and by any credits that may be applied against the tax.[254] If the penalty applies for a particular month, payments made during that month, even payment in full, do not reduce that month's penalty.[255]

Penalty abatement

Installment agreements.--For a taxpayer who filed his or her original return on time (taking filing extensions into account) and who later enters into an installment agreement, the basic .5 percent-per-month penalty is reduced to .25 percent for any month the installment agreement is in effect.[256] This change will take effect for installment payments made after December 31, 1999.

Reasonable cause.--A taxpayer can avoid penalties for failure to pay by demonstrating reasonable cause and lack of willful neglect.[257] Under IRS regulations, a taxpayer seeking reasonable cause abatement must show that he or she exercised "ordinary business care and prudence in providing for payment of" his or her taxes, but still was unable to pay the tax, or would have suffered "undue hardship" if he or she paid on the due date.[258]

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[252] Sec. 6651(d)(2)(b).

[253] P.L. 99-514.

[254] Sec. 6651(b).

[255] Note that under section 6651(a)(2) and (3), the penalties apply to each month or fraction of a month that tax is unpaid.

[256] Sec. 6651(h).

[257] Sec. 6651(a)(2) and (3).

[258] Treas. Reg. sec. 301.6651-1(c)(1).

Factors that may indicate a taxpayer failed to exercise ordinary business care include the following: (1) lavish or extravagant living expenditures that reduce a taxpayer's ability to pay tax obligations, or (2) investments in illiquid or speculative assets.[259]

The term "undue hardship" is neither defined nor illustrated in the failure-to-pay penalty regulations. However, in a related context, regulations dealing with extending the due date for tax payments do cast some light on the meaning of this term.[260] According to the payment extension regulations, undue hardship means more than mere inconvenience to a taxpayer. The taxpayer must be faced with a substantial financial loss if he or she makes a timely tax payment. Thus a taxpayer who would have to sell assets at a distress price in order to pay on time might well argue that he or she is faced with undue hardship. A taxpayer who can make a payment by selling assets at or near their fair market value would not "ordinarily" be considered to suffer undue hardship.

A higher standard of "ordinary business care or prudence" may be required if a taxpayer has failed to pay trust fund taxes, such as FICA or withheld income tax.[261]

An individual taxpayer with a valid filing extension who has paid at least 90 percent of the tax due by the return's original due date will be presumed to have good cause with respect to the remaining balance due for the period between the original and extended due dates, provided he or she pays the remainder of the balance due with the return.[262]

Recommendation

For a discussion of the Joint Committee staff recommendations relating to the failure to pay penalties (including the recommendation that the penalty be repealed), see the discussion in Part A., above, relating to recommendations of general applicability.

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[259] *Id.*

[260] Treas. Reg. sec.1.6161-1(b).

[261] Treas. Reg. sec. 301.6651-1(c)(2).

[262] Treas. Reg. sec. 301.6651-1(c)(3).

F. Failure to Deposit Penalty

Background and Present Law

Overview

The past three decades have been marked by a growing appreciation for the importance of the time value of money and the benefits of efficiently using "float" (money in transit from a transferor to a transferee). Reflecting that awareness, Congress and the IRS have taken a number of steps to see that tax revenues collected by or on behalf of the Federal government are actually made available to the government as quickly and as efficiently as possible. Enforcing prompt payment also reduces the risk of collection problems. This is particularly important when the taxes involved are trust fund taxes, such as withheld social security and Medicare taxes, because the government gives employees credit for amounts withheld on their behalf even if those amounts are not paid over to the government.

It is not efficient for the IRS to collect payments directly by cash or check and then physically to transport those payments to a bank for deposit. Thus, a more efficient system has been established for taxpayers who pay, or who collect and pay over, large amounts of tax. These taxpayers must deposit their payments directly into government accounts at Federal Reserve branches or at commercial banks authorized to act as Federal depositories. Currently, such deposits account for over 80 percent of the Federal government's cash flow.[263] To enhance efficiency even further, organizations and individuals who deposit significant amounts of tax must now make their deposits via electronic funds transfers ("EFT").

Deposit requirements

In general

The IRS has broad authority to determine how Federal taxes are to be collected.[264] Present law permits the Secretary to authorize the use of Federal Reserve branches, commercial banks, savings and loans, and credit unions that are depositories or financial agents of the Federal government to accept tax payments on the government's behalf under such conditions as the Secretary may prescribe.[265] The IRS has provided detailed guidance specifying how, how much, where, and when Federal taxes are to be deposited. Under these rules, deposits are required for taxes paid in connection with the following Federal tax returns:

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[263] According to 1997 IRS Data Book and Joint Committee staff estimates.

[264] Sec. 6302(a).

[265] Sec. 6302(c).

Form 720 Quarterly Federal Excise Tax Return
Form 940 Employer's Annual Federal Unemployment Tax (FUTA) Return
Form 941 Employer's Quarterly Federal Tax Return
Form 943 Employer's Annual Tax Return for Agricultural Employees
Form 945 Annual Return of Withheld Federal Income Tax[266]
Form 990-C Farmer's Co-op Income Tax Return
Form 990-T Exempt Organization Business Income Tax Return
Form 1042 US Annual Return of Income Tax Paid at Source[267]
Form 1120 U.S. Corporation Income Tax Return
Form CT-1 Employer's Annual Railroad Retirement Tax Return

To avoid penalties, tax depositors must make their payments in full, on time, and in the right manner. For example, Red Corp. owes $10,000 worth of excise taxes, due on March 1. On that date, Red delivers $10,000 in cash to the IRS service center where it files its excise tax returns. Blue Corp. also owes $10,000 worth of excise taxes, due on March 1. Blue deposits the full amount at a Federal depositary on March 4. Result: Red and Blue are both subject to penalty. Red made its payment in full and on time, while Blue was three days late. But Red did not follow correct payment procedures. Because of the amount it owed, Red was required to deposit its tax payment at a Federal depositary, not pay it directly to IRS. The government, as a practical matter, did not have immediate use of Red's payment because of the delay inherent in processing and depositing cash received at an IRS service center.

General employer's withheld income and FICA taxes (Form 941)

In general.--The largest category of tax deposits and the largest single source of Federal government revenue consists of employment taxes deposited by employers in connection with Form 941. For this purpose, employment taxes generally include income tax withheld from wages, tips, taxable fringe benefits, and supplemental unemployment compensation benefits, and the amounts withheld for the employer and employee share of social security and medicare taxes.

Employers are classified by size of tax liabilities for purposes of determining (1) whether an employer has to make deposits, (2) how often it must make them, and (3) how it must make them. Small employers do not have to deposit employment taxes. Medium size employers must deposit their taxes once a month. Larger employers must deposit their taxes up to twice a week (and sometimes more often than that). Most larger employers must make their tax deposits via EFT.

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[266] This relates to non-payroll income tax withholding (i.e., backup withholding on interest, dividends, etc., withholding on IRAs, pensions, annuities, gambling winnings, and deferred compensation).

[267] Relates to withholding on U.S.-source income of foreign persons.

Most employers can determine at the beginning of each calendar year the deposit schedule that applies for the year.[268] The determination of the employer's deposit requirements for a calendar year depends upon the aggregate amount of employment taxes reported by the employer during a lookback period, which is the twelve month period ending on June 30 of the preceding calendar year.

Employers with less than $1,000 of liability.--An employer does not have to make deposits for any calendar quarter in which its employment tax liabilities are below $1,000. Instead it may send its tax payments directly to the IRS along with its Form 941.[269] This rule overrides any deposit requirements that would otherwise apply based on the employer's status under the lookback period rules.

Once-a-month depositors.--Employers whose employment taxes are $50,000 or less during the lookback period are required to make their deposits once a month. Each month's deposit is due the 15th day of the following month. If the 15th day of the following month is not a banking day, the deposit is due the first banking day after the15th.[270]

Twice-a-week depositors.--An employer with more than $50,000 of employment taxes during the lookback period is required to make its deposits up to twice a week, depending on when and how often it has paydays. The deposit schedule is determined as follows:

Taxes for any payday on:	Must be deposited by:
Saturday through Tuesday	The following Friday
Wednesday through Friday	The following Wednesday

In a normal week, there are never less than three weekdays between the end of a half-weekly deposit period and the deposit deadline. For example, for the half-weekly period ending on Tuesday, an employer usually has up to the close of normal banking hours on Friday to make its deposit. If any of these weekdays is a bank holiday, the due date of the deposit is extended accordingly.[271]

Next-business-day depositors.--Whenever an employer's cumulative employment tax liability reaches $100,000 within a single deposit period, it becomes liable to make deposits on

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[268] Treas. Reg. sec. 31.6302-1(b).

[269] Treas. Reg. sec. 31.6302-1(f)(4).

[270] Treas. Reg. sec. 31.6302-1(c)(1).

[271] Treas. Reg. sec. 31.6302-1(c)(2).

the following banking day. The details of this rule vary depending on whether the company is on a once-a-month or twice-a-week schedule before reaching the $100,000 threshold.

In the case of an employer required to make monthly deposits, when the cumulative liability reaches $100,000 for a particular month, then (1) the company must deposit its cumulative tax liability by the following banking day;[272] and (2) the company becomes a twice-a-week depositor for the rest of that calendar year and for all of the following calendar year.[273]

In the case of an employer required to make twice weekly deposits, when the cumulative liability reaches $100,000 or more as of any day, the company must deposit those taxes by the following banking day.[274] An employer with multiple divisions and/or locations may have several paydays a week. Such an employer could cross the $100,000 threshold more than once during a half-week period and would have to make next-banking-day deposits each time.

EFT Deposits.--An employer whose aggregate deposits of withheld income, FICA, and railroad retirement taxes were more than $78,000,000 in 1993 or more than $47,000,000 in 1994 must make its Federal tax deposits by EFT. An employer that becomes subject to EFT rules remains subject to them permanently and must make all of its tax deposits (not just employment tax deposits) via EFT.[275] An EFT depositor that pays by any other means is subject to a 10-percent penalty.[276]

IRS has proposed modifying the deposit threshold at which companies become mandatory EFT depositors for periods that begin on or after January 1, 2000. The proposal covers companies whose deposits have exceeded $200,000 in 1998 or in any later calendar year. For purposes of determining whether the $200,000 threshold has been met, all tax deposits, not just employment taxes, would be taken into account.[277] IRS had previously issued regulations requiring companies with $50,000 or more of employment tax deposits in 1995 to begin making their deposits by EFT starting with deposits due on or after January 1, 1997. Companies with $50,000 or more of employment tax deposits in 1996, were to begin making their deposits by EFT starting with deposits due on or after January 1, 1998. In a series of penalty waiver announcements, IRS effectively postponed the start of mandatory EFT deposits based on prior year's liabilities of

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[272] Treas. Reg. sec. 31.6302-1(b)(3)(i).

[273] Treas. Reg. sec. 31.6302-1(b)(2)(ii).

[274] Sec. 6302(g); Treas. Reg. sec. 31.6302-1(b)(3)(ii).

[275] Treas. Reg. 31.6302-1(h)(2).

[276] Rev. Rul. 95-68, 1995-2 C.B. 272.

[277] Prop. Treas. Reg. sec. 31.6302-1(h)(2)(ii).

$50,000 through the end of 1999.[278] Under the latest proposal, companies with deposit liabilities between $50,000 and $200,000 will not be required to make EFT deposits.

Waiver for small deposit shortfalls.--The failure-to-deposit penalty is automatically waived for any shortfall that is either below $100 or less than 2 percent of the required deposit. To qualify for this waiver, the employer must deposit the shortfall (1) by the return due date, in the case of once-a-month depositors, or (2) by the first deposit date that falls on or after the 15th day of the following month (but not later than the return due date), in the case of twice-a-week or next-banking-day depositors.[279] Although due dates for shortfall deposits generally coincide with the due dates for regular deposits, shortfall makeups must not be combined with the regular deposit. If a shortfall is not deposited separately, it will not be recognized as a makeup deposit, and the employer is likely to be penalized.

Farm employers' withheld income and FICA taxes (Form 943)

Farm employers are also separated by size into once-a-month and twice-a-week depositors. However, certain differences apply. In particular, there is a 12-month rather than a 6-month lag between the end of each lookback period and the start of the related deposit period.[280] In addition, employment taxes on farm wages must be deposited separately from the tax on nonfarm wages. An employer that has both farm and nonfarm employees must count the tax on farm wages separately from the tax on nonfarm wages in determining employment taxes during lookback periods and in determining whether the $100,000 threshold for next-banking-day deposits has been crossed.[281]

Railroad employers' withheld income and Railroad Retirement Tax Act (RRTA) taxes (Form CT-1)

Employers of railroad workers generally are subject to the same rules that apply to other employers. However, an employer with employees subject both to FICA and RRTA taxes must deposit them separately, and RRTA taxes are not generally aggregated with FICA taxes to determine which set of deposit rules are applied. Like farm employers, railroad employers use a lookback period that ends 12 months before the start of a given calendar year (rather than one

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[278] See Notice 97-43, 1997-2 C.B. 294; Notice 98-30, 1998-22 I.R.B. 9; Notice 99-12, 1999-9 I.R.B. 44. See also sec. 931 of the Taxpayer Relief Act of 1997 (Pub. L. 105-34).

[279] Treas. Reg. sec. 31.6302-1(f)(3).

[280] Treas. Reg. sec. 31.6302-1(f).

[281] Treas. Reg. sec. 31.6302-1(g).

ending 6 months before) to determine whether they are once-a-month or twice-a-week depositors.[282]

Non-payroll income tax withholding (Form 945)

Organizations that withhold non-payroll income taxes, such as backup withholding on interest, dividends, etc., or withholding on IRAs, pensions, annuities, gambling winnings, and deferred compensation, must deposit such taxes separately from any employment taxes. Status as a once-a-month or twice-a-week depositor is determined at the beginning of each calendar year. It depends on whether or not the organization deposited more or less than $50,000 worth of such taxes during a 12-month lookback period. As with farm and railroad employers, there is a 12 month rather than a 6 month lag between the end of the lookback period and the beginning of the related calendar year.[283]

Income tax withholding on non-U.S. individuals and corporations (Form 1042)

In general.--Organizations that withhold income tax on payments such as interest, dividends, royalties, etc. payable to non-U.S. taxpayers must track the amounts they are required to withhold and make their deposits on a schedule based on how much and how quickly these taxes accumulate. These depositors do not get the benefit of a lookback period that lets them know in advance what their deposit schedule will be. The frequency of their deposits always depends on events that occur during the deposit period.

Four-times-a-month depositors.--If the accumulated withholding is $2,000 or more at the end of any quarter-monthly period, it must be deposited by the 3rd banking day following the close of the quarter-month.[284] For shortfalls of 10 percent or less, the penalty is waived if the shortfall is deposited by the first regular deposit due date that falls after the 15th of the following month, but no later than January 31 for December shortfalls. These shortfall liabilities are ignored in determining whether the $2,000 threshold for making a deposit has been met.[285]

Once-a-month depositors.--If quarter-monthly deposits are not required under the rule described above, accumulated withholding that totals $200 or more by the end of any month must be deposited by the 15th of the following month (or by the next banking day after the 15th if the 15th is not a banking day).[286]

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[282] Treas. Reg. sec. 31.6302-2.

[283] Treas. Reg. sec. 31.6302-4(c)(2).

[284] Treas. Reg. sec. 1.6302-2(a)(1)(ii).

[285] *Id.*

[286] Treas. Reg. sec. 1.6302-2(a)(1)(i).

No deposit required.--Withholding that does not have to be deposited under the once-a-month or 4-times-a-month rules can be paid directly to the IRS when the related Form 1042 is filed.[287]

Corporate and nonprofit organization income and unrelated business tax (UBIT) deposits (Forms 1120, 990-C, and 990-T)

All corporate income and UBIT tax payments, both quarterly estimated taxes and return balances, must be deposited rather than paid directly to the IRS.[288] Deposits made by mail and actually received by a depositary are considered timely if they are postmarked at least two days before the actual due date (even if received after the due date).[289] Organizations that are EFT depositors (either for employment taxes or for nonpayroll withholding) must deposit their corporate income taxes or UBIT via EFT.[290]

Excise tax deposits

Deposit schedules for excise taxes cover a wide range of different taxes subject to varying deposit schedules. Most excise taxes must be deposited twice a month, usually within 9 days after the close of each half-monthly period. Some taxes are due for deposit on the 14th day following the end of the half-month.[291] Half-monthly deposits of excise taxes on airline tickets and communications services are due one half month plus one week and three business days after the close of each half monthly period.[292]

Some September deposits are subject to accelerated due dates. For example, deposits due under the normal 9 or 14 day rules for the period, September 16 through September 25 must be deposited by September 28.[293] EFT depositors must deposit amounts for the period, September 16 through September 26 by September 29.[294] Airline ticket and communications services tax

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[287] Treas. Reg. sec. 1.6302-2(a)(1)(iv).

[288] Sec. 6302(c).

[289] Treas. Reg. sec. 1.6302-1(b).

[290] Treas. Reg. sec. 1.6302-1(a)(2).

[291] Treas. Reg. sec. 40.6302(c)-1. For ozone-depleting chemicals, the taxes are due for deposit within 30 days of the end of the half-month.

[292] Sec. 6302(e)(1).

[293] Sec. 6302(f)(1).

[294] Sec. 6302(f)(3).

deposits for the period September 1 through September 10 must be deposited by September 28. For EFT depositors, airline ticket and communications services tax deposits for the period September 1 through September 11 must be deposited by September 29.[295]

Penalties for failure to deposit

Under present law, there is a 4-tier penalty rate structure for failures to make deposits. This penalty structure is designed to reward timely voluntary correction of deposit shortfalls and/or quick compliance with IRS payment demands. The applicable penalty rates are as follows:

Tier 1: 2 percent if a taxpayer corrects a late or underdeposited amount within 5 days after the due date of the return on which it takes credit for the deposit.

Tier 2: 3 percent additional (5 percent overall) on late or short deposits that a taxpayer corrects more than 5 days after the return due date, but within15 days.

Tier 3: 5 percent additional (10 percent overall) on late or short deposits that a taxpayer corrects more than 15 days after the return due date.[296]

Tier 4: 5 percent additional (15 percent overall) on deposits that are not made within 10 days after IRS issues a delinquency notice (or that are not made on the date IRS issues an immediate payment demand in jeopardy cases).[297]

The IRS's current procedure, under which it for applies deposits against a taxpayer's oldest open balance, can trigger multiple penalties based on a single shortfall. For example, Green Corp. is required to deposit withheld income and FICA taxes eight times a month. For the first calendar quarter of 1999, Green's withheld taxes total $25,000 for each deposit period. Green erroneously deposits only $15,000 for the first deposit period. It then deposits the full $25,000 for each subsequent period. IRS will assess a $200 penalty (2 percent of $10,000) for the first deposit period. When it receives Green's second deposit of $25,000, IRS will credit $10,000 to cover the shortfall for the first period and apply $15,000 to the second deposit period. Since the second deposit period is now short $10,000, IRS will assess another $200 penalty

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[295] Sec. 6302(e)(2).

[296] Sec. 6656(b)(1)(A).

[297] Sec. 6656(b)(1)(B). This tiered structure was enacted in 1989, when Congress made substantial changes in the structure of the failure-to-deposit penalty. Congress felt the prior-law flat 10 percent penalty was too harsh in some instances. It also felt taxpayers should be given incentives to correct underpayments as quickly as possible and to comply promptly with IRS payment requests. The Omnibus Budget Reconciliation Act of 1989, P.L. 101-239, replaced the flat 10 percent penalty with this four tiered penalty rate structure.

against Green for the second deposit period. This sequence will be repeated as each deposit comes in. By the end of the quarter, Green will have been assessed 24 penalties, totaling $4,800, even though it only made a single $10,000 underpayment on its first deposit obligation for the quarter.

To mitigate this problem, the IRS Reform Act provided that a taxpayer is permitted to designate the deposit period to which payments are applied. The taxpayer can make this designation anytime during the 90-day period after IRS mails a penalty notice. To make the designation, the depositor need only phone the toll-free number shown on the penalty notice and designate the period to which a payment(s) is applied. So long as the designation is within the scope of the statute, the IRS will honor it.[298]

In addition, the IRS Reform Act provides that, beginning with deposits due after December 31, 2001, each deposit will first be applied to the most recent open period rather than the earliest period, unless a taxpayer explicitly designates otherwise.[299]

Penalty waiver and abatement

Explicit waiver authority for changes in circumstances

The IRS has explicit authority to waive the failure-to-deposit penalty in some cases. To be eligible for a waiver of the penalty, the depositor must (1) have inadvertently failed to comply with the deposit requirements, (2) have filed the related return on time, (3) meet the net worth requirements applicable for an award of attorneys' fees (i.e., generally have a net worth of $2,000,000 or less (for individuals, estates or trusts) or $7,000,000 or less (for corporations, partnerships, unincorporated association, organizations, etc.) and have no more than 500 employees), and (4) be subject for the first time to either the deposit requirements themselves or to a more frequent deposit schedule than the one to which the taxpayer had previously been subject.[300]

Reasonable cause abatement

The failure-to-deposit penalty can be abated if the taxpayer establishes the failure resulted from reasonable cause and not willful neglect.[301] A taxpayer seeking abatement must file a

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[298] Notice 99-10, 1999-2 IRB 11.

[299] Sec. 6656(e).

[300] Sec. 6656(c).

[301] Sec. 6656(a).

statement of the facts establishing reasonable cause and lack of willful neglect with the IRS Service Center where it files its returns. The statement must be made under penalty of perjury.[302]

Examples of cases in which taxpayers were found to have had reasonable cause include the following: (1) reasonable belief that employees were independent contractors,[303] (2) difficulty in coordinating information received from multiple work locations, coupled with reasonable attempts to estimate the required amounts,[304] and (3) evidence that an EFT depositor gave proper instructions to a bank that was to carry out the funds transfer.[305]

In certain cases, taxpayers have tried but failed to establish reasonable cause for purposes of abatement of the penalty. In cases of employee malfeasance, courts hold employers to a high standard in supervising employees responsible for making tax deposits.[306] For example, in one case, an auto dealer's bookkeeper, the victim of an abusive personal relationship, failed to deposit payroll taxes and intercepted IRS correspondence to keep her employer from finding out about the problem. When the dealer discovered the problem, it promptly paid the back taxes and the IRS abated penalties that resulted. A few years later, believing the bookkeeper had gotten beyond her personal problems, the dealership rehired her. At first she was closely supervised by an outside accounting firm, but eventually it was decided that she could work on her own. When she again failed to make the deposits and tried to interfere with IRS communications to her employer, the dealer again made full payment of all back taxes. This time IRS refused to waive the penalties, and the US District Court for the District of Minnesota concurred. The Court pointed out that

> Since a corporation can only act through its employees or officers, the failure of a corporation to timely file tax returns or to timely make required tax payments or deposits almost invariably will be the result of the failure of one or more of the corporation's employees or officers to carry out his or her assigned duties. If an employee or officer's

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[302] Treas. Reg. sec. 301.6656-1(b).

[303] Lieb, Jr. v. U.S., 438 F. Supp. 1015 (D. Okla. 1977); Diaz v. U.S., 71A AFTR-2d 93-3563, 90-1 USTC ¶50,209 (USDC, CD-CA, 1990).

[304] FMC Corp. v. U.S., 74 AFTR 2d 94-5626, 94-2 USTC ¶50,416 (N.D. Ill. 1994); Dana Corp. v. U.S., 764 F. Supp. 482 (N.D. Ohio 1991).

[305] Rev. Rul. 94-46, 1994-2 CB 278.

[306] Conklin Bros. Of Santa Rosa v. U.S., 986 F. 2d 315 (9th Cir. 1993); San Diego Drywall v. U.S., 56 F.3d 73 (9th Cir. 1995); Valen Mfg. Co. v. US, 90 F.3d 1190 (6th Cir. 1996); Obstetrical & Gynecological Group, P.A. v. U.S., 44 AFTR 2d 79-5438, 79-2 USTC ¶9511 (USDC, D-DC, 1979).

non-performance of duties was deemed to be reasonable cause, the IRS would rarely be able to impose tax penalties on a corporation.[307]

The court applied a standard under which the dealer would have had to show that the bookkeeper's actions amounted to criminal misbehavior in order to justify penalty abatement.

In cases of financial hardship, there is considerable controversy over the question of when, if ever, such hardship can serve as a reasonable cause for delay in depositing trust fund taxes. A few courts have accepted financial hardship as reasonable cause when the only practical alternative would be to go out of business.[308] In practice, such a justification is rarely accepted.[309] In one recent case, the court explicitly held that financial hardship could, in theory, serve as reasonable cause for failing to make timely deposits but went on to rule that the taxpayer in the case before it had failed to demonstrate sufficient hardship to qualify for relief.[310]

Recommendation

In the past few years, Congress has mandated a number of changes to eliminate unwarranted penalties and to enable the Federal tax deposit system to function more smoothly. Among these are provisions making abatement routinely available for companies newly subject to deposit requirements and for companies newly subject to accelerated deposit schedules. Other changes facilitate greater taxpayer control over the way their deposits are credited in order to eliminate "cascading" penalties. Many of these changes have only recently begun to take effect or have future effective dates to allow IRS time to make needed changes in its data processing facilities and procedures. In addition, the IRS has proposed changes and delayed implementation of electronic deposit requirements to ease the burden on smaller businesses and to facilitate a smoother transition for those companies that will be participating in the system.

The Joint Committee staff recommends that no new legislation be enacted in this area for at least two years in order to allow these scheduled statutory and regulatory changes to be

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[307] Mason Motors Co. v. U.S., 8 F. Supp. 2d 1177, 1180 (D. Minn. 1998).

[308] In re: Pool & Varga, Inc., 58 AFTR 2d 86-5373, 86-1 USTC ¶9445 (E.D. Mich. 1986); In re: Slater Corp., 76 AFTR 2d 95-7113, 96-1 USTC ¶50,043 (Bankr. D. Fla. 1995).

[309] See, e.g., Brewery, Inc. v. U.S., 33 F.2d 589 (6th Cir. 1994); C.J. Rogers, Inc. v. U.S., 66 AFTR 2d 90-5831, 91-1 USTC ¶50,297 (E.D. Mich. 1991); Ray Steven Paving Co. v. U.S., 72 AFTR 2d 93-5573, 93-2 USTC ¶50,539 (D. Ariz. 1993); In re: Woodstein Lauderdale, Inc., 74 AFTR 2d 94-6256 (Bankr. D. Fla. 1994); In re: Upton Printing Co., 76 AFTR 2d 95-5308, 95-2 USTC ¶50,377 (Bankr. D. La. 1995); In re: Gordon Selway, Inc., 76 AFTR 2d 95-6162, 95-2 USTC ¶50,456 (Bankr. D. Mich. 1995); Bostar Foods, Inc. v. U.S., 79 AFTR 2d 97-1041; 97-1 USTC ¶50,285 (W.D. Ky. 1997).

[310] Fran Corp. v. U.S., 998 F. Supp 296 (S.D.N.Y. 1998).

implemented and evaluated. However, the Joint Committee staff will continue to monitor carefully how the recent statutory and regulatory changes have affected the administration of the rules relating to deposit requirements and the waiver and abatement of penalties for failure to deposit and whether further statutory changes are necessary to enhance the effectiveness and user-friendliness of the systems relating to deposits of Federal taxes.

One specific area that the Joint Committee staff will continue to monitor is the operation of, and exceptions to, the lookback mechanism. The current-rule lookback mechanism allows most employers to know at the start of each return period when they will be required to make deposits; consequently, most employers can stay on the same deposit schedule for the entire calendar year. But certain events that occur during a return period may trigger an abrupt change in the deposit schedule. For example, a small employer, anticipating a deposit liability below $1,000 for a calendar quarter may assume it is exempt from depositing requirements. If unforeseen payroll increases in the last month of the quarter cause it to exceed the $1,000 threshold, it will be delinquent on deposits it should have made for the first two months.

When events like these occur, the employers involved often do not realize there is a problem until they receive a penalty notice, which typically arrives several months after the event. In the meantime, the taxpayer will often have been operating under less restrictive rules for which it no longer qualifies, and will have accumulated a number of delinquencies. Existing rules provide for abatement of penalties on the first missed deposit under these circumstances, but there is no explicit authority for abating subsequent penalties that may have arisen in the interim.

Treasury may wish to consider revising its deposit regulations so that events such as these generally trigger a change in the deposit schedule in a later calendar quarter. This would give the IRS an opportunity to notify the taxpayer of the change in status before it takes effect. It would also give the depositor time to recognize its new obligations and adjust its operating procedures accordingly.

Payroll service providers have come to play an increasingly important role in the deposit system. In general, the industry has enhanced the system's efficiency. However, as with any large volume operation, some level of error is inevitable. When errors do occur, they may involve large numbers of taxpayers in various locations across the country. Current IRS procedures often require such problems to be handled on a case-by-case basis. This typically involves a large expenditure of time and resources by the service providers and by the IRS. The Joint Committee staff recommends that the IRS continue to work with payroll service providers to expedite resolution of problems where a single error or mishap may impact multiple taxpayers.

G. Tax Return Accuracy Penalties

1. Overview

Under present law taxpayers and tax preparers are required to make the following statement under penalty of perjury on their Federal income tax return:

> *I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.*

Failure to satisfy the obligations embodied in the foregoing statement are sanctioned with both criminal and civil penalties. It is a felony to sign a return unless the signer believes it to be "true and correct as to every material matter." However, criminal prosecution and conviction is rare because the government must prove the offending taxpayer's guilty state of mind beyond a reasonable doubt. Two of the Code's civil penalties, sections 6662 for taxpayers and 6694 for tax professionals, provide the principal means by which the Federal government assures accuracy of tax return information.

Section 6662 establishes a penalty for substantial understatement of tax liability on an income tax return, but this section does not establish an ethical standard of conduct for taxpayers. Section 6694 imposes a penalty on a tax preparer who prepares a tax return which understates tax liability and fails to meet certain other requirements. As described below, the thresholds for avoidance of a penalty when taking an aggressive position on a tax return are so low, they provide little incentive for taxpayers to determine the appropriate tax treatment for such items on their returns. In addition, the IRS audits only a small fraction of the returns filed in any given year. For 1997, the IRS audited only 1.28 percent of all individual income tax returns and 2.67 percent of all corporate income tax returns.[311] This gives rise to what is referred to as the "audit lottery." As noted in Part V, above, a taxpayer weighs the costs of noncompliance with the potential benefits in determining whether to engage in noncompliant behavior. One of the costs of noncompliance is the risk of getting caught. Thus, a low audit rate will make it more likely that a taxpayer will engage in noncompliant behavior.

Most tax professionals recognize a dual responsibility to their clients and to the integrity of the tax system as a whole. However, in cases in which tax professionals view their role as predominantly one of advising a client as to the most aggressive tax return position, the self-assessment aspect of our tax system is undermined. To combat this problem, section 6694 penalizes return preparers who assist taxpayers in understating tax liabilities on their returns.[312]

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[311] According to Internal Revenue Service, *1997 Data Book.*

[312] Sec. 6694.

Specific procedural rules govern these "preparer penalties."[313] Preparers also may be subject to penalties aimed generally at abusive tax shelter promoters and at people who aid or abet tax understatements.[314]

2. Present law

a. Accuracy-related penalty

The accuracy-related penalty is imposed on taxpayers at a rate of 20 percent of the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement.[315] If the correct income tax liability for a taxable year exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 ($10,000 in the case of most corporations), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.

In determining whether a substantial understatement exists, the amount of the understatement generally is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment. Substantial authority is an objective measure of accuracy which requires a balancing of various authorities by assessing their relative weight of persuasiveness and relevance. Regulations identify the relevant authorities permitted to be used for this analysis.[316] While reasonable basis along with disclose generally avoids imposition of a penalty, in no event does a corporation have a reasonable basis for its tax treatment of an item attributable to a multi-party financing transaction if such treatment does not clearly reflect the income of the corporation.[317]

The accuracy-related penalty also applies to that portion of the understatement of tax attributable to the taxpayer's negligence without regard to whether the understatement is substantial in proportion to the taxpayer's tax liability. Negligence involves the failure to use reasonable care by taking a position on the return which does not have a reasonable basis. This has generally been interpreted to mean whether a "reasonably prudent person" would have acted in a similar manner

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[313] Sec. 6696.

[314] Secs. 6700-6701, and 6703. (See Part VIII, below, for Joint committee staff recommendations relating to corporate tax shelters.

[315] Sec. 6662.

[316] Treas. Reg. sec. 1.6662-4(d)(3)

[317] Treas. Reg. sec. 1.6662-4(d)(3)(ii).

as the taxpayer. Negligence also arises if the taxpayer carelessly, recklessly, or intentionally disregards a rule or a regulation. For this purpose, rule or regulation generally means Code provisions, final and temporary regulations, and published revenue rulings and notices.

Reasonable basis is the minimum accuracy standard for negligence. If a return position lacks reasonable basis, then negligence applies. If a taxpayer takes a position contrary to a rule or regulation, the taxpayer is not treated as disregarding the rule or regulation if the position has a realistic possibility of being sustained on its merits.[318] A taxpayer may also avoid a penalty for disregard of a rule or regulation if the taxpayer has a reasonable basis for the position and discloses this position. Return positions not having a reasonable basis are by definition to be negligent and subject of the negligence penalty.

Special rules apply for "tax shelters." With respect to tax shelter items of non-corporate taxpayers, the penalty may be avoided only if the taxpayer establishes that, in addition to having substantial authority for his position, he reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. The penalty cannot be avoided in the case of (1) a partnership or other entity, (2) an investment plan or arrangement, or (3) any other plan or arrangement, if a significant purpose of such partnership, entity, plan or arrangement is the avoidance or evasion of Federal income tax.

The understatement penalty generally is abated (even in the case of corporate tax shelters) in cases if the taxpayer can demonstrate that there was "reasonable cause" for the underpayment and that the taxpayer acted in good faith. The relevant regulations provide that reasonable cause exists if the taxpayer "reasonably relies in good faith on an opinion based on a professional tax advisor's analysis of the pertinent facts and authorities [that] . . .
unambiguously concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service."[319]

b. Preparer tax return penalty

1st tier penalty

A return preparer is subject to a $250 penalty if: (1) a return or refund claim is prepared and reflects a position which does not have a realistic possibility of being sustained on its merits; (2) the taxpayer's liability is understated as a result of the position; and (3) the preparer knows or should know the position is reflected on the return or claim.[320]

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[318] Treas. Reg. sec. 1.6662-3(b)(2).

[319] Treas. Reg. sec. 1.6662-4(g)(4)(i)(B).

[320] Sec. 6694(a).

The 1st tier penalty can be avoided if: (1) a return position that does not have a realistic possibility of being sustained on its merits is disclosed and is not frivolous,[321] or (2) if a preparer shows there was reasonable cause for the understatement and that he or she acted in good faith.[322] A return position is "not frivolous" if it is not patently improper.[323] Reasonable cause and good faith take into account a number of factors including (1) did the error result from a complex, uncommon, or highly technical provision of the law; (2) has the preparer made this sort of error often; (3) is this an isolated error which is so obvious, flagrant, or material that it should have been caught and corrected even in an isolated instance; (4) is the error material; and (5) is the preparer's normal office practice designed to ensure accuracy and consistency in the preparation of returns. However good office practice will not justify abatement for frequent or flagrant errors, or errors that are part of a pattern.[324]

The preparers' "not frivolous" standard, is not well defined. There is very little judicial precedent, for example, to illustrate the meaning of "frivolous." In one case related to section 6702, which penalizes taxpayers for filing frivolous returns, the Third Circuit U.S. Court of Appeals noted that the statute "does not define the terms 'position' or 'frivolous,' but whatever else is meant by the term 'frivolous,' it is reasonable to conclude that a claim is frivolous when there is no argument on either the law or the facts to support it."[325]

A preparer who has been penalized may contest the penalty (and freeze collection action) by paying at least 15 percent of the amount assessed within 30 days of the notice and demand date and then filing a refund claim. If IRS denies the refund claim, the preparer has another 30 days to sue for a refund in U.S. District Court. If the IRS fails to act on the refund claim within six months, the preparer has 30 days (beyond the six month waiting period) to bring suit.[326] If a refund suit is filed, IRS can counterclaim for the balance of the penalty.[327] A preparer who pays the full penalty has three years from the date of payment to file a refund claim.[328]

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[321] Sec. 6694(a)(3).

[322] Sec. 6694(a).

[323] Treas. Reg. sec. 1.6694-2(b)(2).

[324] Treas. Reg. sec. 1.6694-2(d).

[325] Kahn v. United States, 753 F.2d 1208, 1214 (3rd Cir. 1985)

[326] Sec. 6694(c).

[327] Sec. 6694(c)(1).

[328] Sec. 6696(d)(2).

Under Treasury regulations, a return preparer for purposes of this penalty is anyone who is paid for preparing a return or a substantial portion of a return.[329] A return preparer need not physically put words or numbers on a form or schedule. It is enough if the preparer furnishes sufficient information and/or advice for the return (or a significant portion of it) to be prepared. However, simply giving legal advice about the tax consequences of a situation or transaction is not enough to make someone a preparer. The advice must be about facts already in existence or a transaction that has already taken place, and it must relate to determining the existence, character, or amount of a return entry.[330] Since a person can be a preparer without entering information on a return, or signing the return, several persons working for a single organization might satisfy the definition. For example, several members of a law firm might collaborate in giving advice on how to report a particular transaction on a return. Then several members of an accounting firm might be involved in physically preparing and reviewing the forms and schedules on which that same transaction is reflected. When this happens, only one person per firm is considered a preparer with respect to that return. If someone from a firm signs the return, that individual is considered the preparer. If no one at a given firm is the signing preparer, the person with overall supervisory authority with respect to the return or claim is the preparer from that firm.[331]

The regulations provide that a position has a realistic possibility of being sustained on its merits when someone who is knowledgeable in tax law, having made a reasonable and well informed analysis of the position, would conclude that the chance of winning a contest is at least half as good as the chance of losing, i.e., there is a one in three chance of success. This analysis should take into account the same authorities that determine whether taxpayers have "substantial authority" under the accuracy related penalty for positions taken on their returns."[332]

The regulations state that a signing preparer must make certain disclosures on IRS forms 8275 or 8275-R (which require adequate identification of the rule being challenged by the return position) to avoid the 1st tier penalty. For a limited class of return positions (specified in annual Revenue Procedures issued by the IRS), disclosure of all relevant facts on the regular tax return forms and schedules without attaching forms 8275 or 8275-R is sufficient.[333] For a non-signing preparer who gives return advice directly to a taxpayer, disclosure on the return itself is sufficient. If disclosure on the return is not feasible, the non-signing preparer must (1) tell the client about any return position that does not have a realistic possibility of success and, (2) notify the client that taking the position on a return without disclosing it may trigger an accuracy-related penalty. If the position involves a tax shelter, the client should be told that even disclosure may not help the client

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[329] Treas. Reg. sec. 1.6694-1(b)(1); 301.7701-15(a).

[330] Treas. Reg. sec. 301.7701-15(a)(1).

[331] Treas. Reg. sec. 1.6694-1(b)(1).

[332] Treas. Reg. sec. 1.6694-2(b)(1).

[333] Treas. Reg. sec. 1.6694-2(c)(3)(i) and 1.6662-4(f).

avoid the penalty. If the preparer's advice on the return position is in writing, the disclosure and penalty warning must also be in writing. A preparer who gives oral advice may make the disclosure warning orally as well. But the preparer must then be able to prove the warning was given. A contemporaneously prepared written memorandum of the oral warning will usually satisfy this requirement.[334] For a non-signing preparer who gives return advice to another tax preparer, actual disclosure on the return is adequate. When disclosure on the return is not feasible, the preparer may notify the other preparer of the need to make disclosure under the 1st tier preparer penalty rules. Written advice must be accompanied by a written disclosure warning. Oral advice may be accompanied by an oral disclosure warning, but the preparer must be able to prove the oral warning was provided; this generally done through the preparation of a contemporaneous memorandum.[335]

2nd tier penalty

A preparer is subject to a $1,000 penalty if she prepares a return on which tax liability is understated as a result of (1) the preparer's willful attempt at understatement, or (2) a return position that intentionally or recklessly disregards rules or regulations. If a single position falls under both the 1st tier and 2nd tier penalties, the 2nd tier penalty is reduced to $750, so that the combined penalties add up to $1,000.[336] The same procedure for contesting the penalty is available as with the 1st tier penalty (i.e., paying 15 percent, filing a refund claim, then filing suit in U.S. District Court if the refund claim is denied or not acted upon).[337]

A willful attempt to understate tax liability involves factual distortions, such as ignoring, disregarding, or misstating information furnished by the taxpayer in order to reduce the liability. For example, listing six dependents when the taxpayer informs the preparer he has two dependents, or failing to include items of income the taxpayer has disclosed to the preparer will subject the preparer to this penalty.[338]

Intentional disregard of the rules or regulations includes taking a return position that contradicts a Code provision, a final or temporary Treasury regulation issued under the Code, or a Revenue Ruling or IRS Notice published in the Internal Revenue Bulletin of which the preparer is aware.[339] Reckless disregard of the rules or regulations constitutes taking a return position that

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[334] Treas. Reg. sec. 1.6694-2(c)(3)(i)(A)

[335] Treas. Reg. sec. 1.6694-2(c)(3)(i)(B).

[336] Sec. 6694(b).

[337] Sec. 6694(c).

[338] Treas. Reg. sec. 1.6694-3(b).

[339] Treas. Reg. sec. 1.6694-3(c) and (f).

contradicts a Code provision, a final or temporary Treasury regulation issued under the Code, or a Revenue Ruling or IRS Notice published in the Internal Revenue Bulletin of which the preparer did not know because the preparer made little or no effort to find out about it under circumstances indicating substantial deviation from conduct a reasonable preparer would observe.[340]

A preparer may take a return position that contradicts a known rule or regulation without penalty if (1) the position has a realistic possibility of being sustained on its merits, or (2) the position is adequately disclosed and is not frivolous.[341] Disclosure is adequate for a signing preparer if the disclosure is made on Form 8275 or 8275-R. A nonsigning preparer providing advice to a taxpayer has adequate disclosure if the position is disclosed on Form 8275 or 8275-R. The nonsigning preparer is also protected by advising the taxpayer that the position is contrary to IRS rules and regulations and that the taxpayer may be subject to the accuracy-related penalty unless the challenge is made in good faith and the position is disclosed on form 8275 or 8275-R. A nonsigning preparer providing advice to another preparer is protected by pointing out that the position must be disclosed in accordance with the 2nd tier penalty rules.[342]

Other 1st and 2nd tier issues

The 1st tier preparer penalty is subject to a 3-year statute of limitations starting from the date the relevant return is filed.[343] There is no statute of limitations on assessment of the 2nd tier preparer penalty.[344] The 1st and 2nd tier penalties can only be assessed against a preparer whose actions lead to understatement of a taxpayer's liability.[345]

c. Other preparer penalties

Preparers are subject to certain information reporting and record-keeping penalties. For each category of improper behavior the penalty equals $50 per occurrence, with an annual cap of $25,000. A preparer can avoid any one of these penalties by showing the preparer had reasonable cause and was not willfully neglectful.[346] Penalized behavior includes the following:

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[340] Treas. Reg. sec. 1.6694-3(c) and (f).

[341] Treas. Reg. sec. 1.6694-3(c)(2) and (3).

[342] Treas. Reg. sec. 1.6694-3(e).

[343] Sec. 6696(d)(1).

[344] Lamb v. U.S. 977 F.2d 1296 (8th Cir., 1992); Capozzi v. U.S. 980 F.2d 872 (2nd Cir., 1992).

[345] Sec. 6694(d).

[346] Sec. 6695.

(1) Failure to furnish a taxpayer with a copy of any return or claim prepared for the taxpayer's signature.[347]

(2) Failure to sign any return or claim the preparer is required to sign.[348]

(3) Failure to include a preparer's ID number or, where applicable, the ID number of a preparer's employer on a return the preparer is required to sign.[349]

(4) Failure to retain a copy of the return itself, or a listing of the taxpayer names and ID numbers with respect to each return prepared.[350]

(5) Failure to make return copies or client lists available for IRS inspection.[351]

(6) Failure to file an annual return listing the names and ID numbers of each person employed to prepare returns, or omission of required information on such a return.[352]

Preparers are subject to a penalty of $50 per occurrence, subject to a $25,000 annual cap, for signing or negotiation of a tax client's refund check.[353]

Preparers are subject to a penalty for not exercising due diligence in determining a taxpayer's eligibility for the earned income credit. The penalty is $100 per occurrence with no annual cap.[354]

d. Standards for tax return positions

In general

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[347] Sec. 6695(a).

[348] Sec. 6695(b). For exceptions to this general signature rule see Treas. Reg. sec. 1.6695-1(b)(2), Rev. Rul. 78-370, 1978-2 CB 355, and PLR 9821038.

[349] Sec. 6695(c).

[350] Sec. 6695(d).

[351] *Id.*

[352] Sec. 6695(e).

[353] Sec. 6695(f).

[354] Sec. 6695(e).

The accuracy-related and return preparer penalties are designed to delineate (1) when an erroneous position should be considered innocent and not subject to penalty, (2) when taxpayers should specifically notify the IRS that they are adopting controversial positions, and (3) when taxpayers are taking unduly aggressive positions and should be penalized for any resulting tax deficiency regardless of disclosure.

The following is a brief overview of the standards contained in the accuracy related penalties for taxpayers and preparers:

Standards which do not require disclosure of tax return position to IRS

Taxpayers' "more likely than not" standard

The substantial understatement penalty does not apply in the case of a tax shelter item of a non-corporate taxpayer if the taxpayer had substantial authority for his or her position and the taxpayer can demonstrate that he or she had a reasonable belief that the position is "more likely than not" the proper treatment.[355] This standard generally has been interpreted to mean there is a greater than 50 percent likelihood of prevailing if the taxpayer's position is challenged by the IRS. A taxpayer will be considered to have a reasonable belief that the treatment is more likely than not the proper treatment if the taxpayer relies upon the opinion of a professional advisor and the opinion is based upon the pertinent facts and authorities analyzed similar to the manner described in the substantial authority standard.[356]

Taxpayers' "substantial authority" standard

A taxpayer is not subject to an accuracy related penalty for an undisclosed erroneous return position--even a position that leads to a substantial understatement of tax liability--provided there is "substantial authority" for the position.[357] The regulations describe substantial authority in terms of a spectrum. It means a position that has a less than 50 percent chance of being sustained if

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[355] The Uruguay Round Agreements Act of 1994, P.L.103-465, eliminated the use of this exception for corporate taxpayers. Thus, corporate taxpayers with a substantial understatement from a tax shelter item will have to rely on the reasonable cause exception in section 6664(c) to avoid an understatement penalty. The reasonable cause exception is a facts and circumstances test, but having a reasonable belief that the taxpayer's position is "more likely than not" the proper position will be an important factor in determining whether reasonable cause exists.

[356] Treas. Reg. sec. 1.6662-4(g)(4)(ii).

[357] Sec. 6662(d)(2)(B)(i).

it were challenged, but has a greater chance of success than a position which has a "reasonable basis".[358]

In assessing whether a position was supported by substantial authority when it was adopted, certain specified sources of authority may be consulted.[359] None of these sources of authority are to be viewed in isolation. For example, a judicial opinion in favor of a particular position must be weighed against other specified authority (if there is any) that contradicts the position. The regulations describe a balancing process. A taxpayer can rely on favorable authority and consider it substantial only if its weight is substantial in relation to any countervailing authority that may exist.[360] The regulations list the specific authorities that may be consulted.[361]

Tax professionals' "realistic possibility of being sustained" standard

A tax advisor who is a "preparer" with respect to a tax return or refund claim is subject to a 1st tier penalty if, among other items, the position did not have a realistic possibility of being sustained on its merits.[362]

A return position is considered to have had a realistic possibility of being sustained on its merits if a hypothetical tax professional making a reasonable, well-informed analysis would conclude that the likelihood of the position being upheld was approximately one in three or better.[363]

Standards requiring disclosure of tax return position to IRS

Taxpayers' "reasonable basis" standard

For individuals, the substantial understatement penalty does not apply to any understatement related to a position that (1)was adequately disclosed on the return, (2)the position does not relate to a tax shelter, and (3)it has a "reasonable basis."[364]

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[358] Treas. Reg. sec. 1.6662-4(d)(2).

[359] Treas. Reg. sec. 1.6662-4(d)(3).

[360] *Id.*

[361] Treas. Reg. sec. 1.6662-4(d)(3)(iii).

[362] Sec. 6694(a). Treas. Reg. sec. 1.6694-2(b)(1), described above.

[363] Treas. Reg. sec. 1.6694-2(b)(1).

[364] Sec. 6662(d)(2)(B)(ii).

Legislative history indicates that reasonable basis is intended to be "a relatively high standard of tax reporting." A return position that merely represents a colorable claim or an arguable position would not meet this standard. Significantly, the standard is not met if the best that can be said of a return position is that it is not patently improper.[365] Under the regulations, "patently improper" defines the minimum standard for a tax preparer to avoid penalty through disclosure of a return position.[366] Thus, there is a higher standard for taxpayers than for tax professionals who advise them. Despite the legislative history's "relatively high standard" description, logic dictates that the term "reasonable basis" must imply something less than substantial authority. This is so since a position supported by substantial authority need not be disclosed to avoid the sec. 6662 penalty.

Tax preparers' "not frivolous" standard

If a tax professional is a preparer with respect to a return or refund claim, and the preparer knows or should know of a position taken on the return that falls short of the "realistic possibility of being sustained" standard, and the position causes the tax liability on the return to be understated, then the preparer is subject to penalty unless (1) the preparer took steps to ensure disclosure of the position,[367] and (2) the position is "not frivolous."[368] The regulations define a frivolous position as one that is patently improper.[369] This standard is similar to the litigation standard in the Tax Court under Rule 33 where claims may be litigated if well grounded in fact and warranted by existing law.

The current standards for taxpayers and tax preparers discussed above are summarized in Table 7, below.

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[365] H.Rept. 103-213, Conference Report, Omnibus Budget Reconciliation Act of 1993, Aug. 4, 1993, at 669.

[366] Treas. Reg. sec. 1.6694-2(c)(2).

[367] A signing preparer, in effect, would have to require adequate disclosure as a condition of signing the return. A nonsigning preparer would have to provide a warning concerning the taxpayer's exposure to an accuracy related penalty if the item is not disclosed or, in the case of a tax shelter item, even if it is disclosed. Treas. Reg. sec. 1.6694-2(c)(3).

[368] Sec. 6694(a).

[369] Treas. Reg. sec. 1.6694-2(c)(2).

Table 7.--Existing Standards for Tax Return Positions

Taxpayers' Substantial Understatement of Tax (Sec. 6662)			Practitioners' Preparer Penalty (Sec. 6694)		
Standard	**Likelihood of Success if Challenged [1]**	**Effect of Meeting Standard**	**Standard**	**Likelihood of Success if Challenged**	**Effect of Meeting Standard**
More likely than not	Greater than 50 percent	No penalty exposure for non-corporate tax shelter items where substantial authority also exists	No similar standard	N/A	N/A
Substantial authority	40 percent	No penalty exposure	Realistic possibility of being sustained	33**a** percent or greater	No penalty exposure
Reasonable basis[2]	20 percent	No penalty exposure if disclosed and not a tax shelter item	Not frivolous	5 to 10 percent	No penalty exposure if disclosed. Applies to tax shelter and non-tax shelter items

[1] It is recognized that describing the accuracy standards in terms of their arithmetical probability of success might seem to indicate a high degree of precision. No such precision is intended or implied. The numerical values shown in this table are meant to indicate in general terms the relative levels of accuracy to which taxpayers and practitioners are held. While some may question the value of quantifying these standards due to their inherently uncertain terms, most students of professional conduct standards use these or similar methods to describes these standards. The 33 1/3 percent standard for realistic possibility of being sustained appears in the Treasury regulations under section 6694. All other numerical values shown in the chart represent a general consensus of scholars and practitioners based on a survey of the literature.

[2] Reasonable basis is also the standard that defines negligence.

3. Recommendations

Federal tax law is complex and constantly evolving. It is unrealistic to expect taxpayers to file "perfect" returns, on which every position taken is unquestionably correct. Still, the U.S. Supreme Court has pointed out that "self assessment...is the basis of our American scheme of income taxation."[370] Self assessment requires a high degree of cooperation from the taxpayer to file an accurate tax return. While some have questioned whether the IRS should audit more returns, it is impractical to propose that audits should be a routine fact of life for even a significant minority of taxpayers other than the large multinational firms that are covered by the IRS's Coordinated Examination Program (CEP).

However, as discussed in Part V, above, a self-assessment system will work properly if taxpayers perceive the system to be fair and believe that the costs of noncompliance outweigh the benefits of such noncompliance. Among the costs of noncompliance are (1) the risks of

[370] Commissioner of Internal Revenue v. Lane Wells Co. 321 U.S. 219, 223 (1944).

noncompliance being detected by the IRS and (2) the penalties that are imposed when noncompliance is detected.

The present-law standards for imposition of accuracy-related penalties on taxpayers and return preparers arguably permit taxpayers to take positions on tax returns that have an inappropriately low chance of success if challenged by the IRS. Such a low standard has the effect of increasing perceptions of unfairness because taxpayers who take aggressive positions on their returns are unlikely to be penalized. The low standard also reduces the potential costs of noncompliance because the IRS is less likely to prevail when a return position is challenged.

Therefore, the Joint Committee staff finds it appropriate to make a number of recommendations to increase both (1) the standards for taxpayers and preparers applicable under the accuracy-related penalties and (2) the amount of the return preparer penalty. In addition, the Joint Committee staff makes a recommendation relating to IRS recordkeeping with respect to taxpayer disclosures. The Joint Committee staff believes that these recommendations will improve both the equity and administrability of the accuracy-related penalty system.

a. New minimum tax return standards for taxpayers and tax preparers

Recommendation

The Joint Committee staff recommends that for both taxpayers as well as tax preparers, the minimum standard for each undisclosed position on a tax return is that the taxpayer or preparer must reasonably believe that the tax treatment is "more likely than not" the correct tax treatment under the Code. This standard would imply that at the time the return was signed, there was a greater than 50 percent likelihood that all undisclosed positions would be sustained if challenged. The reasonable cause exception for substantial understatement is repealed.

Analysis

The fact that a tax return is signed under penalty of perjury implies a high standard of diligence in determining the facts and substantial accuracy in determining and applying the rules that govern those facts. An issue with the present-law tax return and preparer standards as well as the professional ethical standards as described by the American Bar Association and the American Institute of Certified Public Accountants is that none of them require the advisor or taxpayer to seek a tax return position that is "probably right." The current standards arguably legitimize taking positions that have at least a 67 percent chance of being unlawful without any requirement of disclosure to the IRS that such aggressive positions are being taken. A more appropriate standard would require that a taxpayer or a tax advisor, who does not disclose an uncertain position, be required to show that any undisclosed positions taken on the return are at least probably correct.

Some of the comments received in connection with this study alluded to a confusing multiplicity of standards for taxpayers and for tax professionals relating to positions taken on tax returns. "More likely than not" is a simple threshold that is easily understood. It would apply for

both taxpayers and tax preparers and, therefore would reduce the complexity inherent in the five present-law standards for taxpayers and tax preparers.

Opponents to a stricter disclosure standard (such as the Joint Committee staff recommendation) have argued that the tax reporting process is an adversarial one similar to the judicial process, and should have similar standards. They assert that the present law "not frivolous" preparer standard is appropriate because it is similar to the "well grounded" standard in the Tax Court. However, because the position on the tax return is assumed to be correct under present law and the risk of challenge by the IRS to that assumption is low, the relationship between taxpayers and the IRS is not strictly analogous to litigants. In litigation, procedural rules have been developed to require full disclosure of facts and legal authority, mandate the presence of an independent arbiter, and permit full examination of the parties' positions. The absence of these or similar items in the tax reporting process justifies standards requiring a higher degree of accuracy than for litigation. Furthermore, it could be argued that the success of a self-assessment system is undermined if taxpayers and the IRS are assumed, for disclosure purposes to be adversaries.

b. New minimum tax return standards for taxpayers and preparers for disclosed return positions

Recommendation

The Joint Committee staff recommends that, for any position taken or advised to be taken on a tax return, substantial authority should be required and such position should be adequately disclosed. For non-corporate tax shelter items, the present-law standard of "more likely than not" will continue to apply as a means to avoid an understatement penalty, but only if such position is also disclosed. The reasonable cause exception for substantial understatement is repealed.

The revised standards for tax return positions as described in the above recommendations are summarized in the following table.

Table 8.–Proposed Standards for Tax Return Positions

Taxpayers' Accuracy Penalties (Sec. 6662)[1,2]			Practitioners' (Sec. 6694)		
Standard	**Likelihood of Success if Challenged**	**Effect of Meeting Standard**	**Standard**	**Likelihood of Success if Challenged**	**Effect of Meeting Standard**
More likely than not	Greater than 50 percent	Generally, no penalty exposure. For non-corporate tax shelter items, no penalty exposure if disclosed.	More likely than not	Greater than 50 percent	Generally, no penalty exposure. For non-corporate tax shelter items, no penalty exposure if disclosed.
Substantial authority	40 percent	No penalty exposure if disclosed and not a tax shelter item	Substantial authority	40 percent	No penalty exposure if disclosed and not a tax shelter item

[1] It is recognized that describing the accuracy standards in terms of their arithmetical probability of success might seem to indicate a high degree of precision. No such precision is intended or implied. The numerical values shown in this table are meant to indicate in general terms the relative levels of accuracy to which taxpayers and practitioners are held. While some may question the value of quantifying these standards due to their inherently uncertain terms, most students of professional conduct standards use these or similar methods to describes these standards. All other numerical values shown in the chart represent a general consensus of scholars and practitioners based on a survey of the literature These standards will also apply to negligence penalties under sec. 6662.
[2] These standards will also apply for negligence.

Analysis

It seems anomalous under present law that "nonfrivolous" return positions that have a less than 10 percent likelihood of being correct do not expose tax preparers to penalty if they are disclosed. The appropriate standard should be one that requires more than a highly speculative possibility of accuracy.

The present-law standards that define erroneous tax positions are explicitly lower for tax professionals than for their clients. Numerous courts have held a taxpayer may have a reasonable basis for an opinion and thus escape penalty, if he or she reasonably relied on a return preparer's advice. Since the preparer is held to a lower standard than the client, it becomes possible under some circumstances to take positions that have no reasonable basis with neither the preparer nor the client at risk of incurring a penalty. The Joint Committee staff recommendations will correct this anomaly by making the standards consistent for both taxpayers and preparers.

With adequate disclosure, a position with a less-than-probable likelihood of success can be tolerated. Under current guidelines, this would allow taxpayers and their advisors to assert controversial tax return positions that fail to satisfy the "more likely than not" standard, provided they make adequate disclosure, and provided that a well reasoned analysis of authoritative sources would support the conclusion that there exists a greater than 33-1/3 percent likelihood of success.

Requiring disclosure of these items while maintaining the present-law standard of requiring taxpayers to reasonably believe that their tax treatment is proper represents the proper balance for these items in comparison to the other recommended tax return standard changes in this study for corporate tax shelters.

It must be recognized that positions that fall short of a "more likely than not standard" may ultimately be vindicated. Thus taxpayers and their professional advisers should be allowed, within reasonable limits, to take return positions that fall short of a "more likely than not standard," provided such positions are adequately disclosed.

However, disclosure has limited usefulness. Even with disclosure, taxpayers should not be allowed to take any position on a tax return that has less than a 10 percent likelihood of being correct. A standard that low puts a nearly impossible burden on IRS efforts to use disclosures effectively.

c. IRS usage of disclosures made by taxpayers

Recommendation

Current IRS records do not provide adequate detail to judge how effectively the IRS has used taxpayer disclosures to monitor and counter unduly aggressive return positions. The Joint Committee staff recommends that the IRS be required to maintain records that will make monitoring IRS' usage of taxpayer disclosures possible, and that the IRS report periodically to the Congress on the efforts it is making to use taxpayer disclosures for purposes of effective enforcement. If situations exist where the disclosures are not of use to the IRS, the IRS should recommend that such disclosures be eliminated.

d. Revise preparer penalty amounts

Recommendation

The Joint Committee staff recommends that the section 6694 penalties be revised to better reflect the potential tax liabilities involved. In general, the practitioner's fee for preparing or advising a taxpayer with regard to a return is likely to be roughly commensurate with the client's actual or potential exposure to tax liability and the complex issues reported on the return. Under the Joint Committee staff recommendation, the 1st tier section 6694(a) penalty would be changed from a flat $250 amount to the greater of $250 or 50 percent of the tax preparer's fee. The 2nd tier section 6694(b) penalty would be changed from a flat $1,000 amount to the greater of $1,000 or 100 percent of the preparer's fee.

Analysis

Under certain circumstances, the present-law preparer penalty amounts may be inappropriately low and, therefore, an inadequate deterrent to noncompliance, when substantial

dollar amounts of tax are involved. Thus, the Joint Committee staff believes that increases in the amounts of the penalty that can be assessed by the IRS is appropriate.

The Joint Committee staff believes that it is appropriate to assess the amount of the penalty imposed on a preparer by reference to the amount of the preparer's fees, which represent the best measure of the preparer's stake in the taxpayer's return. In general, the preparer's fees are likely to be determined, in part, by the amount of tax liability involved.

The Joint Committee staff considered recommending an increase in the dollar amount of the penalties generally, but concluded that such an approach might lead to anomalous results in situations in which the amount of the penalty outweighed the amount of tax in question.

H. Pension Benefit Penalties--Simplify and Consolidate Form 5500 Penalties

Present Law

Form 5500 filing requirements in general

A plan administrator of a pension, annuity, stock bonus, profit-sharing or other funded plan of deferred compensation must file with the Secretary of the Treasury an annual return for each plan year containing certain information with respect to the qualification, financial condition, and operation of the plan.[371] Title I of ERISA also requires the plan administrator to file annual reports concerning the plan with the Department of Labor and the Pension Benefit Guaranty Corporation ("PBGC").[372] The plan administrator must use the Form 5500 series as the format for the required annual return.[373] The Form 5500 series annual return/report, which consists of a primary form and various schedules, includes the information required to be filed with all three agencies. The plan administrator satisfies the reporting requirement with respect to each agency by filing the Form 5500 series annual return/report with the Internal Revenue Service ("IRS"), which forwards the form to the Department of Labor and the PBGC. The use of the Form 5500 series annual return/report for compliance with the Code and ERISA reporting requirements is not mandated by statute; the combined filing is a result of administrative efforts to simplify administration of the reporting requirements.

Penalties for failure to file Form 5500

If the plan administrator fails to file a timely and complete Form 5500 series annual return, the Code imposes on the plan administrator a penalty equal to $25 per day during which the failure continues, not to exceed $15,000 per return. The Secretary of the Treasury may waive the penalty if the plan administrator demonstrates that the failure to file is due to reasonable cause.[374] In addition, Title I of ERISA provides that the Secretary of Labor may impose on the plan administrator a penalty of up to $1,100 per day. The Secretary of Labor may waive the penalty if the plan administrator demonstrates that the failure to file is due to reasonable cause.[375] Furthermore, Title IV of ERISA provides that the PBGC may impose on the plan administrator a

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[371] Code sec. 6058(a).

[372] ERISA secs. 104(a) and 4065.

[373] Treas. Reg. sec. 301.6058-1(a).

[374] Code sec. 6652(e).

[375] ERISA sec. 502(c)(2); DOL Reg. sec. 2560.502(c)-2(d).

penalty of up to $1,100 per day. The PBGC may waive the penalty if the plan administrator demonstrates that the failure to file is due to reasonable cause.[376]

The Department of Labor has instituted the Delinquent Filer Voluntary Compliance Program ("DFVC Program") to encourage, through the assessment of reduced penalties, delinquent plan administrators to comply with their annual reporting obligations under ERISA. The amount of the penalty under the DFVC Program depends upon whether the plan administrator files the Form 5500 series annual report within 12 months after the due date of the report. If the plan administrator files the delinquent report under the DFVC Program on or before 12 months after the date on which the annual report was due, the reduced penalty is $50 per day up to a maximum of $2,500 for plans with 100 or more participants or $1,000 for plans with less than 100 participants. If the plan administrator files the delinquent report under the DFVC Program more than 12 months after the due date, the reduced penalty is $5,000 for plans with 100 or more participants or $2,000 for plans with less than 100 participants. If a plan administrator elects to use the DFVC Program, the plan administrator must file the complete delinquent Form 5500 series report with the IRS and a copy of the first page of the report with the Department of Labor.[377]

A plan administrator's use of the DFVC Program does not affect the penalty imposed under the Internal Revenue Code for failure to file a timely and complete Form 5500 series annual return. The Department of the Treasury has not established a voluntary compliance program similar to the DFVC Program, and a plan administrator may not correct a delinquent Form 5500 series filing under the IRS Employee Plans Compliance Resolution Program ("EPCRP").

Schedule SSA

The plan administrator of an employee pension benefit plan that is subject to the minimum vesting standards under Title I of ERISA must file with the Secretary of the Treasury for each plan year a registration statement that identifies and provides certain information concerning each plan participant who separates from service during the plan year with a deferred vested benefit under the plan as of the end of the plan year and with respect to whom no retirement benefits were paid under the plan during the plan year.[378] The plan administrator must file the required information for a participant on Schedule SSA as an attachment to the plan's Form 5500 series annual return for the year following the year in which the participant separates from service.[379]

The IRS provides the information contained on Schedule SSA to the Social Security Administration, which enters the information in an electronic pension benefit record. Each month,

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[376] ERISA sec. 4071; PBGC Reg. sec. 4071.3.

[377] Pension and Welfare Benefits Administration Rule Related Notice, April 27, 1995.

[378] Code sec. 6057(a).

[379] Treas. Reg. sec. 301.6057-1(a)(4).

the Social Security Administration determines whether each new claimant for social security benefits or for hospital insurance coverage is listed in this electronic pension benefit record. The Social Security Administration sends a notice to each new claimant for whom it has pension benefit information, informing the claimant that he or she may have a right to future retirement benefits under the plan with respect to which the Schedule SSA was filed. If the claimant filed for the lump-sum death payment on the social security account of a relative, the Social Security Administration sends the claimant the pension information on the deceased individual. The notice shows the type, payment frequency, and amount of pension benefit, as well as the name and address of the plan administrator as reported on the Schedule SSA. The claimant may use this information to claim any pension benefits still due from the pension plan. The Social Security Administration also provides available pension benefit information on request.[380]

If the plan administrator fails to file Schedule SSA as required, or omits from Schedule SSA a participant required to be included, a penalty is imposed on the plan administrator equal to $1 per day per failure or omitted participant, not to exceed $5,000 per plan year. The Secretary of the Treasury may waive the penalty if the plan administrator demonstrates that the failure to file or omission is due to reasonable cause.[381]

Schedule B

For each plan year, the plan administrator of a defined benefit pension plan must file with the Secretary of the Treasury an actuarial report that contains, among other things, a description of the funding method and actuarial assumptions used to determine costs under the plan and a certification concerning the contribution required for compliance with the Code section 412 minimum funding standards.[382] The plan administrator must file the actuarial report on Schedule B as an attachment to the plan's Form 5500 series annual return for the plan year.[383]

If the plan administrator fails to file Schedule B as required, a penalty is imposed on the plan administrator equal to $1,000. The Secretary of the Treasury may waive the penalty if the plan administrator demonstrates that the failure to file is due to reasonable cause.[384]

Change in status of plan

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[380] Treas. Reg. sec. 422.122.

[381] Code sec. 6652(e).

[382] Code sec. 6059.

[383] Treas. Reg. sec. 301.6059-1(a).

[384] Code sec. 6692(e).

The plan administrator of an employee pension benefit plan that is subject to the minimum vesting standards under Title I of ERISA must notify the Secretary of the Treasury of any change in the name of the plan, any change in the name or address of the plan administrator, the termination of the plan, the merger or consolidation of the plan with any other plan, or the division of the plan into two or more plans.[385] The plan administrator must provide the required notification of a plan status change on the plan's Form 5500 series annual return for the year in which the change in status occurs.[386]

If the plan administrator fails to provide notification of a plan status change as required, a penalty is imposed on the plan administrator equal to $1 per day per failure, not to exceed $1,000 per plan year. The Secretary of the Treasury may waive the penalty if the plan administrator demonstrates that the failure is due to reasonable cause.[387]

Recommendation

The Joint Committee staff recommends the consolidation into one penalty of the present-law penalties imposed by the Internal Revenue Code and ERISA for failure to file the Form 5500 Series annual return/report for deferred compensation plans. The penalty that would result from this consolidation would be no less than the existing ERISA penalty for failure to file. In addition, the recommendation would designate the IRS as the agency responsible for enforcement of the reporting requirements and replace the DFVC Program with a similar program under the IRS EPCRP, thereby reducing from three to one the number of government agencies authorized to assess, waive, and reduce penalties for failure to file the Form 5500 series annual return/report. The Secretary of the Treasury would be directed to consult with the Secretary of Labor and the PBGC in imposing penalties. The recommendation also would repeal the separate penalties for failure to file Schedule SSA or omission of a required participant, for failure to file Schedule B, and for failure to provide notification of a plan status change. For penalty purposes, a failure to file Schedule SSA or omission of a required participant, a failure to file Schedule B, or a failure to provide notification of a plan status change would constitute a failure to file a complete Form 5500 series annual return/report.

Analysis

The Form 5500 series annual return/report is crucial to the efforts of the IRS, the Department of Labor and the PBGC to monitor retirement plan compliance with the applicable requirements of the Code and ERISA. The information contained in the annual report/return also is available to participants and beneficiaries who desire to learn about the operation and status of

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[385] Code sec. 6057(b).

[386] Treas. Reg. sec. 301.6057-2(b).

[387] Code sec. 6652(d)(2).

their retirement plan. The penalties for failure to comply with the reporting requirements should be clear enough to permit plan administrators to understand the consequences of noncompliance and significant enough to motivate plan administrators to comply.

The separate penalties imposed by the Internal Revenue Code and ERISA for a plan administrator's failure to file a timely and complete Form 5500 series annual return/report result in a confusing penalty structure. Because Schedule SSA, Schedule B, and notification of a plan status change are required as parts of the Form 5500 series annual return, a failure to file Schedule SSA or an omission of a required participant, a failure to file Schedule B, or a failure to provide notification of a plan status change is, in effect, a failure to file a complete Form 5500 series return. For penalty purposes, however, a failure or omission with respect to Schedule SSA or Schedule B does not constitute a Form 5500 series failure and results in a different and potentially significantly smaller penalty than the penalty for failure to file the Form 5500 series annual return.[388] A failure to provide notification of a plan status change produces the same result. The separate Code and ERISA penalty provisions for the Form 5500 series annual report/return, and the separate Code penalty provisions for Schedule SSA, Schedule B, and notification of a plan status change, complicate the Form 5500 series annual return penalty structure and create the possibility that a plan administrator may face multiple penalties for a failure to file one return/report. A plan administrator that fails to file an annual return/report may be required to pay six different penalties to three different government agencies, with five penalties based upon the number of days following the due date of the return and the other penalty based upon a flat dollar amount. If the plan administrator believes that the failure to file was due to reasonable cause, the plan administrator may be required to demonstrate the existence of reasonable cause to three different government agencies and may receive a different determination from each agency as to the sufficiency of the demonstration. Six different penalties based upon different theories for different components of the Form 5500 series annual return/report make it difficult for plan administrators to understand the penalty structure, as well as for the various agencies to administer the penalties.

Based on its determination that the possible assessment of the significant ERISA penalties for failure to file may deter certain delinquent filers from voluntarily complying with the annual reporting requirements under Title I of ERISA, the Department of Labor established the DFVC Program in an effort to encourage voluntary annual reporting compliance.[389] The possibility that, notwithstanding use of the DFVC Program, a delinquent filer who is unable to demonstrate reasonable cause may face a penalty under the Internal Revenue Code may discourage voluntary compliance.

Furthermore, the separate and relatively less significant Schedule SSA, Schedule B, and notification of plan status change penalties may imply that a plan administrator's obligations to

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[388] Rev. Rul. 84-54, 1984-1 C.B. 260.

[389] *Id.*

facilitate the Social Security Administration's tracking of individual taxpayers' deferred vested retirement benefits, to demonstrate compliance with the minimum funding standards, and to report the status of the plan are less important than the obligation to report basic plan information. In light of the significant role that the Social Security Administration's electronic pension benefit record plays in ensuring that individuals receive their retirement benefits, the fluctuations in permitted or required pension funding that can result from incorrect actuarial assumptions, and the consequences of plan termination or merger, these implications are inappropriate.

The recommendation would simplify the Form 5500 series penalty structure, reduce the number of potential penalties for failure to file, strengthen the incentive for plan administrators to comply with the Schedule SSA, Schedule B and plan status change notification requirements, and promote the purpose of the DFVC Program to encourage voluntary compliance by delinquent filers while retaining the most significant of the present-law penalties for failure to file.

I. Tax Exempt Organizations -- Clarify and Increase Penalty for Failure to File Annual Information Returns for Charitable Remainder Trusts

Present Law

Tax-exempt organizations (other than churches and certain small organizations) are required to file an annual information return, Form 990 (Form 990-PF for private foundations), with the Internal Revenue Service ("IRS"), and are subject to a penalty for failure to file such returns equal to $20 for each day the failure to file continues, not to exceed the lesser of $10,000 or 5 percent of the organization's gross receipts (sec. 6033 and sec. 6652(c)(1)(A)). In the case of tax-exempt organizations with gross receipts in excess of $1 million for any year, the penalty is increased to $100 per day, not to exceed $50,000. Split-interest trusts (described in sec. 4947(a)(2)) and certain trusts claiming charitable deductions under section 642(c) also are required to file an annual information return, Form 1041-A (sec. 6034). The penalty for failure to file Form 1041-A is $10 for each day the failure continues, up to a maximum of $5,000 with respect to any one return (sec. 6652(c)(2)(A)). Split-interest trusts, including charitable remainder trusts described in section 664, generally are required to file an additional annual information return, Form 5227, which provides more information than reported on Form 1041-A regarding the trust's financial activities and whether the trust is subject to certain excise taxes imposed under chapter 42 (Treas. Reg. sec. 53.6011-1(d)).[390]

The penalty imposed under section 6652(c)(2)(A) for failure to file annual trust information returns refers only to "a return required under section 6034." Section 6034 grants the Secretary of the Treasury authority to require the filing of information returns by split-interest trusts and certain other trusts; however, because Form 5227 is required by regulation under section 6011 rather than section 6034, the penalties imposed under section 6652(c)(2) arguably do not apply to a trust's failure to file Form 5227.

In 1996, Congress increased the penalties applicable to exempt organizations for failure to file annual returns in order to provide a greater incentive to organizations to comply with the filing requirements imposed by section 6033. The penalty imposed by section 6652(c)(2)(A) on trusts that fail to file a return required by section 6034 was not increased.

Recommendation

The Joint Committee staff recommends that the penalty imposed under section 6652(c)(2)(A) be clarified to apply to a trust's failure to file Form 5227. In addition, the Joint Committee staff recommends that the penalty imposed under section 6652(c)(2)(A), as applied to a trust's failure to file Form 5227, be increased to the penalty amounts imposed by section

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[390] Split-interest trusts are trusts where some but not all of the interest is held for charitable purposes. Although these trusts are not private foundations, they are subject to some of the private foundation rules.

6652(c)(1)(A) for failure by a tax-exempt organization to file Form 990 or 990-PF, and that Congress consider whether it is appropriate to increase the penalty imposed under Section 6652(c)(2)(A) for failure to file returns required under section 6034 generally.

Analysis

Form 5227 is critical to the enforcement efforts of the IRS as it provides detailed information regarding the financial activities of split-interest trusts and possible liability for the private foundation excise taxes to which these trusts are subject. Increasing the penalty imposed on trusts that fail to file required information returns and ensuring that all relevant returns are covered by such penalty would encourage voluntary compliance by delinquent filers and would assist the IRS in obtaining information about the activities of such trusts.

J. General Administrative Recommendations

1. Standards applicable to the IRS

Discussion and Analysis

The standards applicable to the IRS as to whether it should raise and pursue an issue in an audit or assess a deficiency are very important to taxpayers. These standards directly affect taxpayers in that a decision by the IRS to raise or pursue an issue on audit can cause a taxpayer to incur significant costs, such as the fees charged by professionals to assist the taxpayer in resolving the matter and the time spent by the taxpayer working on the matter. Accordingly, if the IRS raises a matter unnecessarily, a significant burden may be needlessly imposed on the taxpayer. On the other hand, it may be difficult for the IRS to know at the early stages of an inquiry whether it is appropriate to pursue a particular issue. This is particularly true because the tax system is a self-assessment system, and the records and knowledge underlying a position on a tax return are uniquely in the control of the taxpayer. However, as an audit progresses, it should in most instances become clearer whether it is appropriate to pursue a particular issue. The decision as to whether or not to do so requires the exercise of sound judgment by IRS personnel.

A primary articulation of the standards applicable to the IRS and its employees is contained in Revenue Procedure 64-22.[391] That document states:

> The function of the Internal Revenue Service is to administer the Internal Revenue Code. Tax policy for raising revenue is determined by Congress.
>
> With this in mind, it is the duty of the Service to carry out that policy by correctly applying the laws enacted by Congress; to determine the reasonable meaning of various Code provisions in light of the Congressional purpose in enacting them; and to perform this work in a fair and impartial manner, with neither a government or a taxpayer point of view.
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> At the heart of administration is interpretation of the Code. It is the responsibility of each person in the Service, charged with the duty of interpreting the law, to try to find the true meaning of the statutory provision and not to adopt a strained construction in the belief that he is "protecting the revenue." The revenue is properly protected only when we ascertain and apply the true meaning of the statute.
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> The Service also has the responsibility of applying and administering the law in a reasonable, practical manner. Issues should only be raised by examining officers when they have merit, never arbitrarily or for trading purposes. At the same time,

[391] Rev. Proc. 64-22, 1964-1 C.B. 689.

> the examining officer should never hesitate to raise a meritorious issue. It is also important that care be exercised not to raise an issue or to ask a court to adopt a position inconsistent with an established Service position.
>
> Administration should be both reasonable and vigorous. It should be conducted with as little delay as possible and with great courtesy and considerateness. It should never try to overreach, and should be reasonable within the bounds of law and sound administration. It should, however, be vigorous in requiring compliance with law and it should be relentless in its attack on unreal tax devices and fraud.

The Code requires that the IRS pay a taxpayer's reasonable administrative and litigation expenses under specified circumstances.[392] Among other requirements, the IRS is not required to pay these amounts if the IRS can demonstrate that its position was substantially justified. Accordingly, the fact that the IRS paid these expenses may be an indication that its position was not substantially justified, as well as an indication that the IRS may be inappropriately pursuing an issue. The lack of published statistics and analytical information hinders the Congress and taxpayers from assessing the extent to which the IRS may be inappropriately pursuing an issue and from pursuing potential remedies to alleviate this problem.

Recommendations

The Joint Committee staff believes that the standards of conduct applicable to the IRS are an important component of taxpayers' perceptions of the relative fairness of the administration of the tax laws. Just as the Joint Committee staff recommends elsewhere in this study that higher standards be imposed on practitioners, the Joint Committee staff believes that it is appropriate to apply higher standards to the IRS. For example, several provisions of the Internal Revenue Manual (IRM) state that IRS employees should "not adopt a strained construction" of the statute;[393] this phrase is contained in the third paragraph of the Revenue Procedure quoted in its entirety above. When, however, the Manual takes this phrase out of the larger context of the rest of the Revenue Procedure, it may appear that an inappropriately low standard of conduct is applicable to the IRS.[394] Accordingly, the Joint Committee staff recommends that the standards articulated in this revenue procedure be revised to incorporate a higher standard of behavior by the IRS, similar to that which would be imposed on practitioners by the Joint Committee staff recommendations made elsewhere in this study.

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[392] Sec. 7430.

[393] IRM HB (30) (15)10 (January 31, 1994); see also, IRM 4240 424(16) (March 31, 1983); IRM (39) 722.3 (December 2, 1992); IRM (39) 112 (December 2, 1992).

[394] See Corneel, The Service and the Private Practitioner, The American Journal of Tax Policy, vol. 11:2:343, at 359-360 (1994).

The Joint Committee staff also recommends that the IRS be required to publish annually statistics on the number of payments (whether as a result of a settlement or judicial decision) made pursuant to section 7430 and the total amount paid out. The IRS would also be required to publish an analysis of the administrative issues that gave rise to the necessity of making these payments and how these issues were resolved by the IRS. Both of these actions will permit the Congress to assess the extent to which the IRS may be inappropriately pursuing an issue and to pursue potential remedies to alleviate this problem.

2. Uniformity in penalty administration

Discussion and Analysis

Some penalties in the Code are imposed automatically (such as for failure to file or failure to pay), while others are imposed in response to the specific factual situation presented on a tax return (such as negligence). In addition, some penalties can be abated automatically, while others are abated in response to a specific factual presentation made by the taxpayer. In general, most penalties can be abated for reasonable cause, but the details of what constitutes reasonable cause can vary somewhat from penalty to penalty as a reflection of the differences in the types of behaviors that the different penalties are designed to deter. Both the manner in which penalties are imposed and the manner in which they are abated can present issues for consideration with respect to the uniformity of penalty administration.

The system of penalty administration has a number of goals and it is not always possible to reconcile them completely. One goal is uniformity of application of penalties (both in their original imposition and in their abatement) for similarly situated taxpayers. Another goal is to reflect the individual circumstances surrounding the failure for which the taxpayer is being penalized. Another goal is to provide rapid resolution for taxpayers of disputes with the IRS, including disputes over penalties. Accomplishing this goal entails giving "front line" IRS employees the authority to resolve disputes (within certain parameters) on their own authority.

One challenge in providing proper tax administration is balancing all of these goals so that one does not predominate at the expense of the others. For example, one theoretical way to maximize uniformity might be to centralize the administration of penalties in one office. This would, however, make it more difficult for taxpayers to reach a rapid resolution of their disputes with the IRS, because it could be more difficult for taxpayers to deal with a centralized penalty administration structure than with the current locally-based structure. It could also present administrative difficulties, such as divorcing decisions concerning penalties from decisions concerning the underlying liability, when in reality the two may be inextricably interconnected. On the other hand, the maximization of the goal of reflecting individual circumstances could adversely affect both uniformity and the rapid resolution of disputes. Similarly, maximizing the rapid resolution of disputes could adversely affect both uniformity and individualization.

Balancing these goals necessarily means that any one of them will not be maximized. Accordingly, a balanced approach means that some compromises will have to be made to permit the most appropriate balancing of these goals.

Recommendations

Improve statistical information

The Joint Committee staff recommends that the IRS develop better information systems to provide better statistical information on abatements and the reasons and criteria for abatements. Better statistical information enables more rigorous analysis of the systems to occur, which provides the opportunity for problems to surface and be dealt with in a systematic manner.

Improve supervisory review

The Joint Committee staff recommends that the IRS improve the supervisory review of the imposition of penalties as well as their abatement. GAO's report on abatements observes that there are varying amounts of supervisory review of abatements; in some instances, approximately 10% of abatements were reviewed by a supervisor, while for other types of abatements less than 1% were reviewed. Improving the level of review of both penalty imposition and abatement could improve both the uniformity of penalty administration and the reflection of individual circumstances without unduly hindering the rapid resolution of disputes. This could improve the fairness of the penalty system. Another benefit of increased review could be a decline in the perception by some that penalties are on occasion asserted as a way of improving the IRS's bargaining position with the taxpayer, rather than strictly because the taxpayer's behavior justified the penalty. Because, however, the imposition of a penalty in many instances requires the exercising of sound judgment regarding complicated facts and motivations concerning which there may be disputes, it may be difficult to reduce this perception in a meaningful way.

Another way to improve supervisory review would be to establish penalty oversight committees, similar to the Transfer Pricing Penalty Oversight Committee established by the IRS in 1996. That committee was established to provide "uniform administration" of the substantial understatement penalty applicable to transfer pricing adjustments,[395] and particularly "to ensure uniform application of the reasonableness standard and the documentation standards on a nationwide basis."[396] The IRS should consider whether it would be valuable and appropriate to establish administratively similar oversight committees with respect to other penalties. The advantages would be greater uniformity in penalty administration and application. There are, however, relatively few instances in which this penalty has been applied to taxpayers; consequently, National-office level review of this penalty may impose a significant administrative

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[395] Sec. 6662(e).

[396] Announcement 96-16, 1996-13 I.R.B. 22 (March 25, 1996).

burden on the IRS. By contrast, some penalties that apply to individuals (such as the penalty for failure to file tax returns) may be imposed millions of times in a year; this could make replication of the Transfer Pricing Committee model impractical. There may, however, be ways in which the principles of that model could be usefully applied to the more widely applied penalties. Accordingly, the Joint Committee staff recommends that the IRS evaluate whether the principles of this review model could be more broadly applied to other penalties.

3. Communications between taxpayers and the IRS

There are a number of areas in which administrative improvements could be made to IRS communications with taxpayers in connection with interest and penalties.

a. Power of attorney

Discussion and Analysis

More than half of all returns filed are prepared by tax return preparers. In many instances, taxpayers who select a preparer to prepare the tax return also engage the preparer to deal with the IRS on any issues that may arise with respect to that return. To accomplish this, the taxpayer must file an authorization with the IRS before this can occur. This is called a power of attorney. Taxpayers and preparers have experienced frequent problems related to these authorizations, which were mainly attributable to the lack of a centralized database containing these authorizations. The IRS recently announced[397] that it has created a universal database of these authorizations, accessible by IRS employees regardless of the location of their office.

Recommendations

The Joint Committee staff believes that this new universal database has the potential to eliminate many of the problems that taxpayers and preparers have experienced relating to these authorizations, although it is premature to assess the actual extent to which this new database will do so.

b. Contacts with individuals

Discussion and Analysis

The address that an individual places on his or her tax return will be entered by the IRS into the Individual Master File (IMF). In general, IRS notices must be sent to the taxpayer's "last

[397] IRS Information Release IR-1999-48 (May 24, 1999).

known address."[398] Taxpayers can notify the IRS of a change of address by filing Form 8822 with the IRS Service Center for the old mailing address. If the taxpayer later moves, however, without notifying the IRS, correspondence will continue to be sent to the address on the return and then forwarded by the Postal Service. Even if the taxpayer does notify an IRS office of the address change, however, it is not certain that the change will be made to the IMF in a timely manner. The IRS states that changes of address require a 45-day processing period before becoming effective in its systems.[399] Similar problems often occur when taxpayers change their names, usually as a result of marriage. Not all taxpayers are aware of the necessity of notifying the Social Security Administration when their name changes, either through marriage or divorce.

One significant factor contributing to these difficulties is the large number of independent information systems maintained by the IRS that do not permit the sharing of information. The systems modernization program currently underway at the IRS is designed to remedy these types of problems. These problems can create difficulties for both taxpayers and the IRS. Many provisions providing rights to taxpayers are dependent upon mailed notification to the taxpayer. The administrative costs incurred by the IRS are also increased because of these administrative difficulties.

Recommendations

The Joint Committee staff recommends that the IRS make it a high priority in its tax systems modernization program to improve the processes by which the names and addresses of individuals are updated. In particular, the Joint Committee staff recommends that the IRS shorten significantly the 45-day processing time for address changes that is set forth in Revenue Procedure 90-18. Also, the IRS should revise that revenue procedure to articulate the rules applicable to changes of address contained on electronically filed tax returns. For example, one method the IRS might consider employing to accomplish this would be to institute a system similar to the comprehensive one recently inaugurated with respect to powers of attorney.

c. Contacts with businesses

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[398] Sec. 6212(b). An elaborate body of case law has developed to flesh out the contours of the "last known address" requirements. For a discussion of these cases, see Saltzman, IRS Practice and Procedure, pp. 10-14 - 10-18 (2nd Ed., 1991). The requirement that notices be sent to the taxpayer's last known address was originally enacted in section 272(k) of the Revenue Act of 1928 (Pub. L. No. 562, 70th Cong.). The House Ways and Means Committee Report accompanying this legislation states "It is obviously impossible for the Commissioner to keep an up-to-date record of taxpayers' addresses."

[399] Rev. Proc. 90-18, 1990-1 C.B. 491. The processing period may be even longer if the taxpayer provides new address information on a Form 1040: for returns filed after February 14 and before June 1, the new address will be effective in the IRS's systems by July 16. Id.

Discussion and Analysis

Many businesses encounter problems with receiving penalty and interest notices (as well as other notices) from the IRS. These problems are generally not related to moving or changing names (as is the case with individuals), but rather from the fact that many corporations pay a variety of different types of taxes (income, employment, excise, etc.) and the different types of taxes are handled differently for administrative purposes by the IRS. This can mean that different offices of the IRS are issuing notices to the same corporation. Some corporations are structured centrally, so that all these notices should properly be sent to one location. Other corporations are structured so that different divisions operate autonomously, so that notices should properly be sent to different locations depending on the type of tax. These notices do not always reach the appropriate person at the corporation in a timely manner. This can happen because the IRS does not put the proper name on the notice. Alternatively, the IRS may also create difficulties by making a requested change of name or address, but doing it for types of taxes beyond what has been requested by the taxpayer.

Recommendations

The Joint Committee staff recommends that the IRS establish administrative systems that assure that the proper representative of a taxpayer receives the proper notice directly from the IRS. For example, this could be accomplished by instituting a system similar to the comprehensive one recently inaugurated with respect to powers of attorney. Another alternative that the IRS should consider is whether it might be beneficial for all correspondence addressed to business taxpayers to be addressed to the chief tax officer (or a similar title), and not to specific, named individuals.

d. More efficient modes of communication

Discussion and Analysis

The IRS generally communicates with taxpayers (or their designated representatives) in one of three methods: by mail, by telephone, or in person. Many telephone or in person contacts are initiated by the taxpayer, whereas many mail contacts are initiated by the IRS. Many of the difficulties taxpayers encounter in the course of communicating with the IRS are inherent to mail communications: documents missing in the mail, difficulties in forwarding documents, maintaining updated address records, etc.

Recommendations

The Joint Committee staff recommends that the IRS consider whether recent technological advances, such as e-mail and the fax, permit the utilization of alternate means of communicating with taxpayers to eliminate some of the difficulties with the present system. The Joint Committee staff encourages the IRS to study this issue and, if appropriate, to alter its administrative systems. Because the mailing of some notices is statutorily mandated, the IRS should also, if appropriate, present legislative recommendations to the Congress for its consideration.

VIII. JOINT COMMITTEE STAFF RECOMMENDATIONS RELATING TO CORPORATE TAX SHELTERS

This Part of the study addresses a corporation's participation in an arrangement in which a significant purpose is the avoidance or evasion of Federal income tax (commonly referred to as a "corporate tax shelter"). Under present law, in addition to certain substantive provisions and common-law doctrines, there are several penalty provisions that in some fashion address corporate tax shelters. A penalty and interest study, therefore, would not be complete without an analysis of and recommendations with respect to the penalty regime as it relates to corporate tax shelters.

The Joint Committee staff is convinced that present law does not sufficiently deter corporations from entering into arrangements with a significant purpose of avoiding or evading Federal income tax. The Joint Committee staff believes that certain clarifications and enhancements to the present-law penalty provisions would provide an effective means for deterring such behavior. Specifically, the Joint Committee staff recommends increasing the penalty rate with respect to any understatement resulting from a corporate tax shelter from 20 percent to 40 percent of the understatement. In addition, specific indicators would be provided which give rise to a conclusion that, with respect to a corporate participant, a significant purpose of an arrangement is the avoidance or evasion of Federal income tax (i.e., that the arrangement is a corporate tax shelter). The corporate tax shelter penalty could be reduced only if certain new disclosure requirements are satisfied. The penalty could be completely abated only if, in addition to disclosure, other high standards are met. The Joint Committee staff further believes that payment of a penalty in connection with a corporate tax shelter may be indicative of corporate behavior that is contrary to public policy and warrants disclosure to shareholders.

Corporate taxpayers are not the only culpable parties involved in corporate tax shelter activities. Therefore, the Joint Committee staff also recommends enhancing the penalties applicable to promoters and advisers who aid or abet in connection with an understatement of tax resulting from a corporate tax shelter. Recommendations also are made with respect to the present-law registration requirements for promoters of corporate tax shelters. In addition, recommendations are made with respect to increasing standards of tax practice in connection with corporate tax shelters.

This Part of the study first discusses the background with respect to the corporate tax shelter problem. This includes a discussion of statutory and common-law doctrines that may be employed to address corporate tax shelters as well as the relevant present-law penalty provisions and standards of tax practice regarding tax shelters. The background section also briefly discusses corporate tax shelter proposals made by the Administration in connection with the President's Fiscal Year 2000 Budget Proposal in February 1999. Next, the study analyzes the modern corporate tax shelter problem. Common characteristics of a corporate tax shelter are described, as well as factors that have contributed to the expansion of the corporate tax shelter problem. A broad conceptual framework for responding to the corporate tax shelter problem also is provided. Finally, the study describes in detail the Joint Committee staff recommendations for enhancing the penalty structure with respect to corporate tax shelters.

A. Background

1. Application of present law to corporate tax shelters

Under present law, there is no clear, uniform standard as to what constitutes a corporate tax shelter; however, there are a number of statutory provisions and judicial doctrines that attempt to police corporate transactions in which a significant purpose is the avoidance or evasion of Federal income tax. Additionally, the Code itself defines corporate tax shelters in a variety of contexts.[401]

a. Statutory provisions limiting tax benefits in connection with tax shelters

(i) Section 269

If a taxpayer engages in certain transactions for the principal purpose of evading or avoiding Federal income tax by securing the benefit of a deduction, credit, or other allowance that would not otherwise have been available, the Secretary of the Treasury (the "Secretary") has the authority to disallow the resulting benefits. The Secretary may only exercise this special authority with respect to three defined transactions: (1) if any person or persons acquire, directly or indirectly, control (defined as at least 50 percent of vote or value) of a corporation; (2) if a corporation acquires, directly or indirectly, property of another corporation (not controlled, directly or indirectly, immediately before the acquisition, by the acquiring corporation or its stockholders) where the basis of the property is determined by reference to the basis in the hands of the transferor corporation; or (3) if a corporation acquires at least 80 percent control (measured by both vote and value, but excluding certain nonvoting preferred stock) of another corporation, an election pursuant to section 338 is not made, and the acquired corporation is liquidated pursuant to a plan of liquidation adopted within two years after the acquisition date.

Because "tax shelter" transactions sometimes involve securing the benefits of deductions, credits, or other allowances that would not have otherwise been available to the tax shelter participants, to the extent that the transaction involved is of the type described above, section 269 may apply to deny the anticipated tax benefits.

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[401] Section 6662(d)(2)(C)(iii) defines a tax shelter for purposes of the understatement penalty (see definition below); section 6111(a) imposes a registration requirement with respect to certain tax shelters (see definition below); section 461(i)(3) defines a tax shelter for purposes of certain tax accounting rules as (1) an enterprise (other than a C corporation), the interests in which have been offered for sale in an offering required to be registered with a Federal or State securities agency, (2) a syndicate (a partnership or other entity, other than a corporation that is not an S corporation, if more than 35 percent of the losses of the entity are allocable to limited partners or limited entrepreneurs), and (3) a tax shelter (as defined in section 6662(d)(2)(C)(iii)); section 448(d)(3) generally adopts the section 461(i)(3) definition of a tax shelter for purposes of limiting the application of the cash method of accounting.

(ii) Section 446

Section 446(b) provides that if a taxpayer's method of accounting does not clearly reflect income, taxable income shall be computed under the method that, in the opinion of the Secretary, does clearly reflect income. The Secretary has broad discretion to determine whether a method of accounting clearly reflects income.[402] As the Tax Court in ACM v. Commissioner observed, "a taxpayer's method of accounting does not clearly reflect income when it does not represent 'economic reality.'"[403] Thus, to the extent that a corporate tax shelter involves deferrals of income or acceleration of deductions or basis recovery, or otherwise involves methods of accounting, the Secretary may employ section 446 as a substantive means to modify the taxpayer's method of accounting in order to clearly reflect income.

(iii) Section 482

Section 482 provides that when two or more entities are controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate income, deductions, credits, or allowances between or among the entities in order to prevent the evasion of taxes or to reflect clearly the income of an entity. The Internal Revenue Service ("IRS") may assert section 482 as authority to counteract tax shelters that involve the misallocation of income among different business entities.

In order to apply section 482 with respect to corporate tax shelters, the transaction in question must involve transfers between or among "two or more entities . . . controlled . . . by the same interests . . . ."[404] However, the IRS has adopted a broad interpretation of what it means to be controlled for this purpose. Acting in concert to avoid taxes may cause two unrelated entities to be considered part of the same controlled group.[405]

The breadth of the section 482 definition of a control group is illustrated by the Ninth Circuit case, Paccar, Inc. v. Commissioner.[406] There, an independent warehouse company was established solely to provide its customers with tax write-offs, pursuant to old inventory accounting rules. The independent warehouse company's only business purpose was to service tax

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[402] Thor Power Tool v. Commissioner, 439 U.S. 522, 531 (1979); Commissioner v. Hansen, 360 U.S. 446, 467 (1959); Ferrill v. Commissioner, 684 F.2d 261, 263 (3d Cir. 1982).

[403] ACM Partnership v. Commissioner, 73 T.C.M. (CCH) 2189, 2214 (1997) (dictum) (citing Prabel v. Commissioner, 882 F.2d 820, 826-27 (3d Cir. 1989)), aff'd in part and reversed in part, 157 F.3d 231 (3d Cir. 1998), cert. denied, 1999 U.S. LEXIS 1899 (Mar. 22, 1999).

[404] Sec. 482.

[405] Treas. Reg. sec. 1.482-1(i)(4).

[406] 849 F.2d 393 (1988), aff'g 85 T.C. 754 (1985).

avoidance clients, and it provided unimportant nontax-related services to those clients. The Ninth Circuit held that the warehouse company was controlled by its clients and that its transactions lacked economic substance. Therefore, the court upheld the Commissioner's redetermination of the petitioner's tax liability pursuant to section 482.

Three recent Field Service Advice Memoranda addressing certain lease stripping transactions illustrate the IRS's use of section 482 as a substantive rule in connection with transactions for which the IRS also raised the sham transaction and economic substance doctrines (discussed below).[407] Hence, in certain circumstances section 482 may provide the IRS with a statutory mechanism for addressing corporate tax shelter activity.

(iv) Section 7701(l)

Section 7701(*l*) provides: "[t]he Secretary may prescribe regulations recharacterizing any multiple-party financing transaction as a transaction directly among any 2 or more of such parties where the Secretary determines that such recharacterization is appropriate to prevent [the] avoidance of . . . tax . . . ." The subsection authorizes Treasury to prescribe regulations to deal generally with complicated, tax-motivated lending transactions that lack economic substance.[408] On January 6, 1999, the IRS proposed regulations pursuant to section 7701(*l*) to eliminate the abuse of "step down" or "fast pay" preferred stock (discussed in greater detail below).[409] Earlier, the IRS proposed regulations to deal with lease stripping transactions, which are intended to allow one party to realize income from a lease and another party to report depreciation deductions related to that income, and issued final regulations dealing with certain conduit financing arrangements.[410] Hence, the authority granted under section 7701(*l*) provides the IRS with yet another means to address certain corporate tax shelter arrangements involving financing transactions.

b. Judicial doctrines applicable to tax shelters

(i) Overview

In addition to the statutory provisions discussed above, over the years the courts have developed several doctrines to deny certain tax-advantaged transactions their intended tax benefits. These doctrines are not entirely distinguishable, and their application to a given set of facts is often blurred by the courts and the IRS. There is considerable overlap among the

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[407] Field Service Advice Memoranda 199920012 (May 21, 1999), 199914018 (Apr. 12, 1999), and 199909005 (Mar. 8, 1999).

[408] See, e.g., Aiken Industries, Inc. v. Commissioner, 56 T.C. 925 (1971).

[409] Prop. Treas. Reg. sec. 1.7701(*l*)-3.

[410] Prop. Treas. Reg. sec. 1.7701(*l*)-2; Treas. Reg. sec. 1.881-3.

doctrines, and typically more than one doctrine is likely to apply to a transaction. Because of these ambiguities, invocation of these doctrines can be seen as at odds with an objective, "rule-based" system of taxation. Nonetheless, the doctrines provide a useful tool under present law to police, at a minimum, the most egregious tax shelter abuses.[411]

The Supreme Court has made it clear that "[t]he legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted."[412] When a taxpayer, however, "crosses the line" such that what was done, apart from tax motive, was not the thing which the statute intended, the tax advantage should be denied.[413] The general doctrines used to deny such tax benefits are (1) the sham transaction doctrine, (2) the economic substance doctrine, (3) the business purpose doctrine, (4) the substance over form doctrine, and (5) the step transaction doctrine.[414]

(ii) Sham transaction doctrine

Sham transactions are those in which the economic activity that is purported to give rise to the desired tax benefits does not actually occur. The transactions have been referred to as "facades" or mere "fictions"[415] and, in their most egregious form, one may question whether the transactions might be characterized as fraudulent.

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[411] See, e.g., ACM v. Commissioner, 157 F.3d 231 (3d Cir. 1998), aff'g 73 T.C.M. (CCH) 2189 (1997).

[412] Gregory v. Helvering, 293 U.S. 465, 469 (1935), aff'g 69 F.2d 809 (2d Cir. 1934). In the lower court opinion with respect to this case, Judge Learned Hand stated this concept another way: "Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." 69 F.2d at 810.

[413] Gregory, 293 U.S. at 469.

[414] The Gregory case is often cited as the seminal case with respect to several of these doctrines, especially the sham transaction, economic substance, and business purpose doctrines. For a general discussion of these doctrines, see Alvin C. Warren, Jr., The Requirement of Economic Profit in Tax Motivated Transactions, 59 Taxes 985 (1981), and David P. Hariton, Sorting Out the Tangle of Economic Substance, 52 Tax Law. 235 (1999).

Although many of the cases raising these doctrines deal with individual tax shelters, they also have applied in the corporate context. See, e.g., ACM Partnership v. Commissioner, 73 T.C.M. (CCH) 2189; ASA Investerings v. Commissioner, 76 T.C.M. (CCH) 325 (1998).

[415] See, e.g., Knetsch v. United States, 364 U.S. 361 (1960) (disallowing deduction for prepaid interest on a nonrecourse, riskless loan used to purchase deferred-annuity savings bonds).

At a minimum, the sham transaction doctrine can be said to apply to a "sham in fact." For example, where a taxpayer purported to buy Treasury notes for a small down payment and a financing secured by the Treasury notes in order to generate favorable tax benefits, but neither the purchase nor the loan actually occurred, the court applied the sham transaction doctrine to deny the tax benefits.[416]

Although the sham transaction doctrine generally applies when the purported activity giving rise to the tax benefits does not actually occur, in certain circumstances, a transaction may be found to constitute a sham even when the purported activity does occur. For example, if a transaction is entered into to generate loss for the taxpayer, and the taxpayer actually has risk with respect to the transaction, but that risk has been eliminated through a guarantee by a broker that the broker will bear the market risk and that the only consequences to the taxpayer will be the desired tax benefits, such transaction may be found to be "in substance" a sham.[417]

Finally, as discussed above, the delineation between this doctrine (particularly as applied to shams "in substance") and the "economic substance" and the "business purpose" doctrines (both discussed below) is not always clear. Some courts find that if transactions lack economic substance and business purpose, they are "shams" notwithstanding that the purported activity did actually occur.[418]

(iii) Economic substance doctrine

(A) In general

The courts generally will deny claimed tax benefits where the transaction giving rise to those benefits lacks economic substance independent of tax considerations -- notwithstanding that the purported activity did actually occur. The Tax Court has recently described the doctrine as follows:

> The tax law . . . requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. The doctrine of economic substance becomes applicable, and a judicial remedy is

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[416] See Goodstein v. Commissioner, 267 F.2d 127, 131 (1st Cir. 1959). In ASA Investerings, the Tax Court disallowed losses on the grounds that the taxpayer and the foreign bank in the transaction never actually entered into the purported partnership which was formed to effectuate the transaction, implicitly applying the sham transaction doctrine.

[417] See, e.g., Yosha v. Commissioner, 861 F.2d 494 (7th Cir. 1988) (holding options straddles to be shams because the broker insured the clients against market risk).

[418] See United States v. Wexler, 31 F.3d 117, 124 (3d Cir. 1994). In Wexler, the promoter of a tax shelter was brought up on criminal fraud charges. In the jury instructions, the court blurred the distinction between sham transactions and transactions having no business purpose or lacking economic substance.

> warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings.[419]

The seminal authority most often credited for laying the foundation of the economic substance doctrine is the Supreme Court and Second Circuit decisions in Gregory v. Helvering.[420] In Gregory, a transitory subsidiary was established to effectuate, utilizing the corporate reorganization provisions of the Code, a tax advantaged distribution from a corporation to its shareholder of appreciated corporate securities that the corporation (and its shareholder) intended to sell. Although the court found that the transaction satisfied the literal definition of a tax-free reorganization, the Second Circuit held (and the Supreme Court affirmed) that satisfying the literal definition was not enough:

> [T]he underlying presupposition is plain that the readjustment shall be undertaken for reasons germane to the conduct of the venture in hand, not as an ephemeral incident, egregious to its prosecution. To dodge the shareholder's taxes is not one of the transactions contemplated as corporate "reorganizations."[421]

Since the time of Gregory, several cases have denied tax benefits on the grounds that the subject transactions lacked economic substance.[422] The economic substance doctrine can apply even when a taxpayer exposes itself to risk of loss and where there is some profit potential (i.e., where the transactions are real) if the facts suggest that the economic risks and profit potential were insignificant when compared to the tax benefits.[423] In other words, the doctrine suggests a balancing of the risks and profit potential as compared to the tax benefits in order to determine

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[419] ACM, 73 T.C.M. at 2215.

[420] 293 U.S. 465 (1935), aff'g 69 F.2d 809 (2d Cir. 1934).

[421] Gregory, 69 F.2d at 811.

[422] See, e.g., Knetsch v. United States, 364 U.S. 361 (1960); Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966) (holding that an unprofitable, leveraged acquisition of T-bills, and accompanying prepaid interest deduction, lacks economic substance); Sheldon v. Commissioner, 94 T.C. 738 (1990) (holding that a marginally profitable, leveraged acquisition of T-bills, and accompanying prepaid interest deduction, lacks economic substance, and imposing penalties); Ginsburg v. Commissioner, 35 T.C.M. (CCH) 860 (1976) (holding that a leveraged cattle-breeding program lacks economic substance).

[423] See Goldstein v. Commissioner, 364 F.2d 734, 739-40 (2d Cir. 1966) (disallowing deduction even though taxpayer has a possibility of small gain or loss by owning T-bills); Sheldon v. Commissioner, 94 T.C. 738, 768 (1990) (stating, "potential for gain . . . is infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions").

whether the transactions had "purpose, substance or utility apart from their anticipated tax consequences."[424]

(B) Modern application in corporate context: ACM

A recent application of the economic substance doctrine in the corporate context is well illustrated by the Tax Court and Third Circuit opinions in ACM Partnership v. Commissioner.[425] ACM involved an intricate plan designed to create losses where the offsetting gains would escape U.S. taxation.

In ACM, Colgate-Palmolive Company had reported a sizeable capital gain in 1988 (approximately $105 million) from its sale of a subsidiary. Colgate wanted to avoid or minimize paying Federal income tax on that gain.[426] The transaction at issue was designed for that purpose: i.e., to avoid ever paying tax on a realized gain.[427] The transaction originated with a proposal that Merrill Lynch presented to Colgate in 1989 involving the formation of a partnership with a foreign bank and utilization of special ratable basis recovery rules under the section 453 regulations in connection with the purchase and sale of short-term securities.

Under the proposed transaction, a partnership would be formed in which a foreign bank would hold a substantial interest. The partnership would buy short-term securities and shortly thereafter sell them for the same price. The consideration for the sale would be approximately 70 percent cash and the remaining amount in installment notes that would provide for six semiannual payments equal to a notional principal amount multiplied by the London Interbank Offering Rate ("LIBOR").[428] These installment notes would be considered as contingent and, therefore, would

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[424] Goldstein, 364 F.2d at 740. Even this articulation of the economic substance doctrine will fall short in its application to some sets of facts. For example, taxpayers motivated solely by tax considerations have been permitted by the courts to time their recognition of accrued economic losses, notwithstanding that the IRS attacked such tax-motivated transactions as lacking economic substance. See, e.g., Cottage Savings v. Commissioner, 499 U.S. 554 (1991) (allowing losses, pursuant to section 1001(a), on exchanges of substantially identical mortgages); Doyle v. Commissioner, 286 F.2d 654 (7th Cir. 1961). In Doyle, the IRS argued that the taxpayer's use of a straddle to recognize loss on its stock without taking itself out of its ownership in the stock lacked economic substance; held: the transactions were at arm's length and, therefore, bona fide so that the losses were allowed under section 165.

[425] 157 F.3d 231 (3d Cir. 1998).

[426] ACM, 73 T.C.M. at 2191.

[427] See Richard M. Lipton, Tax Opinions for Corporate Tax Shelters, 148 J. Tax'n 331, 334 (1997).

[428] ACM, 73 T.C.M. at 2191.

fall within the special ratable basis recovery rule under the section 453 regulations, which provide:

> when a stated maximum selling price cannot be determined as of the close of the taxable year in which the sale or other disposition occurs, but the maximum period over which payments may be received under the contingent sale price agreement is fixed, the taxpayer's basis (inclusive of selling expenses) shall be allocated to the taxable years in which payment may be received under the agreement in equal annual increments.[429]

The result of the approach would be a large gain in the first year that would be allocated almost entirely to the foreign bank (with no U.S. tax consequences to the foreign bank). The foreign bank's interest in the partnership would then be redeemed. Losses would be created in subsequent years that would almost entirely be allocated to Colgate and which could be carried back to offset its capital gain from the sale of its subsidiary.

Colgate initially had reservations with respect to Merrill Lynch's proposal because it did not seem to serve Colgate's business purposes.[430] However, Colgate became interested in using the partnership to invest in its own debt in order to rebalance its debt portfolio.[431] Colgate's debt acquisition objectives were then incorporated into the tax reduction strategy.

To accomplish its goal, in November 1989, Colgate (through a subsidiary) formed a partnership ("ACM") with a subsidiary of ABN, N.V. (a foreign bank), and a subsidiary of Merrill Lynch. Each partner contributed cash. At the outset, ABN held an 82.6 percent interest in the partnership, Colgate held a 17.1 percent interest and Merrill Lynch a 0.3 percent interest. The total contributions to the partnership were $205 million.

At the end of November 1989, ACM paid $205 million to purchase floating-rate notes that were paying interest at a rate that was only three basis points above the rate the funds were already earning in deposit accounts. The interest rates on the floating-rate notes were scheduled to reset only once a month, and ACM had prearranged to dispose of the notes in a 24-day period encompassing only one interest rate adjustment and virtually guaranteeing that ACM would have no real exposure to interest rate or principal value fluctuations with respect to the notes.[432] Twenty-four days later, ACM sold $175 million of the floating-rate notes in exchange for

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[429] Temp. Treas. Reg. sec. 15A.453-1(c)(3)(i).

[430] ACM, 73 T.C.M. at 2191.

[431] Id. at 2192.

[432] ACM, 157 F.3d at 250 and n.35.

$140 million in cash plus LIBOR notes worth an estimated $35 million.[433] Colgate alone bore virtually all of the approximately $5 million in transaction costs.

With respect to the $175 million of notes sold in 1989, pursuant to Temporary Regulation section 15A.453-1, ACM recovered only $29 million of its basis and therefore reported a $111 million capital gain, most of which was allocated to the foreign partner that was not subject to U.S. tax.[434]

In 1991, pursuant to a preconceived plan, Colgate purchased part of ABN's interest in ACM, and ACM redeemed the remainder of ABN's interest, leaving Colgate with a 99.7 percent interest. Subsequent to redeeming the foreign partner (and pursuant to the same plan), ACM sold the LIBOR notes for $11 million, recognizing a capital loss of $85 million under Temporary Regulation section 15A.453-1(c). Virtually all of this loss was allocated to Colgate. Hence, if given effect for tax purposes, the transaction would have generated a capital loss producing a tax refund for Colgate (after carryback to offset its capital gain from the sale of its subsidiary) and an offsetting capital gain that escaped U.S. taxation.

Both the Tax Court and the Court of Appeals for the Third Circuit held that the transaction lacked economic substance. The Third Circuit held that "both the objective analysis of the actual economic consequences of ACM's transactions and the subjective analysis of their intended purposes support the Tax Court's conclusion that ACM's transactions did not have sufficient economic substance to be respected for tax purposes."[435] The court observed that the economic substance doctrine can apply equally to "shams in substance" as "shams in fact" and that even when the purported activity in the transaction actually occurs, the transaction may be disregarded when (other than tax consequences) the transaction results in "no net change in the taxpayer's economic position."[436] In other words, as an objective matter, to be respected for tax purposes, a transaction must have practical economic effects other than the creation of tax losses.[437] The court found that there was "a lack of objective economic consequences arising from ACM's offsetting acquisition and virtually immediate disposition of the [floating-rate] notes. . . . we find that these transactions had only nominal, incidental effects on ACM's net economic position."[438]

The court stated that economic substance is a prerequisite to sustaining a transaction:

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[433] In several transactions in December 1989, proceeds of the sale were used to purchase outstanding Colgate debt.

[434] ACM, 73 T.C.M. at 2213.

[435] ACM, 157 F.3d at 248.

[436] Id. at 248.

[437] Id.

[438] Id. at 250.

> In order to be deductible, a loss must reflect actual economic consequences sustained in an economically substantive transaction and cannot result solely from the application of a tax accounting rule to bifurcate a loss component of a transaction from its offsetting gain component to generate an artificial loss, which, as the Tax Court found, is "not economically inherent in" the transaction. 73 T.C.M. at 2215. . . . Based on our review of the record regarding the objective economic consequences of ACM's short-swing, offsetting investment in and divestment from the [floating-rate] notes, we find ample support for the Tax Court's determination that ACM's transactions generated only "phantom losses" which cannot form the basis of a capital loss deduction under the Internal Revenue Code.[439]

Finally, in addition to finding that the transaction lacked objective economic substance, the court held that to be respected for tax purposes, a transaction must have, and the ACM transaction did not have, a subjective nontax objective. The court found that:

> While ACM purported to combine the tax avoidance objective of Merrill Lynch's initial May 1989 proposal with the nontax debt acquisition objectives incorporated into subsequent proposals, ACM's pursuit of these two distinct objectives within the same partnership cannot obscure the fact that the contingent installment exchange, which was solely responsible for the tax consequences at issue, was executed independently of, did not further, and in fact impeded ACM's pursuit of its nontax debt acquisition objectives . . . . Thus, the nontax motivations behind ACM's debt purchase do not alter the fact that the contingent installment sale was motivated only by tax avoidance purposes.[440]

In short, the court held that a transaction must have sufficient objective economic substance and subjective business motive to be respected for tax purposes, and the ACM transaction lacked both.

(C) Special application: leasing transactions

A line of authorities has developed addressing economic substance (and, as discussed below, business purpose) specifically in connection with leasing transactions. The focus with respect to leasing transactions (particularly leveraged leases and sale-leaseback transactions) is who should be entitled to the benefits of tax ownership such as depreciation deductions.

The determination of tax ownership sometimes overlaps with the determinations of whether the transactions have economic substance and business purpose. The Supreme Court articulated the standard as follows: "where . . . there is a genuine multiple-party transaction with economic

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[439] Id. at 252.

[440] Id. at 256 n.48.

substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties."[441] The Fourth Circuit has interpreted Frank Lyon to require a two-prong analysis with respect to sale-leaseback transactions: namely, the court "must find that the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of profit exists."[442] In analyzing the economic substance of a leasing transaction, the Tax Court found that economic substance was not supported where the discounted present value of the future rental income and sale proceeds would be less than the present value of the amount expended by the investors.[443]

In addition to its application by the courts, economic substance is a component of the guidelines that were adopted in 1975 by the IRS for advance ruling purposes with respect to determining whether certain transactions purporting to be leases of property are, in fact, leases for Federal income tax purposes.[444] The guidelines require that the lessor represent and demonstrate that it expects to receive a profit, apart from the value of or benefits obtained from tax deductions, allowances, credits, and other tax attributes arising from such transaction.

(iv) Business purpose doctrine

Another doctrine that overlays and is often considered together with (if not part and parcel of) the sham transaction and economic substance doctrines is the business purpose doctrine. Although numerous authorities apply this doctrine in the context of individuals or partnerships, as the discussion above with respect to ACM makes clear, the doctrine equally applies in the corporate context. Additionally, the doctrine is not limited to cases where the relevant statutory provisions by their terms require a business purpose or profit potential.[445]

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[441] Frank Lyon Co. v. Commissioner, 435 U.S. 561, 583-84 (1978).

[442] Rice's Toyota World v. Commissioner, 752 F.2d 89, 91-92 (4th Cir. 1985).

[443] Hilton v. Commissioner, 74 T.C. 305, 353 n.23 (1980), aff'd 671 F.2d 316, 317 (9th Cir. 1982). The Tax Court arrived at the present value using a six-percent discount rate found in the estate tax regulations for purposes of making actuarial valuations. Although affirmed on appeal, the Ninth Circuit observed that the six-percent rate was illustrative only and that no suggestion of a minimum required rate of return is intended. See also Estate of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1976). In Estate of Franklin, property was overvalued when acquired by the lessor, and the lessor had no reasonable expectation of a residual value, so the court held that the lessor had no depreciable investment in the property and the nonrecourse debt was not true debt.

[444] Rev. Proc. 75-21, 1975-1 C.B. 715.

[445] ACM, 157 F.3d at 253; Goldstein, 364 F.2d at 736; Wexler, 31 F.3d at 122.

In its common application, the courts use business purpose (in combination with economic substance, as discussed above) as part of a two-prong test for determining whether a transaction should be disregarded for tax purposes: (1) the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction, and (2) the transaction lacks economic substance.[446] In essence, a transaction will only be respected for tax purposes if it has "economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached."[447]

The business purpose test is a subjective inquiry into the motives of the taxpayer -- that is, whether the taxpayer intended the transaction to serve some useful nontax purpose.[448] Finally, where appropriate, the court may bifurcate a transaction in which independent activities with nontax objectives have been combined with an unrelated transaction having only tax-avoidance objectives in order to establish a business purpose for the overall transaction.[449] Thus, a taxpayer cannot utilize an unrelated business objective to hide the lack of business purpose with respect to the particular tax-motivated activities.

(v) Substance over form doctrine

The concept of the substance over form doctrine is that the tax results of an arrangement are better determined based on the underlying substance rather than an evaluation of the mere formal steps by which the arrangement was undertaken. For instance, two transactions that achieve the same underlying result should not be taxed differently simply because they are achieved through different legal steps. The Supreme Court has found that a "given result at the end of a straight path is not made a different result because reached by following a devious path."[450] However, many areas of income tax law are very formalistic and, therefore, it is often difficult for taxpayers and the courts to determine whether application of the doctrine is appropriate.

While tax cases have been decided both ways, the IRS generally has the ability to recharacterize a transaction according to its underlying substance. Taxpayers, however, are

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[446] Rice's Toyota World, 752 F.2d at 91.

[447] Frank Lyon Co., 435 U.S. at 561. Cf. Esmark v. Commissioner, 90 T.C. 171, 198 (1988), aff'd without published opinion, 886 F.2d 1318 (7th Cir. 1989) (not disregarding steps of a transaction where, for example, a tender offer was not a "'mere device' having no business purpose").

[448] See e.g., Rice's Toyota World, 752 F.2d at 89; ACM, 157 F.3d at 231; Peerless Indus. v. Commissioner, 1994-1 U.S.T.C. (CCH) para. 50,043 (E.D. Pa. 1994).

[449] ACM, 157 F.3d at 256 n.48.

[450] Minnesota Tea Co. v. Helvering, 302 U.S. 609, 613 (1938).

usually bound to abide by their chosen legal form.[451] In National Alfalfa Dehydrating & Mill & Co., the Supreme Court ruled as follows:

> This Court has observed repeatedly that, while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, [citations omitted], and may not enjoy the benefit of some other route he might have chosen to follow but did not.[452]

The IRS has published administrative guidance that applies the substance over form doctrine in a variety of contexts.[453] Taxpayers and tax practitioners apply these pronouncements, as well as certain favorable court cases, as an exception to the general rule that taxpayers are bound by their chosen form.

(vi) Step transaction doctrine

An extension of the substance over form doctrine is the step transaction doctrine. The step transaction doctrine "treats a series of formally separate 'steps' as a single transaction if such steps are in substance integrated, interdependent, and focused toward a particular result."[454] The courts have generally developed three methods of testing whether to invoke the step transaction doctrine: (1) the end result test, (2) the interdependence test, and (3) the binding commitment test.

The end result test is the broadest of the three articulations. The end result test examines whether it is apparent that each of a series of steps are undertaken for the purpose of achieving the ultimate result.[455] The interdependence test attempts to prove that each of the steps were so interdependent that the completion of an individual step would have been meaningless without the

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[451] Commissioner v. Danielson, 378 F.2d 771 (3d Cir. 1967), cert. denied, 389 U.S. 858 (1967); In the matter of: Insilco Corporation v. United States, 53 F.3d 95 (5th Cir. 1995).

[452] Commissioner v. National Alfalfa Dehydrating & Mill Co., 417 U.S. 134, 149 (1974). See also Higgens v. Smith, 308 U.S. 473, 477 (1940).

[453] See Rev. Rul. 78-397, 1978-2 C.B. 150, Rev. Rul. 83-142, 1983-2 C.B. 68, and Rev. Rul. 80-154, 1980-1 C.B. 68 (disregarding circular cash flows in transactions); Rev. Rul. 73-427, 1973-2 C.B. 301 (viewing a reverse subsidiary merger as a taxable stock purchase); Rev. Rul. 67-274, 1967-2 C.B. 141 (treating "B" reorganization followed by liquidation of acquired corporation as a "C" reorganization); Rev. Rul. 68-602, 1968-2 C.B. 135 (not respecting contribution of debt from a creditor-shareholder to a debtor-subsidiary for purposes of determining whether the subsidiary is eligible for tax-free liquidation).

[454] Penrod v. Commissioner, 88 T.C. 1415, 1428 (1987).

[455] King Enterprises, Inc. v. United States, 418 F.2d 511, 516 (Ct. Cl. 1969).

completion of the remaining steps. The binding commitment test is the narrowest of the three articulations and looks to whether, at the time the first step is entered into, there is a legally binding commitment to complete the remaining steps.[456]

In determining whether to invoke the step transaction doctrine, the courts have looked to two primary factors: (1) the intent of the taxpayer,[457] and (2) the temporal proximity of the separate steps. If a taxpayer can provide evidence that at the time the first of a series of steps was undertaken, there was no plan or intention to effect the other steps, then the transactions should not be stepped together. An important factor that supports a taxpayer's lack of intent is found where subsequent steps are prompted by external, unexpected events that are beyond the taxpayer's control. Where there is no legally binding commitment to engage in subsequent steps after undertaking the initial transaction, the span of time between the events is an important measure in determining whether the transactions should be stepped together. A significant lapse of time between a series of transactions should prevent the application of the step transaction doctrine.[458]

The step transaction doctrine may not be invoked in all cases, irrespective of the taxpayer's intent or the temporal relationship of the separate steps. Aside from a case involving a legally binding agreement,[459] if each of a series of steps has independent economic significance, the transactions should not be stepped together.[460] Also, the courts have not permitted the application of the step transaction doctrine if its application would create steps that never actually occurred.[461] This limitation is sometimes viewed as prohibiting the use of the step transaction doctrine where the alternative transaction has at least the same number of steps.[462] Another possible limiting factor to the application of the step transaction doctrine is when the steps in a series of transactions are separated by a real and meaningful shareholder vote to continue with the subsequent steps. While such a shareholder vote may be an indication of separate, unrelated steps, particularly when the corporation is publicly traded, it may not be determinative. Finally, as

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[456] Commissioner v. Gordon, 391 U.S. 83, 96 (1968).

[457] McDonalds Restaurants of Ill. v. Commissioner, 688 F.2d 520 (7th Cir. 1982).

[458] Cal-Maine Foods, Inc. v. Commissioner, 93 T.C. 181 (1989) (by implication); Martin D. Ginsburg et al., Mergers, Acquisitions, and Buyouts, para. 608.2.2 (Apr. 1999 edition).

[459] J.E. Seagram Corp. v. Commissioner, 104 T.C. 75 (1995).

[460] Reef Corporation v. Commissioner, 368 F.2d 125 (5th Cir. 1966); Rev. Rul. 79-250, 1979-2 C.B. 156, modified by Rev. Rul. 96-29, 1996-1 C.B. 50.

[461] Esmark, Inc. v. Commissioner, 90 T.C. 171 (1988), aff'd without published opinion, 886 F.2d 1318 (7th Cir. 1989); Walt Disney, Inc. v. Commissioner, 97 T.C. 221 (1991); Grove v. Commissioner, 490 F.2d 241 (2d Cir. 1973).

[462] West Coast Marketing Corporation v. Commissioner, 46 T.C. 32 (1966); Rev. Rul. 70-140, 1970-1 C.B. 73.

discussed above, the IRS and not the taxpayer generally has the ability to recharacterize a series of transactions under the step transaction doctrine.

c. Tax shelter penalties

(i) Civil penalties relating to tax shelters

(A) Taxpayer penalties

Accuracy-related penalty (sec. 6662).--The accuracy-related penalty, which is imposed at a rate of 20 percent, applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. If the correct income tax liability for a taxable year exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 ($10,000 in the case of most corporations), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.

In determining whether a substantial understatement exists, the amount of the understatement generally is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment. In no event does a corporation have a reasonable basis for its tax treatment of an item attributable to a multi-party financing transaction if such treatment does not clearly reflect the income of the corporation.

Special rules apply for "tax shelters." With respect to tax shelter items of non-corporate taxpayers, the penalty may be avoided only if the taxpayer establishes that, in addition to having substantial authority for the position, the taxpayer reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. This reduction in the penalty is unavailable to corporate tax shelters. For these purposes, section 6662(d)(2)(C)(iii) defines a tax shelter as (1) a partnership or other entity, (2) an investment plan or arrangement, or (3) any other plan or arrangement, if a significant purpose of such partnership, entity, plan or arrangement is the avoidance or evasion of Federal income tax.

The understatement penalty generally is abated (even in the case of corporate tax shelters) in cases where the taxpayer can demonstrate that there was "reasonable cause" for the underpayment and that the taxpayer acted in good faith.[463] The relevant regulations provide that reasonable cause exists where the taxpayer "reasonably relies in good faith on an opinion based on a professional tax advisor's analysis of the pertinent facts and authorities [that] . . . unambiguously

[463] Sec. 6664(c).

concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service."[464]

Fraud penalty (sec. 6663).--The accuracy-related penalty under section 6662 discussed above does not apply to any underpayment of tax that is attributable to fraud. Rather, a penalty under section 6663 equal to 75 percent of the understatement may be imposed. The IRS must establish by clear and convincing evidence that an understatement of tax exists and that an understatement is attributable to fraud. The courts have defined fraud to mean an intentional wrongdoing on the part of a taxpayer motivated by a specific purpose to evade a tax known or believed to be owing.[465]

(B) Nontaxpayer penalties

Understatement of taxpayer's liability by income tax preparer (sec. 6694).--Section 6694 imposes a monetary penalty on income tax preparers for any understatement of tax liability on a tax return due to a position for which there was not a realistic possibility of success of being sustained on its merits, but only if (1) the return preparer knew (or reasonably should have known) of the position, and (2) the position was not adequately disclosed on the return or was frivolous.

An "income tax preparer" means any person who prepares for compensation, or who employs other people to prepare for compensation, all or a substantial portion of an income tax return or claim for refund.[466]

The penalty is $250 with respect to each return, unless the preparer establishes that there was reasonable cause for the understatement and the preparer acted in good faith. The penalty amount is increased to $1,000 if any part of the understatement is due to the preparer's willful conduct, or reckless or intentional disregard of the rules and regulations.

Other assessable penalties with respect to the preparation of income tax returns for other persons (sec. 6695).--Section 6695 imposes a penalty on any income tax return preparer who, in

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[464] Treas. Reg. sec. 1.6662-4(g)(4)(i)(B); Treas. Reg. sec. 1.6664-4(c). Although rare, from time to time accuracy related penalties have been asserted in the context of tax shelters generally. See, e.g., Sheldon v. Commissioner, 94 T.C. 738, 769-70 (1990). In the corporate context specifically, see, e.g., Leema Enterprises v. Commissioner, 77 T.C.M. (CCH) 1261 (1999)). Because of the lack of clarity of the various economic substance and business purpose doctrines, however, courts are often reluctant to impose penalties in corporate tax shelter cases. See, e.g., Peerless Indus. v. United States, 94-1 U.S.T.C. (CCH) para. 50,043 (E.D. Pa. 1994).

[465] Stoltzfus v. United States, 398 F.2d 1002, 1004 (3d Cir. 1968), cert. denied, 393 U.S. 1020 (1969); Powell v. Granquist, 252 F.2d 56, 60 (9th Cir. 1958); Webb v. Commissioner, 394 F.2d 366, 377 (5th Cir. 1968); Jenkins v. United States, 313 F.2d 624 (5th Cir. 1963).

[466] Sec. 7701(a)(36)(A).

connection with the preparation of an income tax return, fails to: (1) furnish the taxpayer with a completed copy of the tax return; (2) sign the tax return (if required to do so by regulations); (3) furnish the proper identification number with respect to the tax return; (4) retain a copy of the completed return or a list (with names and taxpayer identification numbers) of the taxpayers for whom a return was prepared; or (5) comply with certain due diligence requirements in determining a taxpayer's eligibility for the earned income credit. Section 6695 also prohibits an income tax preparer from endorsing or otherwise negotiating a refund check that is issued to the taxpayer. In most cases, the penalty is $50 for each failure, with a maximum penalty of $25,000 per category. The failure to comply with the due diligence requirements in determining eligibility for the earned income credit carries a $100 penalty for each failure.

Promoting abusive tax shelters (sec. 6700).--Section 6700 imposes a penalty on any person who organizes, assists in the organization of, or participates in the sale of any interest in, a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if in connection with such activity the person makes or furnishes a qualifying false or fraudulent statement or a gross valuation overstatement. A qualified false or fraudulent statement is any statement with respect to the allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement which the person knows or has reason to know is false or fraudulent as to any material matter. A "gross valuation overstatement" means any statement as to the value of any property or services if the stated value exceeds 200 percent of the correct valuation, and the value is directly related to the amount of any allowable income tax deduction or credit.

The amount of the penalty equals $1,000 (or, if the person establishes that it is less, 100 percent of the gross income derived or to be derived by the person from such activity). In calculating the amount of the penalty, the organizing of an entity, plan or arrangement and the sale of each interest in an entity, plan, or arrangement constitute separate activities. A penalty attributable to a gross valuation misstatement can be waived on a showing that there was a reasonable basis for the valuation and it was made in good faith.

Aiding and abetting understatement of tax liability (sec. 6701).--Section 6701 imposes a penalty on any person who (1) aids, assists, procures, or advises with respect to the preparation or presentation of any portion of a return, affidavit, claim, or other document, (2) knows (or has reason to believe) that the document will be used in connection with any material matter arising under the internal revenue laws, and (3) knows that the document would result in an understatement of another person's tax liability. The concept of aiding or abetting requires "direct involvement" in the preparation or presentation of a tax return or other tax-related document.[467]

Several definitions and special rules apply. The penalty applies to a person who orders (or otherwise causes) a subordinate to do an act, as well as a person who knows of, and does not

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[467] See Staff of the Joint Committee On Taxation, 97th Cong., General Explanation to the Tax Equity and Fiscal Responsibility Act of 1982, 220.

attempt to prevent, participation by a subordinate in an act. A subordinate means any other person over whose activities the person subject to the penalty has direction, supervision, or control. The penalty applies whether or not the understatement is with the knowledge or consent of the persons responsible for the return or other document. By contrast, a person furnishing typing, reproducing, or other mechanical assistance is not subject to the penalty.

The penalty for aiding and abetting with respect to an individual's tax liability is $1,000; the penalty is $10,000 if the aiding and abetting is with respect to a corporation's tax liability. A person can only be subject to this penalty once with respect to a particular taxpayer per period. Courts have held that there is no statute of limitations for purposes of applying this penalty.[468]

Coordination rules apply such that a person who is subject to the aiding and abetting penalty is not also subject to the return preparer penalty (sec. 6694) or the promoter penalty (sec. 6700).

Registration of tax shelters (sec. 6111).--Section 6111 requires an organizer of a tax shelter to register the tax shelter with the Secretary not later than the day on which the shelter is first offered to potential users. A tax shelter for this purpose means any investment with respect to which any person could reasonably infer from the representations made, or to be made, in connection with the offering for sale of interests in the investment that the tax shelter ratio[469] for any investor as of the close of any of the first five years ending after the date on which such investment is offered for sale may be greater than two to one and which is: (1) required to be registered under Federal or State securities laws, (2) sold pursuant to an exemption from registration requiring the filing of a notice with a Federal or State securities agency, or (3) a substantial investment (greater than $250,000 and at least five investors).[470]

In addition, certain arrangements are treated as tax shelters for purposes of the registration requirement if: (1) a significant purpose of the arrangement is the avoidance or evasion of Federal income tax for a corporate participant; (2) the arrangement is offered under conditions of confidentiality; and (3) the tax shelter promoter may receive fees in excess of $100,000 in the aggregate. An arrangement is offered under conditions of confidentiality if: (1) an offeree (or any person acting on its behalf) has an understanding or agreement to limit the disclosure of the transaction or any significant tax features of the transaction; or (2) the promoter claims, knows, or has reason to know that a party other than the potential participant claims that the transaction (or

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[468] Mullikin v. United States, 952 F.2d 920, 922-929 (6th Cir. 1991); see also Kraye v. United States, 93-1 U.S.T.C. (CCH) para. 50,047 (D.N.M. 1992).

[469] The tax shelter ratio is, with respect to any year, the ratio which the aggregate amount of the deductions and 350 percent of the credits, which are represented to be potentially allowable to any investor, bears to the investment base (money plus basis of assets contributed) as of the close of the tax year.

[470] Sec. 6111(c).

any aspect of it) is proprietary to the promoter or any party other than the offeree, or is otherwise protected from disclosure or use. The registration provision with respect to these arrangements is effective for offerings made after the date the Treasury Department issues guidance in connection with such arrangements. At the time of publication of this study, the requisite guidance has not yet been issued; accordingly, this provision is not yet effective.

Any tax shelter registration must include: (1) information identifying and describing the tax shelter, (2) information describing the tax benefits of the tax shelter represented (or to be represented) to investors, and (3) such other information as the Secretary may prescribe.

Under section 6707, the penalty for failing to timely register a tax shelter (or for filing false or incomplete information with respect to the tax shelter registration) generally is the greater of one percent of the aggregate amount invested in the shelter or $500. However, if the tax shelter involves an arrangement offered to a corporation under conditions of confidentiality, the penalty is the greater of $10,000 or 50 percent of the fees payable to any promoter with respect to offerings prior to the date of late registration. Intentional disregard of the requirement to register increases the penalty to 75 percent of the applicable fees.

Section 6707 also imposes (1) a $100 penalty on the promoter for each failure to furnish the investor with the required tax shelter identification number, and (2) a $250 penalty on the investor for each failure to include the tax shelter identification number on a return.

Section 6112 requires promoters to maintain a list identifying each person who was sold an interest in any tax shelter with respect to which registration was required under section 6111 (even though the particular party may not have been subject to confidentiality restrictions). Under section 6708, the penalty for failing to maintain the list required under section 6112 is $50 for each name omitted from the list (with a maximum penalty of $100,000 per year).

(ii) Injunctive actions

(A) Action to enjoin income tax return preparers (sec. 7407)

Under section 7407, the Secretary may bring a civil action in district court to enjoin a tax return preparer from further engaging in conduct (1) described in section 6694 (the understatement of tax liability by a return preparer penalty, discussed above) or section 6695 (other assessable penalties with respect to the preparation of income tax returns, also discussed above), (2) misrepresenting his eligibility to practice or his experience or education, (3) guaranteeing the payment of any tax refund or allowance of any tax credit, or (4) engaging in any other fraudulent or deceptive conduct which substantially interferes with the proper administration of the Internal Revenue laws. For repeat offenses, the court may enjoin the person from acting as an income tax preparer.

(B) Action to enjoin promoters of abusive tax shelters (sec. 7408)

Under section 7408, the Secretary may bring a civil action in district court to enjoin a person from further engaging in conduct subject to penalty under section 6700 (the penalty for promoting abusive tax shelters, discussed above) or section 6701 (the penalties for aiding and abetting the understatement of tax liability, also discussed above). Consequently, statements incidental to the operation of an abusive tax shelter, in addition to statements made in the organization or sale of an abusive tax shelter, are subject to injunction. These actions may be brought in the United States District Court for the district in which the promoter resides, has his principal place of business, or has engaged in the conduct subject to the penalty. If a citizen or resident of the United States does not reside in or have a principal place of business in any U.S. judicial district, such citizen or resident is treated as a resident of the District of Columbia.

The court may grant injunctive relief against any person if it finds (1) that the person has engaged in any conduct subject to the penalty, and (2) that injunctive relief is appropriate to prevent recurrence of such conduct.[471] The IRS does not need to assess or collect the penalty prior to proceeding with an injunction.[472] In addition, case law has indicated that traditional equity factors such as irreparable injury and likelihood of success on the merits need not be considered, provided that the government has satisfied the statutory requirements.[473]

2. Standards of tax practice and professional conduct regarding tax shelters

a. Circular 230 – Treasury regulations which govern practice before IRS

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[471] In addition to the specific injunction actions under sections 7407 and 7408, under section 7402(a), the United States is empowered to seek, and the United States District Court to grant, such decrees or orders, and processes (including injunctions) as may be necessary to enforce the internal revenue laws. The court also has full authority to act under its general equity jurisdiction and possesses the great latitude inherent in equity jurisdiction to fashion appropriate equitable relief. For example, a court could enjoin particular conduct or enjoin all conduct subject to the penalty. In addition, the court could enjoin any action tending to impede the proper administration of the tax law or any action which violates criminal statutes. See e.g., United States v. Landsberger, 692 F.2d 501 (8th Cir. 1982).

[472] See S. Rep. No. 494, 97th Cong., 2nd Sess. 266-69 (1982).

[473] See United States v. Estate Preservation Serv., 38 F.Supp. 2d 846, 850 (E.D. Cal. 1998) (holding that because section 7408 expressly authorizes the issuance of an injunction, the traditional requirements for equitable relief need not be satisfied); see also United States v. H & L Schwarz, Inc., 1987 U.S. Dist. LEXIS 14478 (C.D. Cal. 1987), aff'd sub nom. Bond v. United States, 872 F.2d 898 (9th Cir. 1989); United States v. Music Masters, Ltd., 621 F.Supp. 1046 (W.D.N.C. 1985), aff'd sub nom., without published opinion, United States v. Masters, 816 F.2d 674 (4th Cir. 1987).

An individual who is a member in good standing of the bar of the highest court of a State may represent a person before the IRS.[474] Similarly, an individual who is duly qualified to practice as a certified public accountant in a State may represent a person before the IRS.[475] Individuals not qualifying under either the attorney or the certified public accountant rules may represent a person before the IRS if they qualify either by passing an examination or by nature of their previous employment with the IRS.[476]

The Treasury Department is authorized to regulate the practice of representatives before the Treasury Department (which includes the IRS), and (after notice and opportunity for a proceeding) to suspend or disbar any representative from practice before the Treasury Department for a violation of such rules and regulations.[477] In accordance with this grant of authority, the Treasury Department has issued regulations that govern the practice of attorneys, certified public accountants, enrolled agents, and other persons representing clients (hereafter "practitioners") before the IRS.[478] These regulations are commonly referred to as Circular 230. The IRS Office of Director of Practice is responsible for the enforcement of Circular 230.

(i) Circular 230 standards for tax shelter opinions

Section 10.33 of Circular 230 provides specific rules regarding tax shelter opinions.[479] Section 10.33 requires a practitioner who provides a tax shelter opinion[480] to comply with the following requirements:

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[474] 5 U.S.C. sec. 500.

[475] Id.

[476] Circular 230, sec. 10.4.

[477] 31 U.S.C. sec. 330.

[478] The regulations are found in Title 31, Part 10 of the Code of Federal Regulations.

[479] See generally, Bernard Wolfman, et. al., Standards of Tax Practice (1997 edition) (hereinafter "Wolfman, Holden & Harris"), 16-31, 87-90, and 288-96 (for a detailed analysis of Circular 230).

[480] For this purpose, a "tax shelter" is an investment that has as a significant and intended feature for Federal income or excise tax purposes, deductions in excess of income, or credits in excess of tax liability, from the investment in any year to reduce income or offset taxes from other sources in that year. Certain types of investments are excluded (e.g., municipal bonds, annuities, and qualified retirement plans). A "tax shelter opinion" is advice by a practitioner concerning the Federal tax aspects of a tax shelter either appearing or referred to in the offering materials or used or referred to in connection with sales promotion efforts (regardless of whether a separate opinion letter is issued or if the practitioner's name is used).

C The practitioner must make an inquiry as to all relevant facts, be satisfied that the material facts are accurately and completely described in the offering materials, and assure that any representations as to future activities are clearly identified, reasonable, and complete. The practitioner cannot accept as true asserted facts pertaining to the tax shelter that the practitioner should not, based on the practitioner's background and knowledge, reasonably believe are true. However, the practitioner is not required to independently verify the client's statement of facts unless the practitioner has reason to believe that the facts are not true. Special rules are provided for tax shelters in which the fair market value of property or the expected financial performance of an investment is relevant.

- The practitioner must relate the law to the actual facts and, when addressing issues based on future activities, clearly identify what facts are assumed.

- The practitioner must ascertain that all material Federal tax issues have been considered, and that all of those issues which involve the reasonable possibility of a challenge by the IRS have been fully and fairly addressed in the offering materials.

- Where possible, the practitioner must provide an opinion regarding whether it is more likely than not that an investor will prevail on the merits of each material tax issue in the tax shelter that involves a reasonable possibility of a challenge by the IRS. If the practitioner cannot provide such an opinion, the opinion should fully describe the reasons for the practitioner's inability to so opine.
- Where possible, the practitioner must provide an overall evaluation regarding whether the material tax benefits in the aggregate more likely than not will be realized. If the practitioner cannot provide an overall evaluation, the opinion should fully describe the reasons for the practitioner's inability to so opine.[481] A favorable overall evaluation must be based on a conclusion that substantially more than half of the material tax benefits, in terms of their financial impact on a typical investor, more likely than not will be realized if challenged by the IRS.

- The practitioner must assure that the offering materials correctly and fairly represent the nature and extent of the tax shelter opinion.

Section 10.33 also provides guidance regarding when a practitioner can rely on other opinions.

(ii) Circular 230 standards for tax return advisors and preparers

Section 10.34 of Circular 230 provides specific rules regarding standards for tax return advisors and preparers. It states that a practitioner may not sign a tax return as a preparer if the

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[481] The offering materials must "clearly and prominently disclose" the fact that a practitioner cannot provide an overall evaluation (or that the overall evaluation is not a favorable opinion).

practitioner determines that the tax return "contains a position that does not have a realistic possibility of being sustained on its merits (the 'realistic possibility standard') unless the position is not frivolous and is adequately disclosed to the Service." Similarly, a practitioner may not advise a client with respect to a position on a tax return (or prepare the portion of a return on which a position is taken) unless (1) the practitioner determines that the position satisfies the realistic possibility standard or (2) the position is not frivolous and the practitioner advises the client of any opportunity to avoid the section 6662 penalty by adequately disclosing the position (and the requirements for such disclosure). In any case, a practitioner has a duty to inform the client of any penalties reasonably likely to apply with respect to the position, and the opportunity to avoid such penalties through disclosure.

A position is considered to satisfy the realistic possibility standard if "a reasonable and well-informed analysis by a person knowledgeable in the tax law would lead such a person to conclude that the position has approximately a one in three, or greater, likelihood of being sustained on its merits." A position is frivolous if it is "patently improper."[482]

(iii) <u>Disciplinary actions under Circular 230</u>

When the Director of Practice has reason to believe that a practitioner has violated any of the rules governing practice before the IRS, the Director of Practice can either (1) issue a private reprimand or (2) institute a formal proceeding for the disbarment or suspension of the practitioner.[483] A practitioner can be disbarred or suspended if he or she is shown to be incompetent or disreputable or refuses to comply with the rules of Circular 230.[484] In the context of tax shelter opinions, the term "disreputable conduct" includes (but is not limited to):

> [G]iving a false opinion, knowingly, recklessly, or through gross incompetence, including an opinion which is intentionally or recklessly misleading, or a pattern of providing incompetent opinions on questions arising under the Federal tax laws. False opinions . . . include those which reflect or result from a knowing misstatement of fact or law; from an assertion of a position known to be unwarranted under existing law; from counseling or assisting in conduct known to be illegal or fraudulent; from concealment of matters required by law to be revealed; or from conscious disregard of information indicating that material facts expressed in the tax opinion or offering material are false or misleading.[485]

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[482] The definitions of the "realistic possibility standard" and "frivolous" are found in Circular 230, sec. 10.34(a)(4).

[483] Circular 230, sec. 10.54.

[484] Circular 230, sec. 10.50.

[485] Circular 230, sec. 10.52(j).

Practitioners who violate the Circular 230 standards regarding tax shelter opinions can be suspended or disbarred only if the violation is willful, reckless, or a result of gross incompetence.[486] The same standard (i.e., willful, reckless, or gross incompetence) applies to practitioners who violate the Circular 230 standards for tax return preparers and advisors. A private reprimand requires a showing that the practitioner's behavior constituted a violation of the Circular 230 standards. The Director of Practice also is authorized (but not required) to notify State authorities of the suspension or disbarment of an attorney or accountant licensed by the State.[487]

Disciplinary action against a practitioner begins with a referral of professional misconduct to the Office of Director of Practice. Officers and employees of the IRS are supposed to make a referral to the Director of Practice if they have reason to believe that a practitioner has violated Circular 230. Moreover, the Internal Revenue Manual mandates an information referral to the Director of Practice upon the imposition of certain practitioner penalties[488] Also, the imposition of a substantial understatement penalty may trigger a referral of the preparer to the Director of Practice.[489]

The Director of Practice conducts an informal review to determine if (1) the practitioner is subject to the disciplinary jurisdiction of the IRS, and (2) whether the alleged behavior, if true, constitutes a violation subject to discipline. Following the informal review, the Director of Practice typically notifies the practitioner of the alleged violations and provides the practitioner with an opportunity to respond to the allegations. If the Director of Practice institutes a formal proceeding for suspension or disbarment, the proceeding takes place before an administrative law judge whose decision is appealable to the Secretary (and then to Federal district court). A special

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[486] Circular 230, sec. 10.34(b) and sec. 10.52.

[487] Section 10.74 of Circular 230 gives the Director of Practice the option of notifying the proper State authorities about the suspension or disbarment of an attorney or accountant licensed in that State. Apparently, the Director of Practice has entered into agreements with several State licensing authorities regarding the notification of the suspension or disbarment of an individual licensed in the State, and if requested, information regarding the disciplinary action (unless the disciplinary action was the result of a voluntary suspension or resignation). See Wolfman, Holden & Harris, supra note 479, at 31.

[488] I.R.M. Chapter 20(622)-1 provides that the assertion of practitioner penalties under sections 6700, 6701, 6695(f), 6694(a) and (b), 7407 and 7408, results in a mandatory information referral to the Director of Practice.

[489] I.R.M. sec. 4563.62(k) states that if a return prepared by an attorney, CPA, or an enrolled agent results in the assertion of the substantial understatement penalty, the attorney, CPA, or enrolled agent should be referred to the Director of Practice. The referral should be made when the case is closed and the penalty has been asserted.

expedited suspension process exists for practitioners who have been convicted of a crime or have lost their license for cause.[490]

b. American Bar Association

The American Bar Association ("ABA") has promulgated a series of rules and guidelines concerning the standards of practice for lawyers.[491] The ABA rules, in and of themselves, do not have legal effect. However, most States have adopted rules of professional conduct based on rules promulgated by the ABA (which have the force and effect of law). The two primary sets of rules that have been promulgated by the ABA are the Model Code of Professional Responsibility ("Model Code") and Model Rules of Professional Conduct ("Model Rules").

The ABA, through its Standing Committee on Ethics and Professional Responsibility, issues formal and informal opinions that interpret the Model Code and Model Rules. Of particular relevance to tax practitioners are (1) ABA Formal Opinion 346, regarding a lawyer's duties and responsibilities in rendering tax shelters, and (2) ABA Formal Opinion 85-352, regarding a lawyer's duty in advising a client on a position that can be taken on a tax return.

(i) ABA Formal Opinion 346

Formal Opinion 346 (Revised), issued by the ABA Standing Committee on Ethics and Professional Responsibility in 1982, defines a lawyer's duties and responsibilities in connection with tax shelter opinions that are offered as part of tax shelter investment offerings. The ABA does not have the authority to discipline its members for a violation of Formal Opinion 346; its application and enforcement is left to the State licensing authorities.

Formal Opinion 346 defines a "tax shelter opinion" as advice by a lawyer regarding the Federal tax law applicable to a tax shelter[492] if the advice is referred to either (1) in offering materials or (2) in connection with sales promotion efforts. A tax shelter opinion includes the tax aspects or tax risks portion of the offering materials prepared by the lawyer regardless of whether a separate opinion letter is prepared.

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[490] These rules are found in Circular 230, secs. 10.50 - 10.76.

[491] For a more detailed discussion of the ABA Standards for lawyers, see Wolfman, Holden & Harris, supra note 479, at 5-14.

[492] For purposes of Formal Opinion 346, a "tax shelter" is an investment that has as a significant feature for federal income or excise tax purposes either or both of the following attributes: (1) deductions in excess of income from the investment being available in any year to reduce income from other sources in that year, and (2) credits in excess of the tax attributable to the income from the investment being available in any year to offset income from other sources in that year. Certain types of investments (e.g., municipal bonds, annuities, and qualified retirement plans) are excluded from the definition.

A lawyer who provides a tax shelter opinion violates the disciplinary rules of the Model Code if the lawyer gives a false opinion.[493] A "false opinion" is one that ignores or minimizes serious legal risks or misstates the facts or the law, knowingly or through gross incompetence. A false opinion also includes (1) an opinion that is intentionally or recklessly misleading, and (2) the acceptance of facts as represented by the promoter, when the lawyer should know that a further inquiry would disclose that such facts are untrue.

Formal Opinion 346 also describes the principles and considerations that should guide lawyers in the rendering of tax shelter opinions. The lawyer should verify the facts presented to him and make further inquiries when the facts are incomplete, inconsistent, or otherwise open to question. The lawyer also should relate the law to the actual facts to the extent the facts are ascertainable when the offering materials are circulated, and not issue an opinion that disclaims responsibility for inquiring as to the accuracy of the facts, fails to analyze critical facts, or discusses purely hypothetical facts.[494] The lawyer should satisfy himself that either he or another professional has considered all material tax issues. Moreover, the tax shelter opinion should "fully and fairly address" each material tax issue for which a reasonable possibility exists that the IRS will challenge the proposed tax effects. The lawyer should, if possible, state his or her opinion of the probable outcome on the merits of each material tax issue, as well as an overall evaluation of the extent to which the tax benefits, taken as a whole, are likely to be realized (or not realized) as contemplated by the offering materials.[495]

(ii) ABA Formal Opinion 85-352

ABA Formal Opinion 85-352[496] defines the basic ethical standard governing lawyers engaged in federal tax practice. It provides that "[a] lawyer may advise reporting a position on a return even where the lawyer believes the position probably will not prevail, there is no 'substantial authority' in support of the position, and there will be no disclosure of the position on the return. However, the position to be asserted must be one which the lawyer in good faith believes is warranted in existing law or can be supported by a good faith argument for an

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[493] Formal Opinion 346 provides that a lawyer who gives a false opinion would have exceeded "the duty to represent the client zealously within the bounds of the law" (citing Model Code of Professional Responsibility DR 7-101). In addition, knowingly misstating facts or law violates DR 7-101, and is "conduct involving dishonesty, fraud, deceit, or misrepresentation," in violation of DR 1-102(A)(4).

[494] The lawyer can assume facts that are not currently ascertainable so long as the assumptions are clearly identified in the offering materials, and are reasonable and complete.

[495] In general, an issue is considered "material" if the deduction or credit in question would have a significant effect in sheltering other income from taxes.

[496] ABA Formal Opinion 85-352, reprinted in 39 Tax Law. 631 (1986).

extension, modification, or reversal of existing law. This requires that there is some realistic possibility of success if the matter is litigated."

ABA Formal Opinion 85-352 represents a higher threshold than had been contained in the previous standard, as articulated in ABA Formal Opinion 314. The standard for tax practitioners under ABA Formal Opinion 314 required only that "a lawyer could freely urge the statement of positions most favorable to the client just so long as there [was] reasonable basis for the position."

The standard in ABA Formal Opinion 85-352, which Congress adopted in 1989 as its model for income tax return preparers (section 6694(a)) is a lower standard than the "substantial authority" standard of section 6662(b)(2). A lawyer may advise the taxpayer to take a return position that does not meet the "reasonable possibility of success standard" provided that it is not frivolous and is either adequately disclosed or it is filed as a claim for refund. Thus, a lawyer is ethically permitted to advise the taxpayer to take a position on a tax return that subjects the taxpayer to the risk of the substantial understatement penalty.

c. American Institute of Certified Public Accountants

The American Institute of Certified Public Accountants ("AICPA") has not issued standards of practice specifically related to tax shelter arrangements. However, AICPA Statements on Responsibilities in Tax Practice (1991 Revision) represent general guidance for AICPA members, but do not constitute enforceable standards. Rather, the statements are considered only educational and advisory in nature.[497]

The statements provide guidance for CPAs in recommending tax return positions and in preparing or signing tax returns, including claims for refund. Statement No. 1.02(a) provides that a CPA should not recommend a return position, or sign a tax return, unless there is "a good faith belief that the position has a realistic possibility of being sustained administratively or judicially on its merits if challenged." In order to satisfy the realistic possibility standard, a CPA should have a good faith belief that the position is warranted by existing law or can be supported by a good-faith argument for an extension, modification, or reversal of existing law through the administrative or judicial process. The likelihood of audit or detection should not be taken into account in determining whether the realistic possibility standard is satisfied.

A CPA may recommend positions that are not frivolous so long as they are adequately disclosed on the return.[498] A frivolous position is one which is knowingly advanced in bad faith and is patently improper. In recommending certain tax return positions, and signing returns, CPAs should advise the client of any potential penalty consequences and any opportunities that are

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[497] The statements have been approved by at least two-thirds of the members of the Responsibilities in Tax Practice Committee and the Tax Executive Committee.

[498] AICPA Statement on Responsibilities in Tax Practice (hereinafter "Statement") No. 1.02(c).

available to avoid the penalties, such as through disclosure.[499] CPAs should not recommend tax return positions that are intended to exploit the IRS tax return audit selection process or serve as mere arguing positions advanced solely to obtain leverage in the bargaining process of settlement negotiations with the IRS.[500]

d. State licensing authorities

Each State, by virtue of the State courts (for lawyers), or through a licensing board (for CPAs), regulates and disciplines practitioners who are authorized or licensed to practice in the State. Many State regulatory bodies maintain rules that mirror the standards of national organizations, such as the ABA and the AICPA. Tax practitioners that fail to abide by their respective State requirements may be subject to disciplinary actions, such as disbarment, suspension, reprimand, or denial of license to practice within such State.

3. Administration proposals

The President's Fiscal Year 2000 Budget Proposal, as submitted to the Congress on February 1, 1999, included 16 different proposals that the Treasury Department referred to as relating to corporate tax shelters. Of these proposals, ten are transaction-specific proposals and are not discussed in this study.[501]

a. General definitions

The proposals would provide a new statutory definition of a corporate tax shelter. A corporate tax shelter would be any entity, plan, or arrangement (based on all facts and circumstances) in which a direct or indirect corporate participant attempts to obtain a tax benefit in a tax avoidance transaction. A tax benefit would be defined to include a reduction, exclusion, avoidance, or deferral of tax, or an increase in a refund, but would not include a tax benefit clearly

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[499] Statement No. 1.02(d).

[500] Statement No. 1.03.

[501] The ten transaction-specific proposals are: (1) require accrual of time value element on forward sale of corporate stock; (2) modify tax treatment of built-in losses and other attribute trafficking; (3) modify treatment of ESOP as S corporation shareholder; (4) limit tax-free liquidations of U.S. subsidiaries of foreign corporations; (5) prevent capital gains avoidance through basis shift transactions involving foreign shareholders; (6) limit inappropriate tax benefits for lessors of tax-exempt use property; (7) prevent mismatching of deductions and income inclusions in transactions with related foreign persons; (8) restrict basis creation through section 357(c); (9) modify anti-abuse rules related to assumption of liabilities; and (10) modify company-owned life insurance rules. See Staff of the Joint Committee on Taxation, 106th Cong., Description of Revenue Provisions Contained in the President's Fiscal Year 2000 Budget Proposal 178-204 (JCS-1-99) (for a more detailed discussion of these proposals).

contemplated by the applicable provision (taking into account the Congressional purpose for such provision and the interaction of such provision with other provisions of the Code).

A tax avoidance transaction would be defined as any transaction in which the reasonably expected pre-tax profit (determined on a present value basis, after taking into account foreign taxes as expenses and transaction costs) of the transaction is insignificant relative to the reasonably expected net tax benefits (i.e., tax benefits in excess of the tax liability arising from the transaction, determined on a present value basis) of such transaction. In addition, a tax avoidance transaction would be defined to cover certain transactions involving the improper elimination or significant reduction of tax on economic income.

b. Proposals with broad application to corporate tax shelters

(i) Modify the substantial understatement penalty for corporate tax shelters

The proposal would make three modifications to the substantial understatement penalty as it applies to corporate tax shelters. First, the penalty rate would be increased to 40 percent with respect to any item attributable to a corporate tax shelter. Second, the 40 percent rate would be reduced to 20 percent if the corporation fulfilled specified disclosure requirements. Third, the reasonable cause exception from the substantial understatement penalty would be unavailable with respect to any item attributable to a corporate tax shelter.

To fulfill the specified disclosure requirements, the corporate taxpayer must: (1) disclose (within 30 days of closing the transaction) to the IRS National Office appropriate documents describing the transaction; (2) file a statement with the corporation's tax return verifying that this disclosure has been made; and (3) provide adequate disclosure on the corporation's tax returns as to the book/tax differences resulting from the corporate tax shelter item for all taxable years of the tax shelter.

(ii) Deny certain tax benefits to persons avoiding income tax as a result of tax avoidance transactions

The proposal would expand section 269 by authorizing the Secretary to disallow a deduction, credit, exclusion, or other allowance obtained in a tax avoidance transaction.

(iii) Deny deductions for certain tax advice and impose an excise tax on certain fees

The proposal would deny a deduction to a corporation for fees paid or incurred in connection with the purchase and implementation of, as well as the rendering of tax advice related to, a corporate tax shelter. The proposal would also impose a 25-percent excise tax on fees (such as underwriting fees) paid or incurred in connection with the purchase and implementation of, as well as the rendering of tax advice related to, a corporate tax shelter.

The proposal would not apply to expenses incurred to represent the taxpayer before the IRS or a court. If a taxpayer claimed a deduction that would otherwise be denied under the proposal, the deduction would be considered to be in connection with a corporate tax shelter for purposes of the proposed 40-percent substantial understatement penalty.

(iv) Excise tax on certain rescission provisions and provisions guaranteeing tax benefits

The proposal would impose a 25-percent excise tax on the maximum payment that might be made under a tax benefit protection arrangement. The excise tax is imposed at the time the benefit protection arrangement is entered into, regardless of whether benefits are actually paid in the future. A tax benefit protection arrangement would include a rescission clause, a guarantee of the legal basis of the benefits, insurance, or any other arrangement that has the same economic effect.

(v) Preclude taxpayers from taking tax positions inconsistent with the form of their transactions

The proposal would preclude a corporate taxpayer from taking any position on a return or claim for refund that the income tax treatment of a transaction is different from that required by its form if a tax-indifferent party has a direct or indirect interest in the transaction. Several exceptions would apply. First, this rule would not apply if the taxpayer discloses the inconsistent position on its timely filed, original tax return for the taxable year that includes the date on which the transaction was entered into. Second, this rule would not apply if reporting the substance of the transaction more clearly reflects the income of the taxpayer (to the extent this exception is permitted in regulations). Third, this rule would not apply to transactions that are identified in regulations.

The form of a transaction is to be determined based on all facts and circumstances, including the treatment that would be given the transaction for regulatory or foreign law purposes.

A tax-indifferent party would be defined as a foreign person, a Native American tribal organization, a tax-exempt organization, or a domestic corporation with expiring loss or credit carryforwards.[502]

The Secretary would have the authority to prescribe regulations to carry out the purposes of the rule, including a definition of the "form" of a transaction. Moreover, the proposal would not prevent the Secretary from asserting the substance over form doctrine or imposing any applicable penalties.

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[502] Loss and credit carryforwards would generally be treated as expiring if the carryforward is more than three years old.

(vi) Tax income from corporate tax shelters involving tax-indifferent parties

The proposal would provide that any income allocable to a tax-indifferent party with respect to a corporate tax shelter is taxable to such tax-indifferent party. The U.S. tax imposed on the income allocable to the tax-indifferent party would be determined without regard to any statutory, regulatory, or treaty exclusion or exception. The proposal also would provide that any other participants in the corporate tax shelter (i.e., any participant other than the tax-indifferent party) would be jointly and severally liable with the tax-indifferent party for taxes imposed.

In the case of a foreign person, U.S. tax on the income or gain allocable to such person would be determined without regard to any exclusion or exception provided in a treaty or otherwise. Any such income or gain that is not certain types of U.S.-source passive income would be treated as effectively connected with a U.S. trade or business without regard to whether such income is U.S.- or foreign-source. If the foreign person properly claims the benefit of an income tax treaty, the U.S. tax otherwise owed by such foreign person would be collected from the other participants in the corporate tax shelter transaction who are not exempt from U.S. tax.

In the case of a Native American tribal organization, the tax on the income allocable to such person would be determined without regard to any exclusion or exception. However, the tax would be collected only from participants of the corporate tax shelter transaction who are not exempt from U.S. tax.

In the case of a tax-exempt organization, the income would be characterized as income that is subject to UBIT. In the case of a U.S. corporation with expiring loss or credit carryovers, the tax on the income allocable to such corporation would be computed without regard to such losses or credits.

B. Analysis

1. The modern corporate tax shelter problem

There is a growing perception that corporations are increasingly using sophisticated transactions to avoid or evade Federal income tax. Such a phenomenon could pose a serious threat to the efficacy of the tax system both because of the potential drain on revenue and the potential threat to the integrity of the self-assessment system. These concerns are discussed below.

a. Proliferation of corporate tax shelters

The proliferation of corporate tax shelters is believed to be both widespread and significant. A recent Forbes cover story titled "The Hustling of X-Rated Shelters" highlights the breadth and scope of the corporate tax shelter problem.[503] The article, among other things, quoted from letters sent to medium-size corporations from a large public accounting firm. The letters described a proposal to "implement our tax strategy to eliminate the Federal and State income taxes associated with [the company's] income for up to five (5) years." The fee for the tax strategy was a contingency fee of 30 percent of the tax savings plus out-of-pocket expenses, with a portion of the fee being refunded if the taxpayer ended up owing the taxes. The Forbes article noted how "[h]esitant at first to participate, respectable accounting firms, law offices and public corporations have lately succumbed to competitive pressures and joined the loophole frenzy."[504] The Forbes article is but one of a series of recent news stories describing corporate tax shelter activities.[505]

The recognition of a corporate tax shelter phenomenon is not limited to media reports. Several prominent associations representing corporate tax executives, lawyers, and accountants have voiced their concerns with the growing popularity of corporate tax shelters and its potentially harmful effects on the Federal income tax system. At a recent hearing before the United States Senate Committee on Finance, the president of the Tax Executives Institute testified that "TEI agrees that the situation cannot be ignored. As tax executives, we see the challenge to the tax

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[503] Janet Novack and Laura Saunders, The Hustling of X-Rated Shelters, Forbes, Dec. 14, 1998, at 198-208.

[504] Id. at 199.

[505] See, e.g., Richard W. Stevenson, Taxing the Treasury's Patience -- Gimme Shelter: The Unwritten Corporate Theme Song, N.Y. Times, June 4, 1999, at C1, C18; Floyd Norris, The Rise of Phony Corporate Tax Shelters, N.Y. Times, Feb. 8, 1999, at C1; Anita Raghavan and Jacob M. Schlesinger, Cat and Mouse: Wall Street Concocts New Tax-Saving Ploy; Then It's Feds' Turn, The Wall Street Journal, Nov. 16, 1997, at A1, A4; E.S. Browning, Where There's a Tax Cut, Wall Street Finds a Way, The Wall Street Journal, Oct. 21, 1997, at C1, C2; Allan Sloan, Deals: Did Times Mirror Deserve That Tax Break? It Depends on Your Definition of "Sale", The Washington Post, Oct. 13, 1998, at C3.

system every day."[506] At the same hearing, the Chair of the ABA Tax Section stated that "[w]e have witnessed with growing alarm the aggressive use by large corporate taxpayers of tax 'products' that have little or no purpose other than reduction of Federal income taxes."[507] The New York State Bar Association Tax Section similarly testified that "[o]ur perception is that the number of widely-marketed, aggressive corporate tax shelter transactions has grown significantly in the last decade . . . based on admittedly anecdotal evidence derived from our experience as tax professionals, we believe that the growth in such transactions has been quite substantial. In our view, corporate tax shelters (properly identified) represent a major problem for our system."[508] The AICPA testified that "[w]e begin by recognizing that tax laws are usually followed, but that they can also be abused. Where there are abuses, we hold no brief for them -- whether they fall under the pejorative rubric of 'tax shelters' or any other part of our tax system. Thus, we sympathize with and support efforts to restrict improper tax activities through appropriate sanctions."[509]

b. Challenge to the efficacy of the tax system

The corporate tax shelter phenomenon poses a serious challenge to the efficacy of the tax system. An obvious concern is the extent of the loss of tax revenues. No direct measure of this loss is currently available. This is partly due to the difficulty of deriving a functional definition of what constitutes a corporate tax shelter. Moreover, the common interests of the direct participants and promoters of tax shelter arrangements are generally served by keeping such arrangements hidden from view in both financial and tax reporting.

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[506] Statement of Mr. Lester D. Ezrati, on behalf of the Tax Executives Institute, Inc., Revenue Provisions in the President's FY2000 Budget: Hearings Before the Senate Comm. on Finance, 106th Cong. (Apr. 27, 1999), at 6.

[507] Statement of Stefan F. Tucker, Chairman, Section of Taxation, American Bar Association, Revenue Provisions in the President's FY2000 Budget: Hearings Before the Subcomm. on Oversight of the House Committee on Ways and Means, 106th Cong. (Mar. 10, 1999) (hereinafter "ABA Tax Section testimony"), at 4.

[508] New York State Bar Association Tax Section, Report on Corporate Tax Shelters (May 5, 1999) (hereinafter "NYSBA May Report"), at 7.

[509] Statement of David A. Lifson, Chairman, Tax Executive Committee, American Institute of Certified Public Accountants, Revenue Provisions in the President's FY2000 Budget: Hearings Before the Senate Comm. on Finance, 106th Cong. (Apr. 27, 1999) (hereinafter "AICPA Tax Division testimony"), at 14.

Although economic information concerning the cost of tax shelters is largely anecdotal, some believe that the resulting revenue loss may be in excess of $10 billion a year.[510] This amount is equal to approximately five percent of annual corporate income tax receipts. To place this aggregate figure in perspective, the provision enacted in 1998 that curtailed one specific corporate tax shelter, liquidating REITs, was estimated to increase revenues by almost $1 billion annually.[511]

Of equal importance is the harm that such transactions cause to the integrity of the tax system. The income tax system is a self-assessment system that requires taxpayers to calculate their tax liability each year. IRS resources limit the number of returns audited each year. "Although the description of the taxpayer's self-assessment duty is backed by the threat of civil liabilities, it is clear that the existing tax system could not function properly if the great majority of taxpayers did not report the correct amount of tax without the government's prior determination of tax liability."[512] The proliferation of corporate tax shelters causes taxpayers to question the fairness of the tax system. This could result in significant noncompliance problems. As the Chair of the NYSBA Tax Section noted,

> The constant promotion of these frequently artificial transactions breeds significant disrespect for the tax system, encouraging responsible corporate taxpayers to expect this type of activity to be the norm and to follow the lead of other taxpayers who have engaged in tax-advantaged transactions.[513]

This challenge to the tax system is magnified because the modern corporate tax shelters or "products" to which the above testimony referred often exploit substantive tax laws that generally work to achieve their desired consequences but that produce irrational results when applied to contexts for which they were never intended.[514] The tax law, particularly as it relates to business transactions, is extremely complex. The complexity in part is a result of the complexity of the economy, but is also a result of an attempt to balance the need for a comprehensive, objective, reliable set of rules with the need for flexibility in order to assure the integrity and fairness of the

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[510] Administration officials cite estimates of revenue losses of more than $10 billion a year. Stevenson, supra note 505, at C18.

[511] This provision was included in the Tax and Trade Relief Extension Act of 1998, Pub. L. No. 105-277.

[512] Wolfman, Holden & Harris, supra note 479, at 43.

[513] Stevenson, supra note 505, at C18. See also NYSBA May Report, supra, note 508, at 8.

[514] See ABA Tax Section testimony, supra note 507, at 6; NYSBA May Report, supra note 508, at 15.

system.[515] As a result, the tax law inevitably involves some ambiguities. Aggressive interpretations or misinterpretations of these ambiguities often become the foundation of a corporate tax shelter. Many tax shelter products take advantage of "glitches" or technical gaps in the tax law or inconsistencies in the way the tax law applies to economically equivalent transactions. Other tax shelter products involve the juxtaposition of unrelated, incongruous Code provisions in connection with a single transaction that results in consequences that were never contemplated by Congress. Finally, mistaken or misguided administrative and judicial interpretations of the law may themselves contribute to the development of corporate tax shelters.

Given the complexity of the economy and the products available and the rapid pace at which both evolve, and especially considering the vigorous development of sophisticated financial instruments, it is extremely difficult for the tax law to react in a timely fashion to the propagation of shelter activity. This effect is exacerbated by the assumption "by the promoter, by counsel and apparently by the taxpayer itself that, if the 'product' comes to the attention of Treasury or Congressional staffs, it will be blocked, but almost invariably prospectively, by administrative action or by legislation."[516]

c. Recent responses to the corporate tax shelter problem

Both the Administration and some members of Congress likewise recently have expressed concern about the proliferation of corporate tax shelters. As previously discussed, the Administration, in the President's Fiscal Year 2000 Budget Proposal, included six broad proposals designed to curb the growth of corporate tax shelters. The proposals address characteristics that the Administration has identified as common to corporate tax shelters, such as the marketing to multiple corporate taxpayers, the involvement of tax-indifferent participants, high transaction costs, contingent or refundable fees, unwind clauses, preferential financial accounting treatment, and property or transactions unrelated to a corporate's core business.[517] The Administration's proposals reflect a multifaceted response to the growing corporate tax shelter problem, and has served as a catalyst for other stakeholders in the tax system to likewise focus their efforts toward the development of a comprehensive legislative response to the problem.

In addition, Congressman Doggett (for himself, and Messrs. Stark, Hinchey, Tierney, Allen, Luther, Bonior, and Farr of California) recently introduced legislation to curb tax abuses by disallowing tax benefits claimed to arise from transactions without substantial economic

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[515] See Edward D. Kleinbard, Corporate Tax Shelters and Corporate Tax Management, 51 The Tax Executive 231, 235 (1999); Hariton, supra note [414] at 237.

[516] ABA Tax Section testimony, supra note [507], at 4 (emphasis added).

[517] Budget of the United States Government for Fiscal year 2000, Analytical Perspectives, at 71.

substance.[518] The proposal would also increase the section 6662 understatement penalty with respect to such transactions. This proposed legislative response is further evidence of the growing recognition of the corporate tax shelter problem.

2. Characteristics of a corporate tax shelter

The tax law relies on a subjective analysis to determine whether a plan or arrangement constitutes a corporate tax shelter. That is, a corporation is treated as having engaged in a tax shelter if a significant purpose of the plan or arrangement is the avoidance or evasion of Federal income tax.[519] It is often difficult to determine a corporation's business purpose for entering into an arrangement and to measure whether the tax avoidance aspect of the arrangement is significant relative to its non-tax aspects. However, the types of corporate tax shelter products that are being developed and offered in the current marketplace share a number of common, more objective characteristics.

For example, in many corporate tax shelter arrangements, the reasonably expected pretax profit from the arrangement is insignificant when compared with the tax benefits that are expected to be derived from the arrangement. Stated another way, but for the tax benefits, the corporate taxpayer would not have entered into the arrangement.

Another common feature is the involvement of a tax-indifferent participant. Many corporate tax shelters are designed to bifurcate certain "desirable" tax benefits from "undesirable" tax consequences. The tax-indifferent participant is compensated to "absorb" the undesirable tax consequences without suffering any adverse economic consequences from the arrangement. For example, the arrangement may result in a tax-indifferent participant having taxable income materially in excess of its economic income.[520] Another variation involves the artificial creation or shifting of basis for the benefit of a corporate participant, with any corresponding taxable income or gain being borne by the tax-indifferent participant.[521]

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[518] See H.R. 2255, 106th Cong., 1st Sess. (June 17, 1999).

[519] Sec. 6662(d)(2)(C)(iii).

[520] Conversely, the corporate participant would have economic income in excess of its taxable income.

[521] Indeed, some commentators have suggested that the involvement of a tax-indifferent participant alone is a sufficient indication of a corporate tax shelter to warrant disclosure of any transaction involving a tax-indifferent participant. See New York State Bar Association Tax Section, Report of Certain Tax Shelter Provisions (June 22, 1999) (hereinafter "NYSBA June Report") (stating "that it would be effective to require any transaction with a tax indifferent party to be specifically disclosed on the corporate taxpayer's return, thereby increasing the likelihood of audit scrutiny").

Because of the uncertainty surrounding whether a corporate tax shelter will withstand scrutiny by the IRS, the courts, or Congress, many shelters include the use of guarantees, tax indemnities, or similar arrangements. These arrangements typically are designed to recompense the corporate participant in the event that it is not entitled to all or any portion of the anticipated tax benefits. In some cases the guarantee of the anticipated tax benefits is provided by the promoter or another interested party in the arrangement. In other cases, the corporate participant purchases tax benefit insurance coverage from a third-party insurer. Along the same line, it is common for tax shelters to use a fee structure that is contingent on the ultimate success of the corporate tax shelter.

Corporations generally are reluctant to engage in transactions that are expected to result in reduced corporate earnings for U.S. financial reporting purposes. As a result, another common indicator of corporate tax shelters is that the expected tax benefits do not result in a corresponding loss for financial reporting purposes. This is particularly the case when the arrangement gives rise to a "permanent difference" for U.S. financial reporting purposes under generally accepted accounting principles.

In addition, when a corporation enters into a transaction for tax-avoidance purposes, the corporation often does not appreciably alter its economic position. This is perhaps most evident where a corporation does not incur additional economic risk as a result of entering into a transaction but nonetheless enjoys significant tax benefits.

3. Contributing factors

Several factors have contributed to the proliferation of corporate tax shelters having the characteristics discussed above. For example, the emerging view of the corporate tax department as a profit center and of the corporate income tax as a manageable cost has increased the pressure to use tax shelter products to decrease a corporation's effective tax rate. Additionally, the relative costs of entering into tax shelter transactions (including the risk that the transaction will be detected upon audit, challenged by the IRS, and ultimately result in a deficiency), as compared to the potential benefits from the tax savings, are insufficient to serve any meaningful deterrent function.

The evolution of the tax advisor's role also has contributed to the relatively unchecked expansion of the corporate tax shelter market. For example, the demand for a "more likely than not" opinion from a tax advisor coupled with competition in the tax opinion business has caused a dilution in the standards for such opinions. This effect is exacerbated by the insufficiency of the standards of practice under Circular 230 and the lack of effective enforcement measures.

a. Emerging view of corporate tax department as profit center

The corporate tax shelter phenomenon may be viewed as a natural evolution in corporate philosophy involving the management of corporate liabilities. In the past several years, corporations have become more sophisticated at controlling and managing their operational

liabilities. More recently, corporations have been applying similar liability management techniques to manage their income tax liability. As one commentator stated,

> My evidence is also anecdotal, but many others have pointed to the same phenomenon, which is simply that senior corporate managers now perceive a corporation's tax liability, not as an inelastic and inevitable misfortune, but rather as a necessary cost that responds to aggressive management, just like other corporate expenses . . . .The fundamental issue with which the tax system needs to grapple, then, is that modern corporate strategists perceive income tax liabilities as another cost of business that can and should be managed, like inventory costs or environmental regulations. The phenomenon, like the other examples just cited, is both inevitable and irreversible.[522]

Treating a corporation's tax liability as a manageable cost means that a corporate tax department's (and its employee's) performance could be evaluated based on a quantitative measure. The corporate tax department's "cost savings" generally is the reduction in the corporation's effective tax rate. This will result in more pressure on corporate tax directors to enter into arrangements in which the tax savings component is significant.[523] Anecdotal evidence suggests that corporate tax directors increasingly are evaluated by the amount of "tax savings" generated by their departments and the effect of such savings on corporate profits.

b. Cost-benefit analysis

Another factor contributing to the proliferation of corporate tax shelters is that, in many cases, the expected tax benefits from the tax shelter far outweigh the associated costs. Businesses constantly are faced with critical decisions on how to best utilize their assets. The decisions are made by comparing the estimated benefits of each opportunity to their associated costs, adjusted for the risk inherent in the transaction.[524] A growing trend is for corporations to apply a similar cost-benefit analysis with respect to corporate tax shelters. The "benefits" are the expected tax savings from the tax shelter. The "costs" of the tax shelter include: (1) the direct costs of planning and implementing the tax shelter; and (2) the cost associated with "enforcement risk," such as (a) the risk of detection on audit, (b) the likelihood of success at the IRS and in court, and (c) the risk

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[522] Kleinbard, supra note 515, at 233.

[523] NYSBA May Report, supra note 508, at 11. The NYSBA reports: "managing the effective tax rate on corporate income has, it appears, become one way that a substantial majority of corporations . . . compete indirectly with respect to financial earnings results. In that context, it is inevitable that corporate tax managers will frequently be put under pressure to participate in aggressive tax-driven transactions by their financial colleagues, who are often considerably more irreverent about our tax laws."

[524] For further discussion, see Part V of this study, "Economics of Tax Penalties and Interest."

of penalties and interest. In many cases, the "enforcement risk" component of the tax shelter is minimal, so that it skews the analysis heavily in favor of investing in the tax shelter.

The risk that a corporate tax shelter may be detected on audit is one of the more significant aspects of analyzing the enforcement risks. A popular phrase that describes this risk is "playing the audit lottery." Too often, the risk associated with audit detection is viewed as slight, thus encouraging corporations to play the audit lottery.

Several factors contribute to the minimal risk of audit detection. One factor is the corporate audit rate. With respect to the largest corporations (typically subject to the coordinated examination program), however, the audit rate is not nearly as important as the selection and identification of issues for audit.

Audits of large corporations typically follow an agreed-upon agenda of issues that is negotiated at the outset by the IRS and the corporate taxpayer. Agreement on the agenda is a necessary feature for conducting an audit that often involves the review of a myriad of corporate entities, documents, and records over a period of time, as well as the retention and coordination of outside IRS consultants to advise on business processes used by the taxpayer. For a large corporation, "playing the audit lottery" means to have included its strongest issues on the audit agenda, and to have its most aggressive positions (such as tax benefits arising from a corporate tax shelter) excluded from the audit agenda or only given a cursory review. A corporation that is successful in implementing this strategy has in effect "won the audit lottery" despite being under audit.

Identification of the issue is not the only challenge with respect to the effective auditing of corporate tax shelters. Some corporate tax shelters are in fact easier to detect than others. For example, the IRS already receives information on certain tax shelters that are registered with the IRS. The IRS also can obtain the names of corporations engaged in tax shelter activities by auditing the promoter.[525] Once the IRS becomes aware of the tax shelter transaction, however, the IRS must analyze and evaluate the merits of the transaction. Even assuming that a corporate tax shelter product is detected, the auditors are often at a tremendous disadvantage because of the complexity and sophistication of the corporate tax shelter products. Given the limited resources of the IRS, the audit team often cannot devote the time needed to fully develop the analysis of the facts and the law with respect to a corporate tax shelter. Practitioners and their firms devote considerable resources to the development of the products; given their complexity and rapid development, the IRS simply cannot keep up with the marketplace. As the ABA recently testified:

> A sad additional fact is that all parties to these transactions [corporate tax shelters] know there is substantial likelihood that the device employed, including the

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[525] See David C. Garlock, A Tax Executive's Guide to Evaluation Tax-Oriented Transactions, 39 Tax Management Memorandum No.4, (BNA 1998), S-46, S-53 (by auditing the promoter, the IRS was able to obtain information identifying taxpayers that engaged in transactions similar to the transaction at issue in the ACM case).

> imaginative assertion of the proper factual setting, will not be uncovered by IRS agents even if the corporation is audited, as most large taxpayers are. The tax law is too complex and the returns of major taxpayers are too voluminous. Many tax shelter products involve numerous parties, complex financial arrangements and invoke very sophisticated provisions of the tax law. It often takes time and painstaking analysis by well-informed auditors to ascertain that what is reported as a legitimate business transaction has little, if any, purpose other than the avoidance of Federal income taxes. Accordingly, there is a very reasonable prospect that a product will win the "audit lottery." This aspect of the problem is compounded by the fact that present law gives no reward for full disclosure in the case of corporate tax shelter transactions.[526]

Closely related to the detection risk is the likelihood of success at the IRS and in court. Unlike the individual tax shelters of the 1970s and 1980s, which often depended on inflated valuations, artificial deductions, and other such gimmicks, the modern corporate tax shelter typically has an apparent foundation in the tax law. By taking advantage of "glitches," or the juxtaposition of unrelated Code provisions, these transactions are designed to "work." So even after the corporate tax shelter is discovered and analyzed, the IRS must factor in the possibility that it may not prevail if the matter is litigated. Most arrangements are not litigated, but rather become part of a larger settlement offer in the course of the audit. In these cases, the corporate taxpayer may settle for a percentage of the tax benefits claimed, which likely still exceed its "cost" of entering into the tax shelter.

The risk of penalties and interest also plays a key role in the cost-benefit analysis. The interest rate for large corporate underpayments of tax is equal to the Federal short-term rate plus five percentage points.[527] This above-market interest rate, however, is mitigated by the fact that a corporation can deduct the interest attributable to underpayments of tax. Thus, a corporation's after-tax cost with respect to the interest may not be significantly higher than its opportunity cost of funds.[528]

Of greater significance is the imposition of penalties. The real possibility that an understatement of tax attributable to a corporate tax shelter could result in the imposition of a meaningful penalty would have a significant effect on the cost-benefit analysis. Under present law,

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[526] ABA Tax Section testimony, supra note 507, at 6.

[527] This increased rate, however, only applies to large corporate underpayments for periods beginning the 30th day after the earlier of the day the IRS sends (1) a statutory notice of deficiency or (2) a first letter of proposed deficiency that allows a taxpayer an opportunity for administrative review at IRS Appeals. Sec. 6621(c)(1). For the calendar quarter beginning July 1, 1999, the interest rate for large corporate underpayments is 10 percent. The after-tax rate, taking into account the deductibility of the interest, is 6.5 percent.

[528] See Part V.B. of this study for a discussion of a taxpayer's opportunity cost of capital.

however, the chances of a corporation being subject to a penalty from a corporate tax shelter are remote. As discussed below, the principal reason is because of the deference that is shown to tax shelter opinions. The NYSBA recently commented:

> Moreover, under our penalty system, as long as the corporate taxpayer has reasonably relied on an opinion of counsel, the only downside to the taxpayer will likely be the payment of interest on the deficiency, which at the best acts as a blunt and insufficient penalty for being wrong. Thus, when a probability analysis is done and the chances of detection and ultimate unfavorable outcome are combined with the lack of predictable and substantial penalties for the failure of the position of the taxpayer to be sustained, a rational corporate taxpayer can often conclude that engaging in even a transaction highly questionable under current law is, financially, well worth the risk.[529]

In short, the current system is unbalanced in that there appear to be large potential benefits from entering into a corporate tax shelter transaction with little corresponding cost. It is reasonable to conclude that the corporate tax shelter phenomenon will continue and grow unless and until there is a meaningful shift in this cost-benefit calculus.

c. Tax advisor opinions

Opinions regarding the tax aspects of corporate tax shelters ("tax advisor opinions") are accorded considerable weight in determining whether a penalty is imposed. Many, if not most, tax shelters include a tax advisor opinion that analyzes the tax treatment of the items giving rise to the material tax benefits. For the reasons discussed below, these opinions typically conclude that the tax treatment of such items is "more likely than not" the proper tax treatment.

The existence of a "more likely than not" opinion plays a critical role in a corporation's decision to invest in a tax shelter because it represents the minimum standard necessary for an opinion to enable a taxpayer to avoid the 20 percent substantial understatement penalty. As the Chair of the ABA Tax Section recently noted,

> We are particularly concerned about [the aggressive use of tax shelters by corporate taxpayers] because it appears that the lynchpin of these transactions is the opinion of the professional tax advisor. The opinion provides a level of assurance to the purchaser of the tax plan that it will have a good chance of achieving its intended purpose. Even if the taxpayer ultimately loses, the existence of a favorable opinion is generally thought to insulate the taxpayer from penalties for attempting to understate its tax liability.[530]

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[529] NYSBA May Report, supra note 508, at 13.

[530] ABA Tax Section testimony, supra note 507, at 4 (emphasis added).

The ambiguities in the applicable statutory and judicial case law, coupled with the subjective nature of judicial doctrines, have led to a significant divergence of views regarding whether a particular arrangement satisfies the "more likely than not" standard. As a result, there is added pressure on tax advisors to issue such opinions. As one commentator noted,

> The legal ambiguity and hence variance in perception of a given shelter, together with the different attitudes lawyers bring to interpretive issues makes it easy for a shelter promoter to obtain a more likely than not opinion; all the promoter has to do is to 'shop' the opinion to more than one firm. Eventually, the promoter will find a lawyer who will give the opinion.[531]

At the same time, there appears to be a lack of legal accountability if the tax shelter opinion is flawed.

> In theory, a company that purchased a shelter that was successfully challenged in court could sue an opinion writer. In practice, a necessary condition of a suit -- judicial rejection of a shelter -- is itself a rarity. . . . As noted earlier, the primary function of a tax opinion is to insulate companies that purchase the shelter from penalties. An opinion succeeds in this function by its very existence. The tacit understanding of the nature of an opinion makes it less likely that an opinion writer will be sued, and makes reliance in a suit harder to establish. Finally, the 'more likely than not' standard and the confused nature of the tax law work against any potential liability.[532]

One troubling practice with respect to tax advisor opinions is the reliance on generic fact patterns. Thus, the analysis in the tax advisor opinion may be based on facts that are not necessarily the facts of the specific transaction, particularly where the arrangement is offered to multiple parties. A related concern involves the assumption of critical elements of the opinion. For example, the tax advisor opinion may assume as fact that an arrangement has some genuine nontax business purpose. As discussed below, Circular 230 and ABA Formal Opinion 346 contain rules regarding the application of the law to the actual facts, and restrictions on the use of assumptions and hypothetical facts. The lack of sufficient enforcement measures, however, hamper the effectiveness of these rules.

d. Insufficient standards of practice and lack of enforcement of these standards

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[531] Joseph Bankman, The New Market in Corporate Tax Shelters, 83 Tax Notes 1775, 1782 (1999). See also NYSBA May Report, supra note 508, at 53 (stating, "we suspect that many others of us, whether we would acknowledge it to ourselves or not, feel subtle pressures to give favorable opinions in order to be 'at the table,' to continue to be involved with our clients' transactions, and ultimately to generate our fair share of revenues for our firms").

[532] Bankman, supra note 531, at 1782-83.

Circular 230 is the primary administrative tool to enforce practitioners' compliance with the standards of practice, and the Director of Practice is responsible for exercising disciplinary authority over practitioners. For a number of reasons, Circular 230, in its present form, is ill-suited to regulate the conduct of practitioners as it relates to corporate tax shelter activities. The problems with Circular 230 are twofold: the insufficiency of the standards and the lack of effective enforcement measures.

(i) Insufficient standards

The Circular 230 standards are too limited to serve as an effective deterrent against professional misconduct in the corporate tax shelter area. For example, Circular 230 sets forth the rules, duties, and conduct of practitioners "relating to authority to practice before the Internal Revenue Service."[533] The phrase "practice before the Internal Revenue Service"

> comprehends all matters connected with the presentation to the IRS or any of its officers or employees relating to a client's rights, privileges, or liabilities under the laws or regulations administered by the Internal Revenue Service. Such presentations include the preparation and filing of necessary documents, correspondence with and communications to the Internal Revenue Service, and the representation of a client at conferences, hearings, and meetings.[534]

If a practitioner's tax practice consists of advising taxpayers with respect to corporate tax shelters, the practitioner's activity may not constitute "practice before the Internal Revenue Service." Thus, the significance of the Circular 230 standards (and the effectiveness of the disciplinary sanctions) is greatly diminished. The scope of Circular 230 must be expanded if it is to play a meaningful role in regulating corporate tax shelter activity. The Circular 230 standards should apply to any individual who issues an opinion with respect to a corporate tax shelter or is required to register a corporate tax shelter under section 6111.

The definitions of "tax shelter" and "tax shelter opinion" also contribute to the inadequacies of Circular 230. The definition of a "tax shelter," which refers to deductions in excess of income (and credits in excess of tax liability),[535] reflects the types of tax shelters that were marketed to individuals in the 1970s and 1980s. However, it often bears little resemblance to the corporate tax shelters of today. Likewise, the definition of "tax shelter opinion"[536] is targeted to opinions that are included or referred to in sales promotion efforts, which is not necessarily how corporate tax shelters are being marketed in the current environment.

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[533] Circular 230, sec. 10.0 (emphasis added).

[534] Circular 230, sec. 10.2(a).

[535] Circular 230, sec. 10.33(c)(2).

[536] Circular 230, sec. 10.33(c)(3).

(ii) Lack of effective enforcement measures

A perception exists that enforcement of the Circular 230 standards is not as vigilant as it should be. Regardless of whether this perception is accurate, it has the effect of diminishing the importance with which practitioners regard Circular 230. As one commentator stated,

> Unfortunately, in its current operational mode, the office of the Director of Practice is essentially invisible, and it has a level of influence on professional conduct that is commensurate with that invisibility. This situation should be rectified. The Director of Practice should be a highly visible, highly respected figure within the tax community, making substantial contributions to tax administration, proposing new and better standards of practice, and enforcing existing standards. This would be beneficial not only with regard to controlling aggressive tax shelters but also with regard to enhancing the respect for tax practice standards generally.[537]

One enforcement problem has to do with the relationship between the imposition of practitioner penalties and Circular 230. Typically, practitioner penalties are waived if the practitioner establishes that his or her actions were reasonable and made in good faith. Practitioner actions that lack reasonableness and good faith (such that penalties were imposed) raise serious questions of professional misconduct of which the Director of Practice should be made aware in every instance, as the Internal Revenue Manual appropriately requires. Similarly, the relevant State licensing authorities should be made aware of every instance in which the Director of Practice imposes disciplinary sanctions on a practitioner.

In addition, the Director of Practice does not have the authority to impose monetary sanctions on a practitioner for a violation of the Circular 230 standards. A fixed monetary sanction would have a useful deterrent effect. This would be especially true if the scope of Circular 230 were expanded to include other parties that are involved in the creation, promotion, or implementation of a corporate tax shelter. Because the activities of such other parties may not constitute practice before the IRS, the current Circular 230 disciplinary measures would not function as a meaningful deterrent for those individuals. Reasonable monetary sanctions, therefore, should be a necessary component of broadening the scope of Circular 230.

Another problem with the enforcement of the Circular 230 standards relates to the lack of public information regarding any enforcement efforts undertaken by the Office of Director of Practice. The Director of Practice's disciplinary function is intended not only to discipline the practitioner for his or her professional misconduct, but also to deter others from engaging in similar conduct. The lack of public information dilutes the deterrence function of Circular 230. For example, many referrals to the Office of Director of Practice result in the practitioner

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[537] James P. Holden, 1999 Erwin N. Griswold Lecture Before The American College of Tax Counsel: Dealing With the Aggressive Corporate Tax Shelter Problem, reprinted in 52 Tax Law. 369, 376-77 (1999) (hereinafter "Holden lecture"). The Holden lecture, at 374-77, proposes a number of changes to Circular 230 with respect to corporate tax shelters.

receiving a letter of reprimand. The reprimands are not a matter of public record; typically, only the IRS office that forwarded the referral receives notification of the reprimand. Indeed, there is some question as to whether a practitioner who receives a letter of reprimand must disclose this to clients.[538]

Moreover, even the information with respect to Circular 230 that is made public generally fails to provide a useful level of specificity. In the weekly Internal Revenue Bulletins, the Director of Practice announces the names and addresses of practitioners who have been suspended from practice, their designations (i.e., attorneys, CPAs, enrolled agents or enrolled actuaries) and the date or period of the suspension. These announcements are consolidated and published in the Cumulative Bulletins. According to information published in the IRS Cumulative Bulletins, 158 practitioners were disbarred and 852 practitioners were suspended (including voluntary, involuntary, and expedited suspensions) during the ten-year period of 1988 through 1997.[539] Very little information is known, however, regarding the factual circumstances that gave rise to the disciplinary actions.[540]

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[538] Wolfman, et. al., supra note 479, at 27 n.81.

[539] The statistics cited in the text were collected from the Cumulative Bulletins during the relevant period.

[540] The Office of Director of Practice used to publish summaries of closed cases that were designed to provide information to practitioners regarding the types of activity that may result in disciplinary action. See 1991-14 I.R.B. 38, 1991-29 I.R.B. 44, and 1991-46 I.R.B. 35, reproduced in Wolfman, Holden & Harris, supra note 479, at 543-58.

C. Responding to the Corporate Tax Shelter Problem

A comprehensive response to the corporate tax shelter problem should integrate and build upon several basic but fundamental precepts. First, any response should, wherever possible, promote objective standards that are consistent with our rule-based model of taxation. Second, the response should discourage corporate taxpayers from entering into tax shelter transactions by increasing the risks associated with such transactions. A stringent penalty regime would be more effective in this regard. Third, a mechanism should be developed through which the Treasury can obtain better information with respect to tax shelter activity (1) to enable quick responses to any clarification in law that may be warranted and (2) to enable the IRS to more successfully propose adjustments with respect to such transactions on audit. As a related matter, shareholders should be made aware of a corporation's activities that gave rise to penalties for the avoidance or evasion of Federal income tax. Finally, other, nontaxpayer participants in the corporate tax shelter, such as promoters and advisors, should be held accountable for their role in the tax shelter arrangement.[541]

1. The tax system's dependence on objective criteria

There is merit and a certain appeal to using broad statements of policy and principles to address the modern corporate tax shelter problem. An effective solution, however, must balance the goal of articulating these conceptual principles with our tax system's dependence on objective, rule-based criteria.

Self-assessment is at the heart of the U.S. corporate tax system: it is the primary means through which corporate taxes are collected. Critical to the effectiveness of a self-assessment system is a taxpayer's general ability to rely on an objective body of rules in order to (1) determine its tax liability and (2) plan its legitimate business activities. Equally essential is that the application of this body of rules seems fair and even-handed. That is, a taxpayer must believe that the tax system will not impede unnecessarily its ability to conduct business and that the taxpayer's transactions will be taxed in the same general manner as similar transactions of other taxpayers. Anything that threatens this sense of fairness will erode taxpayer confidence in the system, damage the integrity of the system, and eventually could lead to the decline of self-assessment.[542] As a result, any broad standards of tax law must be sensitive to this need for objectivity. At the same time, adherence to this axiom cannot be inflexible because the proliferation of corporate tax shelters, which in part exploit objective rules, in and of itself will threaten the integrity of the system.

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[541] Although not addressed specifically in this study, any effective response will not be complete unless it is adequately enforced. The IRS should aggressively audit corporations to discover tax shelter activity, litigate such activity, and stringently impose the penalty regime.

[542] See statement of Donald C. Lubick, Assistant Treasury Secretary (Tax Policy), Revenue Provisions in the President's FY2000 Budget: Hearings Before the House Comm. on Ways and Means, 106th Cong. (Mar. 10, 1999), at 13; see generally Hariton, supra note 414, at 237-38; and Kleinbard, supra note 515, at 235.

Thus, a rule to address corporate tax shelters should strike a balance between being broad and flexible on the one hand, but being objective and certain on the other. For example, although it may be difficult to define precisely what it means to be a corporate tax shelter, a general principle should focus on a significant purpose to avoid or evade Federal income tax and be elaborated upon by more objective standards which demonstrate that purpose. Such objective standards would permit a taxpayer to better evaluate whether to proceed with transactions that may be suspect.

2. A case for enhancing the penalties

The goals of a rule addressing corporate tax shelters should be to discourage a taxpayer from entering into a transaction with a significant purpose to avoid or evade tax and to encourage a taxpayer to correctly and accurately report its tax liability on its initial tax return.[543] In short, the goal is to protect the integrity of the system.

There are a number of conceptual approaches for addressing the corporate tax shelter phenomenon. One such approach, which was included in the Administration's proposals discussed above, is a general substantive provision permitting the Treasury and the IRS to deny tax benefits from corporate tax shelters. Although this approach may be effective, it suffers from being inconsistent with the tax system's reliance on objectivity. A substantive rule that would allow the IRS to disallow deductions, credits, exclusions, or other allowances obtained in a tax shelter transaction, apparently even if the taxpayer's position would have otherwise been sustained in court, could inject a new level of uncertainty into the tax law that could impede legitimate business activity. The equity of such a rule would be directly related to both the clarity of the definition of a corporate tax shelter and the clarity of the underlying provisions of the Code upon which the taxpayer relied. The requisite level of clarity may be unrealistic. A reality of a complex tax code is that there will be some ambiguities and glitches. Rather than a substantive rule, the system may be better served by specific legislation addressing those ambiguities and glitches upon their discovery.

Nonetheless, under present law the stakes are not high enough to dissuade a corporate taxpayer from entering into a tax shelter transaction. If the corporate taxpayer is caught, challenged, and loses with respect to a tax shelter transaction, as discussed above, so long as the corporation reasonably relied on the opinion of counsel, penalties are not likely to be imposed. Additionally, although there is a higher standard for avoiding a penalty with respect to a corporate tax shelter under present law as compared to nonshelter activity, the effectiveness of that higher standard is diluted by the uncertainty under present law as to when a "significant purpose" of a corporate transaction is "the avoidance or evasion of federal income tax" (i.e., when a transaction is a corporate tax shelter under section 6662). Finally, even when penalties are raised, the IRS routinely agrees to waive them as part of settlement.[544] Accordingly, the only real disincentive

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[543] See Kleinbard, supra note 515, at 238.

[544] See Garlock, supra note 525, at S-53.

under present law for a corporation to enter into a tax shelter transaction is the possibility of deductible deficiency interest if the taxpayer is caught and ultimately loses, which, as previously discussed, is not a meaningful disincentive.

A meaningful penalty structure should be established to discourage corporate taxpayers from entering into corporate tax shelter transactions. As a starting point, the definition of a corporate tax shelter under section 6662 should be clarified through the specification of a series of objective indicators that would give rise to a conclusion that a "significant purpose" of the arrangement "is the avoidance or evasion of Federal income tax." Even with the adoption of objective indicators, however, there likely will always be some level of subjectivity involved in the determination of when a corporate tax shelter exists. Such subjectivity is much less of a concern in connection with a penalty provision, which would only apply after an understatement is determined, as opposed to a substantive provision, which could be used to create an understatement.[545] Unlike a substantive provision, an enhanced penalty structure such as this would not be inconsistent with objectivity or fairness because the penalty would only apply if the taxpayer's position results in an understatement.

Under this penalty structure, if a transaction is a corporate tax shelter and it gives rise to an understatement, then the taxpayer would be subject to an increased penalty that would be sufficient to alter the taxpayer's cost-benefit analysis when evaluating the transaction. The increased penalty rate generally should be higher than the penalty rate for understatements that are not attributable to corporate tax shelters.[546] Once an understatement with respect to a corporate tax shelter occurs, the penalty should be automatic as a percentage of the understatement. Corporations are generally penalty adverse. Anecdotal evidence suggests that corporations frequently will structure settlements in a manner that will avoid the imposition of penalties, which reflect poorly on the corporation's performance. Thus, to be effective, the IRS should not have the discretion to waive the penalty. The only way for a corporate taxpayer to avoid the penalty would be to properly disclose the transaction in accordance with prescribed requirements, be highly confident as to the likelihood of its position being sustained on its merits, and have a meaningful nontax purpose germane to the taxpayer's business.

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[545] Along the same lines, some have commented that even an overbroad definition of corporate tax shelter, which might capture some legitimate business transactions, would be acceptable in a penalty regime (1) that only applies to understatements and (2) in which taxpayers are on notice that increased penalties may apply. See NYSBA June Report, supra note 521, at 18 (stating, "that it is desirable to put taxpayers who engage in tax motivated transactions on notice that, should they lose, there would be increased costs, even if that risk might chill some otherwise legitimate activity that is covered by the definition").

[546] Increased penalty rates already apply in analogous contexts under present law. For example, with respect to a substantial valuation misstatement a 20-percent penalty applies, whereas with respect to a gross valuation misstatement the penalty rate is increased to 40 percent. See section 6662(e) and (h). A similar two-tiered penalty structure applies with respect to pension liability overstatements and estate or gift tax valuation understatements.

3. The need for disclosure

a. Disclosure to Treasury

A fundamental element of any conceptual framework for dealing with corporate tax shelters is effective, meaningful disclosure of the suspect activity.[547] In order for the system to react in a timely fashion on either a macro or micro level, disclosure is essential. Disclosure should serve two purposes: First, on a macro level, disclosure should function as an "early warning device" providing notice to Treasury of a potential gap or inconsistency in the tax law that warrants attention. This goal would be served best by a separate disclosure statement filed with the IRS shortly after the close of a significant corporate tax shelter transaction. Second, on a micro level, improved disclosure with the taxpayer's return is necessary in order to provide IRS examiners with more adequate information to enable them to identify appropriate audit issues and evaluate the taxpayer's analysis that supports its return position.

To be meaningful, the taxpayer's disclosure should include a summary of the relevant facts and assumptions with respect to the transaction, a description of the tax benefits the taxpayer anticipates from the transaction, an indication of the properties which make the transaction suspect, and a description of the taxpayer's rationale for the tax treatment, including the substantive authority upon which the taxpayer relies. The disclosure also should include a description of the taxpayer's material nontax business purpose. Additionally, disclosure of certain contingent fee arrangements would be relevant.

It is important for any disclosure required of the corporate taxpayer to be afforded an appropriate level of diligence and review. In other words, proper disclosure should be viewed as more than a mere administrative requirement. Accordingly, the corporation's chief financial officer or another senior corporate officer having knowledge of the facts and assumptions made in connection with a transaction should certify that the disclosure statements are true, accurate, and complete. Disclosure, however, cannot and should not be construed as an admission (or otherwise give rise to an inference) that the underlying transaction would not prevail on its merits.

b. Disclosure to shareholders

The Treasury and IRS are not the only parties to which disclosure of corporate tax shelter activity may be important. Tax penalties are a measure for deterring and punishing failure to comply with the tax law. Any sanction for an aggressive transaction in which a significant purpose is the avoidance or evasion of Federal income tax may be indicative of conduct that is contrary to public policy and should be considered a qualitatively material item that warrants disclosure to a corporation's shareholders. For similar reasons, the Securities and Exchange Commission ("SEC") requires disclosure of certain proceedings involving actual and potential violations of environmental regulations where, among other things, a governmental authority is a party to the

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[547] See ABA Tax Section testimony, supra note 507, at 7; AICPA Tax Division testimony, supra note 509, at 19.

proceeding and there are potential monetary sanctions that are not reasonably believed to be less than $100,000. The SEC asserts that disclosure of fines by governmental authorities may be of particular importance in assessing a corporation's environmental compliance problems. "Proceedings involving fines . . . may be more indicative of possible illegality and conduct contrary to public policy."[548] The same qualitative factors justify disclosure to shareholders of tax shelter penalties.

Although there is no disclosure requirement with respect to penalties under current law, there is precedent for a Code requirement of shareholder disclosure. For example, with respect to certain employee remuneration under section 162(m) and golden parachute payments under section 280G, shareholder disclosure is a prerequisite to certain exceptions.

c. Disclosure by promoters

In addition to disclosure by the taxpayer, another means of obtaining an early warning with respect to some corporate tax shelters would be to require disclosure by a promoter of a tax shelter. The corporate tax shelter rubric therefore should include an expansion of the requirement that a promoter of a corporate tax shelter register that shelter. Such registration generally should involve disclosure of the types of information described above in connection with taxpayer disclosure. Under section 6111(d), certain arrangements with a significant purpose to avoid or evade Federal income tax are treated as shelters that are required to be registered if the arrangement is offered under conditions of confidentiality. Although conditions of confidentiality may be an indication of a corporate tax shelter, it should not be a prerequisite to registration because such a standard is easily avoided.

4. Addressing other participants

The corporate taxpayer often does not act alone with respect to its engagement in tax shelter activity. While some corporate tax shelter activity is undoubtedly developed and implemented entirely "in-house," much of the activity involves outside promoters and advisors. To the extent that the goal of a corporate shelter rule is to curb the propagation of tax shelter activity, it is appropriate to address the behavior of the nontaxpayer participants in corporate tax shelters.

One avenue for addressing nontaxpayer participants is to require promoter registration of corporate tax shelters, as discussed above. In addition, the penalty for aiding and abetting the understatement of tax liability through the use of corporate tax shelters should be enhanced so as to pose a realistic threat of sanction to promoters and advisors with respect to a tax shelter. Moreover, the standards of practice with respect to corporate tax shelter activity should be raised. In short, as a conceptual matter, those who encourage or assist in a corporate taxpayer's shelter activity should bear some responsibility for their participation in that activity.

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[548] Securities Act Release No. 6315, 46 Fed. Reg. 25638 (May 4, 1981); see also Instruction 5 to Item 103, 17 CFR 229.103, of Regulation S-K, 17 CFR 229.10 - 229.915.

D. Recommendations

1. Overview of recommendations

The Joint Committee staff makes a series of recommendations to modify the penalties, registration requirements, and standards of practice as they relate to corporate tax shelters. The recommendations fall into two categories: those that affect corporations that participate in tax shelters, and those that affect other parties involved in corporate tax shelters.

a. Recommendations that affect corporations which participate in corporate tax shelters

The Joint Committee staff recommends the following clarifications and enhancements to the present-law penalty for a substantial understatement of income tax (sec. 6662) resulting from a corporate tax shelter:

- Clarify the definition of a corporate tax shelter for purposes of the understatement penalty with the addition of several objective "tax shelter indicators." If a corporate participant enters into an entity, plan, or arrangement that is described by one (or more) of the tax shelter indicators, then a significant purpose of the entity, plan, or arrangement will be considered to be the avoidance or evasion of Federal income tax. The recommendation would not otherwise modify the present-law definition of a tax shelter. Therefore, an entity, plan, or arrangement can be a tax shelter even though it does not display any of the "tax shelter indicators" (i.e., if a significant purpose is the avoidance or evasion of Federal income tax).

- Modify the penalty so that, with respect to a corporate tax shelter, there would be no requirement that the understatement be substantial.

- Increase the penalty rate from 20 percent to 40 percent for any understatement that is attributable to a corporate tax shelter. The IRS would not have the discretion to waive the understatement penalty in settlement negotiations or otherwise for corporate tax shelters.

- Provide that the 40-percent penalty could be completely abated (i.e., no penalty would apply) if the corporate taxpayer establishes that it satisfies certain abatement requirements. Foremost among the abatement requirements is that the corporate participant believes there is at least a 75-percent likelihood that the tax treatment would be sustained on the merits. Another requirement for complete abatement involves disclosure of certain information that is certified by the chief financial officer or another senior corporate officer with knowledge of the facts.

- Provide that the 40-percent penalty would be reduced to 20 percent if certain required disclosures are made, provided that the understatement is attributable to a position with

respect to the tax shelter for which the corporate participant has substantial authority in support of such position.

- Require a corporate participant that must pay an understatement penalty of at least $1 million in connection with a corporate tax shelter to disclose such fact to its shareholders. The disclosure would include the amount of the penalty and the factual setting under which the penalty was imposed.

b. Recommendations that affect other parties involved in corporate tax shelters

The Joint Committee staff makes the following recommendations relating to rules affecting other parties involved in corporate tax shelters:

- Increase the penalty for aiding and abetting with respect to an understatement of a corporate tax liability (sec. 6701) attributable to a corporate tax shelter from $10,000 to the greater of $100,000 or one-half the fees related to the transaction.

- Expand the scope of the aiding and abetting penalty to apply to any person who assists or advises with respect to the creation, implementation, or reporting of a corporate tax shelter that results in an understatement penalty if (1) the person knew or had reason to believe that the corporate tax shelter could result in an understatement of tax, (2) the person opined or advised the corporate participant that there existed at least a 75-percent likelihood that the tax treatment would be sustained on the merits if challenged, and (3) a reasonable tax practitioner would not have believed that there existed at least a 75-percent likelihood that the tax treatment would be sustained on the merits if challenged.

- Require the publication of the names of any person penalized under the aiding and abetting provision and an automatic referral of the person to the IRS Director of Practice.

- Clarify the U.S. government's authority to bring injunctive actions against persons who promote or aid and abet in connection with corporate tax shelters.

- Modify the present-law rules regarding the registration of corporate tax shelters by (1) deleting the confidentiality requirement, (2) increasing the fee threshold from $100,000 to $1 million, and (3) expanding the scope of the registration requirement to cover any corporate tax shelter that is reasonably expected to be presented to more than one participant.

- Include the explicit statutory authorization for Circular 230 in Title 26 of the United States Code and authorize the imposition of monetary sanctions.

- Recommend that, with respect to corporate tax shelters, Treasury amend Circular 230 generally to (1) revise its definitions, (2) expand its scope, and (3) provide more meaningful enforcement measures (such as the imposition of monetary sanctions, automatic referral to the Director of Practice upon the imposition of any practitioner penalty,

publication of the names of practitioners that receive letters of reprimand, and automatic notification to State licensing authorities of any disciplinary actions taken by the Director of Practice).

2. Description of recommendations

a. Recommendations that affect corporations which participate in corporate tax shelters

(i) Penalty structure

(A) Definition of tax shelter

The Joint Committee staff recommends clarifying the definition of a corporate tax shelter for purposes of the understatement penalty (sec. 6662) with the addition of several "tax shelter indicators." The addition of the tax shelter indicators would not otherwise affect the present-law definition of a tax shelter. Thus, as under present-law, an arrangement would be treated as a corporate tax shelter if it has as a significant purpose the avoidance or evasion of Federal income tax.

Specifically, the Joint Committee staff recommends adding the following:

With respect to a corporate participant, a partnership, or other entity, plan or arrangement will be considered to have a significant purpose of avoidance or evasion of Federal income tax if it is described by one (or more) of the following indicators:

(1) The reasonably expected pre-tax profit from the arrangement is insignificant relative to the reasonably expected net tax benefits.

(2) The arrangement involves a tax-indifferent participant, and the arrangement:

(a) Results in taxable income materially in excess of economic income to the tax-indifferent participant,

(b) Permits a corporate participant to characterize items of income, gain, loss, deductions, or credits in a more favorable manner than it otherwise could without the involvement of the tax-indifferent participant, or

(c) Results in a noneconomic increase, creation, multiplication, or shifting of basis for the benefit of the corporate participant, and results in the recognition of income or gain that is not subject to Federal income tax

because the tax consequences are borne by the tax-indifferent participant.

(3) The reasonably expected net tax benefits from the arrangement are significant, and the arrangement involves a tax indemnity or similar agreement for the benefit of the corporate participant other than a customary indemnity agreement in an acquisition or other business transaction entered into with a principal in the transaction.

(4) The reasonably expected net tax benefits from the arrangement are significant, and the arrangement is reasonably expected to create a "permanent difference" for U.S. financial reporting purposes under generally accepted accounting principles.

(5) The reasonably expected net tax benefits from the arrangement are significant, and the arrangement is designed so that the corporate participant incurs little (if any) additional economic risk as a result of entering into the arrangement.

For purposes of this study, the above five indicators collectively are referred to as the "tax shelter indicators."

(B) Definitions

Corporate participant. -- A corporate participant would be defined as any domestic corporation with average annual gross receipts in excess of $5 million (determined in accordance with section 448(c)).

Entity, plan, or arrangement. -- An entity, plan, or arrangement includes all the elements necessary to achieve the intended tax result. It does not include other elements that are not necessary to achieve such tax results, whether or not these other elements are an integrated part of the entity, plan, or arrangement, or have tax ramifications of their own. This "anti-stuffing" concept is intended to prevent corporate participants from, for example, increasing the reasonably expected pre-tax profit by contributing income-producing assets that are not a necessary element of the arrangement. In addition, the mere purchase or sale of an asset, in and of itself, does not constitute and entity, plan, or arrangement. For simplicity, the phrase "entity, plan, or arrangement" is sometimes referred to herein as an "arrangement".

Reasonably expected pre-tax profit. -- The amount of the reasonably expected pre-tax profit would be the excess of expected revenues over expected expenses attributable to the entity, plan, or arrangement. "Reasonably expected" would take into account the probability of receiving the expected cash flows and would reflect the same calculations that the corporate participant used in making the decision to enter into the entity, plan, or arrangement.

All expected items of revenue and expense would be recognized on a cash-flow basis discounted to their present value as of the date on which the corporate participant enters into the entity, plan, or arrangement. All assumptions and determinations must be reasonable and would be made as of the date on which the corporate participant enters into the entity, plan, or arrangement. All taxes,[549] other than Federal income taxes, would be taken into account as expenses in the period in which they are expected to be paid. Similarly, all associated fees and transaction costs would be taken into account as expenses in the period in which they are expected to be paid. In determining the reasonably expected pre-tax cash flow, an event whose timing can be indefinitely deferred without material adverse consequences would be disregarded if its inclusion would make it less likely that the arrangement would constitute a tax shelter.

Reasonably expected net tax benefits. -- The amount of the reasonably expected net tax benefits would be determined by taking into account (on a present value basis) all expected increases and decreases in Federal income tax payments that are attributable to the entity, plan, or arrangement as expected to be reported on the return. All assumptions and determinations must be reasonable and would be made as of the date on which the corporate participant enters into the entity, plan, or arrangement. The reasonably expected net tax benefits would be adjusted to reflect positions actually claimed or reflected on the corporate participant's original return or any amended return filed prior to the receipt of notification that the corporate participant has been scheduled for examination. In determining the reasonably expected net tax benefits, an event whose timing can be indefinitely deferred without material adverse consequences would be disregarded if its inclusion would make it less likely that the arrangement would constitute a tax shelter.

Present value. -- The present value of amounts would be determined using a discount rate equal to the short-term applicable Federal rate plus one percentage point (100 basis points).

Tax-indifferent participant. -- A "tax-indifferent participant" would include a foreign person (e.g., a nonresident alien individual or a foreign corporation) not subject to Federal income tax from the arrangement, a Native American tribal organization, and a tax-exempt organization (unless all or substantially all of the income of such organization from the arrangement is subject to tax). An entity would not be considered a tax-indifferent participant to the extent that the entity or the owners of such entity are currently subject to Federal income tax with respect to the income of the entity related to the arrangement.

Tax indemnity or similar agreement. -- A "tax indemnity or similar agreement" means an indemnity clause, a guarantee, insurance, or any other arrangement under which the corporate participant would be entitled to be recompensed in the event that it is not entitled to all or any portion of the expected net tax benefits, or any other arrangement that has a similar economic effect.

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[549] This includes Federal excise taxes and any foreign, State, or local taxes.

Customary indemnity agreement. -- A customary indemnity agreement includes (but is not limited to) indemnifications with respect to tax representations and warranties regarding the timely filing of all tax returns that are due, the payment of all taxes that are owed, the accuracy of such returns, and the tax audit history of a party to a transaction. Other examples include indemnifications with respect to representations and warranties regarding a seller's status as a United States real property holding corporation, representations and warranties regarding tax-free reorganizations and spin-offs, and the tax-exempt status of a bond issuance.

Principal. -- A principal in a transaction is any party to the arrangement that has a meaningful economic interest in the entity, plan, or arrangement. Ordinarily, an equity or profits interest of less than 10 percent of the value of the entity, plan, or arrangement will not be considered a meaningful economic interest. An insurance policy that is designed to guarantee all or any portion of the tax benefits arising from an entity, plan, or arrangement will not, in and of itself, cause the policy issuer to be considered a principal in such arrangement.

(C) Application of each tax shelter indicator

The following is an analysis of each tax shelter indicator.

Insignificant pre-tax profit relative to tax benefits

The reasonably expected pre-tax profit from the arrangement is insignificant relative to the reasonably expected net tax benefits.

A common characteristic of corporate tax shelters is that they generate little, if any, economic profit but at the same time produce significant Federal income tax benefits. Significant positive cash flows, on the other hand, tend to indicate that a nontax business purpose exists with respect to an arrangement and therefore, the arrangement may have been undertaken irrespective of any tax benefits. Prospective investors generally evaluate the benefits of investment opportunities based on, among other things, a present value analysis of the net cash flows and any other related implications, such as Federal income taxes. Thus prior to undertaking a new investment, the reasonably expected cash flows and other benefits and detriments have been quantified to the extent possible in an effort to make an informed decision.

The determination of whether an entity, plan, or arrangement is described by the "insignificant pre-tax profit relative to tax benefits" indicator involves an evaluation of reasonably expected cash flows. Reasonably expected cash flows must be discounted to present value as of the date on which the corporate participant enters into the entity, plan, or arrangement. As an example, assume a corporate participant enters into an arrangement after evaluating the following reasonably expected cash flows:

> The corporate participant would initially invest $500. The arrangement is designed so that the corporate participant can reasonably expect to receive $300 of positive cash flows each year for five years, but would pay $300 of negative cash flows each year. Thus, its pre-tax cash flows for first five years would completely offset. The corporate participant

reasonably anticipates that the arrangement would provide deductions for tax purposes of $700 a year for the first three years. The arrangement would then generate taxable income for the corporate participant of $250 a year for years four and five. For year six, there is a 95 percent probability that the arrangement will provide the corporate participant with a positive pre-tax cash flow of $563, all of which would be taxable. There is a five-percent chance that for year six there will be a positive, taxable pre-tax cash flow of $1100. When combining the 95-percent scenario with the five-percent scenario, the corporate participant reasonably expects a positive cash flow of $590 for year six. Assume that the corporate participant pays a 35-percent tax rate, and that the short-term AFR is five percent, so that the applicable discount rate (AFR plus one percent is the required discount rate for the present-value computations) is six percent. The reasonably expected cash flows are shown in the chart below.

Year	Expected Cash In	Expected Cash Out	Expected Pre-Tax Cash Flow	Expected Tax Deductions (Income)	Tax Savings (Cost)	After-Tax Cash Flow
0		($500)	($500)			($500)
1	$300	(300)	0	$700	$245	245
2	300	(300)	0	700	245	245
3	300	(300)	0	700	245	245
4	300	(300)	0	(250)	(88)	(88)
5	300	(300)	0	(250)	(88)	(88)
6	590		590	(590)	(206)	384
Total	$2090	($2000)	$90	$1010	$353	$443
PV @ 6%			($84)		$374	

Although there is a positive pre-tax cash flow (a return of less than three percent), when the pre-tax cash flow is discounted to present value at six percent, the reasonably expected pre-tax profit is actually a loss of approximately $84. The reasonably expected net tax benefits on a present value basis are approximately $374 (resulting in an approximately 26-percent after-tax profit). The reasonably expected pre-tax profit from this arrangement is clearly insignificant relative to the reasonably expected net tax benefits.

As a further example, assume that a domestic corporation purchases all rights to a patent for $7.5 million. The patent rights will expire prior to the end of the year. The only expected

income from the patent is the final royalty payment that will be received upon its expiration. The final royalty is expected to be $10 million and subject to a 30-percent foreign withholding tax. The reasonably expected pre-tax profit is a loss of $0.5 million ($7.5 million cash net outflow less $7.0 million net cash inflow, foreign withholding taxes being treated as an expense for this purpose). The reasonably expected net tax benefits are $3 million of foreign taxes available for credit. The reasonably expected pre-tax profit (a loss in this case) is insignificant in relation to the reasonably expected net tax benefits of $3 million and therefore would be considered a corporate tax shelter.[550]

In addition, the ACM case provides a recent example of an arrangement that likely would be described by this indicator. As previously discussed, the court in ACM held that the purported transactions lacked economic substance.[551] In assessing the reasonably expected pre-tax cash flow of the ACM partnership, the court found that "the partnership did not undertake the section 453 investment strategy with a reasonable expectation that it would be profitable, on a pretax basis, . . . Colgate could not have achieved a non-negative net present value under any reasonable forecast of future interest rates."[552] Colgate deducted losses and transaction expenses related to the ACM arrangement that exceeded $100 million, producing approximately $35 million of tax benefits (calculated at the highest marginal corporate income tax rate of 35 percent). The net tax benefits are slightly less when calculated on a present value basis with respect to the date in which the arrangement was entered into, but are nevertheless significant. Thus, the ACM arrangement was reasonably expected to produced an insignificant (actually expected to be negative) pre-tax cash profit relative to the reasonably expected net tax benefits ($35 million), and would be considered to be a corporate tax shelter.

Involvement of tax-indifferent participant

The arrangement involves a tax-indifferent participant, and the arrangement:

- *Results in taxable income materially in excess of economic income to the tax-indifferent participant,*

- *Permits a corporate participant to characterize items of income, gain, loss, deductions, or credits in a more favorable manner than it otherwise could without the involvement of the tax-indifferent participant, or*

- *Results in a noneconomic increase, creation, multiplication, or shifting of basis for the benefit of the corporate participant, and results in the recognition of income or gain*

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[550] This example is based on the facts in Example 1 in Notice 98-5, 1998-3 I.R.B. 49.

[551] For a more detailed discussion of ACM, see Part VIII.A., above.

[552] ACM Partnership v. Commissioner, 73 T.C.M. (CCH) 2189, 2219, 2221 (1997).

that is not subject to Federal income tax because the tax consequences are borne by the tax-indifferent participant.

The involvement of a tax-indifferent participant is a common characteristic of many tax shelters. It is often not economically feasible for a corporate participant to enter into this type of arrangement with someone other than a tax-indifferent participant because the tax-indifferent participant is able to "lend" its special tax status to the arrangement in return for compensation. Additionally, the arrangement typically would be structured so as to minimize (if not completely eliminate) the tax-indifferent participant's exposure to any economic risk from the tax shelter. For these reasons, it is appropriate that the involvement of a tax-indifferent participant is an indication of a corporate tax shelter.

The types of corporate tax shelters involving tax-indifferent participants fall into three general categories. The first category is a transaction that results in taxable income in excess of economic income to the tax-indifferent participant. In some transactions, the allocation of the taxable income primarily to the tax-indifferent participant is followed by a later reversal of the income, which takes the form of a taxable loss that is recognized primarily by the corporate participant.[553] In other transactions, taxable income is attributed to the tax-indifferent participant and gives rise to a corresponding tax deduction that is recognized by the corporate participant. In either event, the tax-indifferent participant's involvement is ostensibly to recognize most (if not all) of the taxable income; the corporate participant stands to receive the benefit of the corresponding loss or deduction.

Certain "lease-in/lease-out" ("LILO") transactions provide an example of this category of tax shelter. In a LILO transaction such as the one described in Rev. Rul. 99-14,[554] the corporate participant enters into a long-term agreement to lease property from a tax-indifferent participant (the "headlease"), and immediately thereafter, the corporate participant leases the property back to the tax-indifferent participant (the "sublease"). The headlease requires the corporate participant to make a sizable rental prepayment at the beginning of the lease, and a "postpayment" at the end of the lease. The sublease requires the tax-indifferent participant to make fixed, annual payments during the lease period. For Federal tax purposes, the corporate participant and the tax-indifferent participant allocate the prepayment over a much shorter period than the term of the headlease. Notwithstanding that the corporate participant includes in gross income the rents received on the sublease,

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[553] For example, as previously discussed in connection with the first tax shelter indicator, in the ACM case, Colgate's interest in ACM went from 17.1 percent in the year that ACM recognized the gain to 99.5 percent in the year that ACM recognized the loss. Therefore, most of the gain was allocated to the tax-indifferent participant whereas the loss was allocated primarily to Colgate.

[554] 1999-13 I.R.B. 3 (Mar. 29, 1999).

> [b]y accounting for each element of the transaction separately, [the corporate participant] purports to generate a stream of substantial net deductions in the early years of the transaction followed by net income inclusions on or after the conclusion of the Sublease primary term. As a result, [the corporate participant] anticipates a substantial net after-tax return from the investment.[555]

Corresponding to this stream of early-year deductions is significant taxable income allocated to the counterparty, which is tax-indifferent. For participating in the transaction, the tax-indifferent participant typically collects an accommodation fee. The taxable income allocated to it, however, (to which it is indifferent) far exceeds its economic income.[556]

The second category of arrangements with tax-indifferent participants involve transactions in which the role of the tax-indifferent participant is to facilitate the taxpayer's ability to characterize items of income, gain, loss, deductions, or credits in a more favorable manner than it otherwise would without the involvement of the tax-indifferent participant. For example, in a "step-down preferred" transaction, a real estate investment trust ("REIT") that is controlled by a corporation ("corporate sponsor") issues preferred stock to a tax-indifferent participant. The preferred stock pays an above-market yield rate for an initial period (e.g., ten years). At the end of the initial period, pursuant to the terms of the arrangement, the value of the preferred stock drops to a nominal amount that is far below the tax-indifferent participant's original investment. This drop in value results from changes in the preferred shareholders' dividend and voting rights which, by virtue of the terms of the arrangement, automatically take effect at the end of the initial period. The above-market "dividend" payments to the tax-indifferent participant in fact represent a recovery of the tax-indifferent participant's investment (i.e., basis recovery). A taxable investor would not likely invest in an arrangement that would require it to treat a substantial portion of its basis recovery as income. In contrast, the tax-indifferent participant is unaffected by the character of the payments. In effect, the involvement by the tax-indifferent participant facilitates the corporate sponsor's ability to repay the tax-indifferent participant with income that is not subject to tax.

The third category of arrangements with tax-indifferent participants involves transactions in which (1) the corporate participant enjoys the benefits of an increased tax basis in property without having incurred an economic "cost" for the tax basis, and (2) the transaction would generally give rise to Federal income tax except that the tax consequences are borne by the tax-indifferent participant. One illustration of this arrangement is a "basis-shift" transaction. For example, assume a foreign parent corporation (the tax-indifferent participant) owns 100 percent of the stock of a foreign subsidiary. An unrelated U.S. corporate participant arranges to acquire a minimal interest in the foreign subsidiary, and an option to acquire a 51 percent interest in the tax-

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[555] Id.

[556] It is also likely that in a LILO transaction such as the one described in Rev. Rul. 99-14, the reasonably expected pre-tax profit, determined on a present value basis, is insignificant when compared to the reasonably expected net tax benefits, causing it also to be described in the previous tax shelter indicator.

indifferent participant. If the foreign subsidiary redeems its stock from the tax-indifferent participant, the tax-indifferent participant would treat the redemption as a dividend,[557] which generally would be subject to Federal income tax except for the fact that the recipient is a foreign corporation. However, the tax-indifferent participant's basis in the stock of the foreign subsidiary arguably would "shift" to the U.S. corporate participant's stock basis in the foreign subsidiary,[558] resulting in a noneconomic increase in the basis of the stock.

Another example of this type of arrangement is a "section 357(c)" transaction. The section 357(c) transaction may involve a foreign parent corporation (the tax-indifferent participant) that owns depreciable property. The depreciable property is encumbered by nonrecourse indebtedness that significantly exceeds the tax-indifferent participant's adjusted basis (and fair market value) in the depreciable property. The tax-indifferent participant contributes the property (subject to the nonrecourse indebtedness) to a wholly-owned domestic subsidiary (the corporate participant) in a transaction that qualifies as a tax-free incorporation under section 351. In general, section 357(c) requires a transferor to recognize gain to the extent the nonrecourse liability exceeds the transferor's basis in the property. In this example, however, the gain is not reported because the transferor is not subject to Federal income tax on such gain. The corporate participant is entitled to a noneconomic increase in the basis of the property.

In both examples, the corporate participant ended up owning property with an increased tax basis for which (1) the corporate participant does not incur a corresponding economic cost, and (2) the tax consequences are borne by a tax-indifferent participant. The tax shelter indicator would not apply to transactions where the corporate participant incurs a commensurate "cost" in connection with the increased tax basis. Thus, it would not apply to an arrangement in which a corporate participant purchases property from a tax-indifferent participant for its fair market value.

Existence of noncustomary tax indemnity

The reasonably expected net tax benefits from the arrangement are significant, and the arrangement involves a tax indemnity or similar agreement for the benefit of the corporate participant other than a customary indemnity agreement in an acquisition or other business transaction entered into with a principal in the transaction.

A common feature of many corporate tax shelters is the use of a tax indemnity or similar arrangement. These arrangements typically are designed to recompense the corporate participant in the event that it is not entitled to all or any portion of the anticipated tax benefits. The guarantee may be acquired from the promoter of the arrangement, a counterparty, or a third-party insurer. Not all indemnity agreements, however, are indicative of a corporate shelter. Therefore, the indicator is limited to arrangements that involve noncustomary indemnity agreements and in which

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[557] This result occurs because of the application of the attribution rules under section 318.

[558] Treas. Reg. sec. 1.302-2(c) ex. 2 illustrates the shifting of basis in the redeemed stock to the remaining stock in a dividend transaction (involving a husband-wife situation).

the expected net tax benefits are significant. The application of this test is illustrated by the following examples:

Example 1: X Co. enters into an arrangement in which the reasonably expected net tax benefits are significant. The arrangement was presented to X Co. by investment bank B, which has a two-percent equity interest in the arrangement. As part of the arrangement, B agrees to reimburse X Co. in the event the IRS disallows any portion of the expected net tax benefits. B's two-percent interest is not a meaningful interest in the arrangement. These facts establish that a significant purpose of the arrangement is the avoidance or evasion of Federal income tax.

Example 2: X Co. enters into an arrangement in which the reasonably expected net tax benefit is expected to be $1 million (a significant expected net tax benefit). X Co. purchases an insurance policy, under which the insurance company agrees to pay up to $1.5 million in the event that the IRS denies any portion of the net tax benefits (including coverage for interest, penalties, and contest expenses) from the arrangement. The insurance company is not treated as having a meaningful economic interest in the arrangement (and thus is not a principal in the transaction). These facts establish that a significant purpose of the arrangement by X Co. is the avoidance or evasion of Federal income tax.

Example 3: X Co. agrees to purchase 50 percent of Y Co.'s wholly-owned subsidiary. Under the agreement, Y Co. represents and warrants that all of the subsidiary's tax returns have been timely filed, that such returns were accurately prepared, and that all taxes owed have been paid. Y Co. agrees to indemnify X Co. for any taxes of the subsidiary attributable to periods prior to X Co.'s acquisition. Because the tax indemnity agreement is a customary indemnity agreement entered into with a principal in the transaction, the tax indemnity agreement does not establish that a significant purpose of the arrangement is the avoidance or evasion of Federal income tax (regardless of whether the arrangement gives rise to significant net tax benefits).

Permanent difference for U.S. financial reporting purposes

The reasonably expected net tax benefits from the arrangement are significant, and the arrangement is reasonably expected to create a "permanent difference" for U.S. financial reporting purposes under generally accepted accounting principles.

Due to a publicly-traded corporation's emphasis on greater reported corporate earnings (because of its influence on stock price), a common element in many corporate tax shelters is that a loss for Federal income tax purposes does not result in a corresponding reduction in corporate earnings for U.S. financial reporting purposes. The tax loss does not reflect an economic loss that would be required to be reported for U.S. financial reporting purposes under generally accepted accounting principles ("GAAP").

The rules under GAAP differ from tax reporting because of the different functions each serves. "The function of GAAP, under SEC auspices, is to prevent management puffery of income. The function of tax accounting law, under IRS auspices, is to prevent management understatement

of income."[559] Therefore, an arrangement that gives rise to a loss for tax purposes but not for GAAP reporting purposes should raise concerns regarding the appropriateness of the claimed tax loss.

Many differences between tax and GAAP reporting, however, may be unrelated to the existence of a corporate tax shelter. For example, a taxpayer may take accelerated depreciation for tax purposes but not for book purposes, resulting in a book-tax disparity that is not necessarily related to a corporate tax shelter. These differences generally reflect temporary differences that will be eliminated when the related asset is recovered or the related liability is settled.[560] While some temporary differences could be the result of tax-avoidance arrangements, it would be overinclusive to use temporary differences, even if significant, as an indicator of a corporate tax shelter.

A difference between GAAP and tax reporting that is never eliminated causes a permanent difference. Such differences result when an arrangement is not and never will be reflected to the same extent for tax and GAAP reporting purposes. Two situations that create permanent differences illustrate concerns regarding the proper measurement of taxable income: (1) when the arrangement has income for GAAP purposes that will never be included for tax purposes, and (2) when the arrangement results in a loss for tax purposes that will never be deducted for GAAP purposes. Many corporate tax shelters are designed to exploit such permanent differences. So while an arrangement that gives rise to a permanent difference may not in and of itself indicate tax avoidance, the combination of a permanent difference with significant net tax benefits indicates that a significant purpose of the arrangement is to avoid or evade Federal income tax.

One example of an arrangement that resulted in a permanent difference and a significant net tax benefit was the "liquidating REIT" transaction, in which taxpayers claimed that the liquidation of a REIT subsidiary permitted (1) the corporate shareholder to receive tax-free distributions from the REIT during the liquidation period, and (2) the REIT to claim a dividends paid deduction with respect to the same distributions. In essence, the income was never subject to Federal income tax but was reported as income for GAAP purposes. If respected, the disparate treatment for tax and financial reporting purposes would create a permanent difference.[561]

Lack of additional economic risk

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[559] Calvin H. Johnson, GAAP Tax, 83 Tax Notes 425, 426 (Apr. 19, 1999).

[560] See SFAS Statement 109 for a discussion of "temporary differences."

[561] In one transaction reported on a financial institution's 1997 10-K, a "special tax benefit" from the liquidation of an affiliate resulted in a permanent difference in excess of $100 million.

The reasonably expected net tax benefits from the arrangement are significant, and the arrangement is designed so that the corporate participant incurs little (if any) additional economic risk as a result of entering into the arrangement.

A common aspect of corporate tax shelters is that the arrangement results in the corporate participant realizing significant net tax benefits without altering its economic position. This is perhaps most evident where a corporate participant incurs little (if any) additional economic risk as a result of entering into the transaction. The New York State Bar Association Tax Section noted that the first characteristic of the "loss generator" transaction is that

> the loss or other deduction sought to be obtained by the taxpayer in the transaction is in no way inherent economically in its current position prior to entering into the transaction. In other words, the transaction does not have the effect of realizing an economic loss that has economically accrued to the taxpayer prior to entering into the transaction; rather the transaction itself 'generates' the loss or other deduction in question.[562]

An arrangement can be designed to limit a corporate participant's economic risk in a number of ways, including (but not limited to) the use of nonrecourse financing, guarantees, stop loss agreements, recission clauses, unwind clauses, hedged positions, or other similar arrangements. For example, in the ACM case, ACM had cash deposited in a bank account earning interest at 8.75 percent. ACM withdrew those funds and purchased Citicorp private placement floating rate notes initially paying 8.78 percent. The interest on those notes was to be paid monthly, and the interest rate would be reset at that point. ACM held those notes (and planned to hold those notes) for only 24 days before disposing of them in the installment sale transaction.

By design, ACM had no additional risk through its fleeting ownership of the Citicorp notes as compared to merely holding the cash on deposit. The interest reset monthly, and ACM was going to hold the notes for less than a month, assuring ACM that the value of the notes would not change. As the Third Circuit said:

> ACM engaged in mutually offsetting transactions by acquiring the Citicorp notes only to relinquish them a short time later under circumstances which assured that their principal value would remain unchanged and their interest yield would be virtually identical to the interest yield on the cash deposits which ACM used to acquire the Citicorp notes. . . .
>
> The variable rate on the Citicorp notes presented a theoretical possibility that the consequences of owning those notes would vary from the consequences of leaving ACM's fund on deposit at a rate of interest virtually identical to the initial rate on the Citicorp notes. However, ACM's exposure to any fluctuation in the rate of return on its Citicorp note investment was illusory, as the interest rates were

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[562] NYSBA May Report, supra note 508, at 19.

> scheduled to be reset only once a month and ACM had arranged to hold the notes for only 24 days . . . .
>
> [The taxpayer's argument] erroneously assumes that ACM had acquired the benefits and burdens associated with the Citicorp notes in an economically substantive sense, when in reality ACM's brief investment in and offsetting divestment from these assets exposed ACM only to de minimis risk of changes in principal value or interest rates.[563]

Thus, although there certainly is some risk inherent in having the cash deposited in the bank, that is risk that the partnership had already accepted in its risk profile. Entering into the transaction did not materially change ACM's economic position or its risk profile. In other words, assuming that the risk of holding cash in the bank is a base line activity for ACM, the purchase and sale of the Citicorp notes, which was a critical element to the installment sale transaction, was a riskless venture. By the design of the arrangement, ACM stood to lose nothing (at least as compared to what it could lose had it not entered into the transaction).

(D) Consequences of tax shelter understatement

Penalty. -- The Joint Committee staff recommends increasing the penalty rate to 40 percent for any understatement that is attributable to a corporate tax shelter.[564] As discussed below, the 40-percent rate would be reduced to 20 percent if certain required disclosures are made, provided that the understatement is attributable to the treatment of a tax shelter item for which the corporate participant has substantial authority. In addition, the 40-percent penalty could be completely abated (i.e., no penalty would apply) if the corporate participant establishes that it satisfies certain abatement requirements.

The penalty rate (whether 40 percent or 20 percent) would apply to the entire understatement attributable to the corporate tax shelter. Thus, the present-law "substantial" threshold would be repealed (but only as it relates to corporate tax shelters). If an understatement penalty is imposed on a corporate tax shelter, no additional penalty on the same understatement would be imposed under section 6662.

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[563] ACM Partnership v. Commissioner, 157 F.3d 231, 250, 250 n.35, and 252 n.39 (3d Cir. 1998) (emphasis added).

[564] It is appropriate for a higher penalty rate under section 6662 to apply to understatements attributable to corporate tax shelters as opposed to other substantial understatements of income tax just as section 6662 presently applies a higher penalty rate (40 percent) for gross valuation misstatements as opposed to substantial valuation misstatements (20 percent).

The Joint Committee staff also recommends the elimination of the present-law reasonable cause exception[565] for any understatement that is attributable to a corporate tax shelter. Also, the IRS would not have the discretion, in settlement negotiations or otherwise, to waive the understatement penalty attributable to corporate tax shelters. The understatement penalty attributable to corporate tax shelters is automatic; if an understatement arises from a corporate tax shelter, this penalty applies unless abated under the procedures described below.

Disclosure to shareholders. -- The Joint Committee staff recommends that a corporate participant that must pay an understatement penalty attributable to a corporate tax shelter be required to disclose that fact (i.e., the payment of the tax shelter penalty) to its shareholders.

Under present law, there is no such disclosure requirement with respect to civil tax penalties. There is precedent in the Code, however, for requiring disclosure to shareholders in certain circumstances. For example, with respect to certain employee remuneration under section 162(m) and golden parachute payments under section 280G, shareholder disclosure is a prerequisite to certain exceptions.

Additionally, the SEC currently requires disclosure to shareholders of any material pending legal proceedings, other than those which are ordinary routine litigation incidental to the registrant's business.[566] If an administrative or judicial proceeding involves provisions regulating the discharge of materials into the environment, such proceeding will not be deemed ordinary routine litigation incidental to the registrant's business, and therefore must be disclosed if, among other things, a governmental authority is a party to the proceeding and the registrant reasonably believes that the potential monetary sanctions, exclusive of interest and costs, could equal or exceed $100,000. As discussed above, proceedings involving fines may be indicative of conduct contrary to public policy.

The Joint Committee staff believes that the qualitative issues that gave rise to the shareholder disclosure requirements in sections 162(m) and 280G, and which resulted in the SEC requiring disclosure of sanctions for violations of environmental laws, are similar to the qualitative issues that arise when a corporate taxpayer is penalized for an understatement of tax attributable to a tax shelter. Shareholders should be made aware of the corporation's attempt to avoid or evade the Federal income tax law. Because it is difficult for shareholders to determine this information from the financial statements, a separate disclosure is needed.

The Joint Committee staff therefore recommends that upon any payment of a penalty under section 6662 of at least $1 million with respect to a corporation's participation in a partnership or other entity, plan or arrangement in which a significant purpose is the avoidance or evasion of Federal income tax, such penalty be disclosed to the corporation's shareholders (regardless of whether the penalty is or will be the subject of ongoing litigation). The disclosure would include

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[565] Sec. 6664(c).

[566] See Item 103, 17 CFR 229.103, Regulation S-K, 17 CFR 229.10 - 229.915.

(1) the amount of the penalty and (2) the factual setting under which the penalty was imposed. The disclosure would unambiguously provide the required information and would entail a clear, separate statement included within an appropriate annual financial statement or other report provided to shareholders. The Secretary should consult with the SEC in regard to any such disclosures that would be required under this rule by companies that are subject to the reporting requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934.

(E) Abatement of the section 6662 penalty

The 40-percent penalty under section 6662 in connection with an understatement attributable to a corporate tax shelter could not be waived by the IRS. The penalty could be abated only under certain circumstances, discussed below.

Complete abatement. -- The penalty would be completely abated (i.e., no penalty would apply) to the extent that the corporate taxpayer can establish that it has satisfied certain "abatement requirements." The abatement requirements are satisfied to the extent that:

- The corporate participant has analyzed the transaction to determine whether any of the tax shelter indicators are met;

- If one or more of the tax shelter indicators are met, the corporate participant has complied with all disclosure requirements (as discussed below);

- A chief financial officer or another senior corporate officer has certified that such disclosures are true, complete, and accurate (again, as required below); and

- At the time the corporate participant enters into the arrangement, the corporate participant is "highly confident" that it will prevail on the merits if the tax treatment for the arrangement is challenged by the IRS.

The corporate participant would be treated as "highly confident" that its tax treatment for the arrangement will prevail if challenged by the IRS only if a reasonable tax practitioner would believe that there existed, at the time the arrangement was entered into, at least a 75-percent likelihood that the tax treatment of the item would be sustained on its merits (without taking into account the possibility that a return will not be audited, that an issue will not be raised on audit, or that an issue will be settled) based upon the facts and law that existed at that time. If the taxpayer relies upon an opinion from a third party in forming its level of high confidence, that reliance must be reasonable. At a minimum, the facts and assumptions used to form the basis of the third-party opinion must not materially differ from the actual facts and assumptions with respect to the arrangement, all facts and circumstances must be considered, and no unreasonable assumptions be made.[567] Moreover, a corporate participant will not be treated as "highly confident" unless it can

[567] Thus, the requirements of Treas. Reg. sec. 1.6664-4(c)(1) must be met.

establish a material purpose germane to its trade or business, other than the reduction of Federal income taxes (a "material nontax business purpose").

Reduction to 20 percent**.** -- The penalty with respect to an understatement in connection with a corporate tax shelter would be reduced to 20 percent to the extent that all disclosure requirements (discussed below) are satisfied, even if the abatement requirements are not otherwise satisfied. Thus, in the case of a corporate participant that has adequately disclosed the arrangement in question, the maximum penalty rate is 20 percent, which would be reduced to zero if other abatement requirements are satisfied.

In no event would the corporate tax shelter penalty be reduced, however, to the extent that the recommended standards with respect to the accuracy-related penalty in general (section 6662) (discussed in detail previously in Part VII.G.) have not been met. Specifically, the Joint Committee staff is recommending that the section 6662 accuracy standard be raised such that those penalties would only be eliminated when (1) the corporate participant believes that there is a greater than 50 percent likelihood that the treatment would be upheld if challenged by the IRS or (2) the relevant facts have been disclosed (the "section 6662(d)(2)(B) disclosure") and the corporate participant has substantial authority supporting its position. These standards also would apply in connection with the corporate tax shelter penalty. It follows that if a corporate participant does not have at least substantial authority supporting its position, whether it discloses or not, the penalty cannot be reduced.

For purposes of the 20-percent rate and the complete abatement of the penalty, it is important to note that corporate tax shelters which are not required to be disclosed under the corporate tax shelter disclosure requirements (discussed below) would be treated as satisfying those disclosure requirements. Thus, if a corporate tax shelter is not subject to the special corporate tax shelter disclosure requirements discussed below (or is otherwise deemed to have been disclosed), and (1) it satisfies a "more likely than not" standard with respect to its position, or (2) it satisfies a "substantial authority" standard with respect to its position and the section 6662(d)(2)(B) disclosure requirements are satisfied, then the corporate tax shelter penalty would be reduced to 20 percent. If the corporate participant that is not subject to the special corporate tax shelter disclosure requirements has only met the substantial authority threshold with respect to a corporate tax shelter and has not satisfied the section 6662(d)(2)(B) disclosure requirements, then the penalty would not be reduced and the 40-percent rate would apply.

A summary of the applicable penalties and abatement standards and a comparison to present law is provided after the discussion of the disclosure requirements below.

(ii) Disclosure requirements for corporate tax shelters

To the extent that a corporation participates in a partnership or other entity, plan, or arrangement which is described by one or more of the tax shelter indicators, the Joint Committee staff recommendation is to treat the corporation as having entered into a "reportable transaction" to which certain disclosure requirements would apply. These disclosure requirements include a

transactional disclosure within 30 days after the close of a transaction (the "30-day disclosure") and additional reporting on the taxpayer's Federal income tax return (the "tax-return disclosure").

Satisfying the disclosure requirements (if any) would be a prerequisite to any abatement of penalties. If the disclosure requirements are satisfied but the other abatement requirements are not, then the maximum penalty would be 20 percent (reduced from 40 percent) of the understatement. If the disclosure and the other abatement requirements (including that the taxpayer is highly confident that its position will prevail on the merits) are both satisfied, then no penalty would be imposed.

(A) 30-day disclosure

To the extent that a reportable transaction has reasonably expected net tax benefits of $1 million or more, the taxpayer must disclose in a special filing to the IRS within 30 days after the close of transaction:

- A summary of the relevant facts and assumptions with respect to the reportable transaction;
- The reasonably expected net tax benefits arising from the reportable transaction;
- Each tax shelter indicator which describes a reportable transaction (it is intended that this could be disclosed by merely checking a box as to which indicators are met; if more than one indicator is met for any given reportable transaction, each applicable indicator should be identified);
- A summary of the corporate participant's rationale and analysis underlying the tax treatment of the reportable transaction including the substantive authority relied upon to support such treatment;
- The corporation's material, nontax business purpose for the transaction; and
- The existence of any expressed or implied fee arrangement with a third party which is contingent upon, may be reduced depending upon, or is otherwise based upon the tax consequences of the reportable transaction.

This 30-day disclosure is intended to provide the Treasury and the IRS with an "early warning device" with respect to corporate tax shelters so that more immediate responses can be formulated. The $1 million threshold is designed to target significant transactions and, when combined with the requirement that the arrangement had to fit the description of a tax shelter indicator, to limit the volume of 30-day disclosure filings. In addition, the information required to be disclosed is narrowly circumscribed so as to involve only the most relevant data.

The chief financial officer or another senior corporate officer with knowledge of the facts would be required to certify, under penalties of perjury, that the disclosure statements are true, accurate, and complete. This would verify that the reportable transaction and corresponding disclosure underwent a sufficient degree of internal diligence and review by the corporate

participant, and should lead to heightened scrutiny of the tax consequences of the arrangement by senior management.

(B) Tax-return disclosure

With respect to all reportable transactions (regardless of the $1 million threshold), a corporate participant must, on the return for the tax year in which the reportable transaction was entered into:

- Include a copy of any required 30-day disclosure, plus disclosure of any material changes in the law or facts from the time that the reportable transaction was entered into; and

- Identify (through checking a box or boxes to the extent that more than one applies) which tax shelter indicators describe one or more reportable transactions reflected on the return.

With respect to reportable transactions with reasonably expected net tax benefits of more than $1 million, the tax-return disclosure would provide useful information to the IRS examination team in connection with their audit of a corporate participant's return. The tax-return disclosure is designed to involve minimal additional effort for a corporate participant that was required to satisfy the 30-day disclosure. With respect to reportable transactions with expected net tax benefits of less than $1 million, the tax-return disclosure would provide an alert as to a potential issue on a return that warrants scrutiny, and again would minimize the burden for the corporate participant.

(C) Exceptions from disclosure to the IRS

By definition, neither 30-day nor tax-return disclosure would be required to the extent that a corporation participates in a partnership or other entity, plan, or arrangement a significant purpose of which is the avoidance or evasion of Federal income tax if none of the enumerated tax shelter indicators are met. Such arrangements would not constitute "reportable transactions." Additionally, certain arrangements (only to the extent provided by the Secretary in regulations) would be deemed to be disclosed for these purposes (notwithstanding that they are otherwise reportable transactions) to the extent that the arrangements are properly reported on certain forms specifically prescribed for arrangements of that type (e.g., Form 1120-FSC for foreign sales corporations; Form 1120-DISC for domestic international sales corporations; Form 8586 for the low income housing credit; Form 1120, schedule K, line 12 for tax-exempt interest; and Form 8860 for the qualified zone academy bond credit).

In addition, an exception from the 30-day disclosure would be provided with respect to any leasing transaction within the scope of Rev. Proc. 75-21,[568] to the extent that the guidelines set forth in that revenue procedure, or the relevant case law thereunder, are satisfied. The volume of such leasing transactions would make 30-day disclosure burdensome for the IRS and the corporate

[568] 1975-1 C.B. 715.

participant. To the extent that the corporate participant has entered into one or more leasing transactions that are described by one or more tax shelter indicators, the corporate participant would be required to identify which indicators have been met by checking the appropriate box or boxes on the return.

(iii) Summary and comparison of applicable penalty rates

Under present law with respect to corporate tax shelters, a penalty under section 6662 can be abated upon a finding that a corporate participant acted with reasonable cause and in good faith. A reasonable belief that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged (i.e., "more likely than not") is generally viewed as satisfying this standard -- irrespective of disclosure.

The following chart summarizes the applicable corporate tax shelter rates in a variety of scenarios and compares the present-law standards with the Joint Committee staff recommendations.

Arrangements with a "Significant Purpose" of Avoidance or Evasion of Tax and Resulting in an Understatement for Corporate Taxpayers

Highest Standard Met	Described by an Indicator	Disclosure Requirements Satisfied	Penalty Under Present Law	Penalty Under Staff Recommendation
Highly Confident	Yes	Yes	0	0
Highly Confident	Yes	No	0	40%
Highly Confident	No	Deemed*	0	0
More Likely Than Not	Yes	Yes	0	20%
More Likely Than Not	Yes	No	0	40%
More Likely Than Not	No	Deemed*	0	20%
Substantial Authority	Yes	Yes	20%	20%
Substantial Authority	Yes	No	20%	40%
Substantial Authority	No	Yes**	20%	20%
Substantial Authority	No	No**	20%	40%
Less Than Substantial Authority: All Cases			20%	40%

*Under the Joint Committee staff recommendations, a transaction that is not described by an indicator is not a "reportable transaction." Therefore, to the extent that a "more likely than not" or higher standard has been satisfied, there is no special tax shelter disclosure or general section 6662(d)(2)(B) return disclosure required in order to reduce penalties.

**These transactions would not be "reportable transactions" to which the special corporate tax shelter disclosures apply. Under the Joint Committee staff recommendations, however, transactions that are not described by a tax shelter indicator nevertheless must satisfy the new, higher section 6662 reporting standards that are recommended in Part VII.G., above. Therefore, if the highest standard satisfied by a transaction is substantial authority, general tax return disclosure rules (i.e., sec. 6662(d)(2)(B) and Treas. Reg. sec. 1.6662-3(c)(2)) must be satisfied in order to abate the penalty, even if the special corporate tax shelter disclosure requirements do not apply. Thus, the disclosure indicated in the boxes accompanying this footnote actually refers to the section 6662(d)(2)(B) disclosure and not corporate tax shelter disclosure.

Key

Highly Confident: 75 percent or greater likelihood of success on the merits if challenged.
More Likely Than Not: Greater than 50 percent likelihood (but less than highly confident) of success on the merits if challenged.
Substantial Authority: Less than more likely than not, but greater than reasonable basis.

b. Recommendations that affect other parties involved in corporate tax shelters

The Joint Committee staff makes the following recommendations with respect to penalties, registration requirements, and other sanctions with respect to parties (other than the taxpayer) that participate in the creation, implementation, or reporting of a tax shelter that results in a understatement penalty for a corporate participant.

(i) Return preparer penalty

As discussed in greater detail in Part VII.G. of this study, above, the Joint Committee staff recommends raising the standard of conduct for income tax return preparers regarding positions on a return that results in an understatement of a taxpayer's liability (sec. 6694). The increased standard would apply with respect to any position on a return or claim for refund (including a position that relates to a tax shelter item).

(ii) Aiding and abetting penalty

The Joint Committee staff recommends that the penalty for aiding and abetting the understatement of tax liability (sec. 6701) through the use of corporate tax shelters be modified in several ways.

First, the penalty with respect to corporate tax shelters would be increased to the greater of $100,000 or one-half the fees related to the transaction received by the person penalized.

In addition, the scope of the penalty provision would be expanded. The penalty would apply to any person who aids or assists in, procures, or advises with respect to the creation, implementation, or reporting of a corporate tax shelter that results in an understatement of tax liability of a corporate participant, and: (1) the person to be penalized knew, or had reason to believe, that the corporate tax shelter (or any portion thereof) could result in an understatement of tax liability of the corporate participant; (2) the person opined, advised, represented, or otherwise indicated (whether express or implied) that, with respect to the tax treatment of the corporate tax shelter (or any portion thereof), there existed at least a 75-percent likelihood that its tax treatment would be sustained on its merits if challenged; and (3) a reasonable tax practitioner would not have believed that, with respect to the tax treatment of the corporate tax shelter (or any portion thereof), there existed at least a 75-percent likelihood that its tax treatment would be sustained on its merits if challenged.

The determination of the likelihood of the tax treatment being sustained on its merits is made at the time the arrangement is entered into, based on the facts and law that existed at that time. In addition, the likelihood of being sustained on the merits does not take into account the possibility that a return will not be audited, that an issue will not be raised on audit, or that an issue would be settled. The person to be penalized would be given a meaningful opportunity to present evidence relevant to the determination of whether the imposition of the section 6701 penalty is appropriate.

The IRS would be statutorily required to publish the names of all persons who have been penalized under this provision. In addition, section 6701 would provide that the imposition of the

penalty would result in an automatic referral of the practitioner to the IRS Director of Practice and the appropriate State licensing authority for possible disciplinary sanctions.

The application of this recommendation is illustrated in the following examples:

Example 1: X, an accountant, advises Z Co. that, with respect to the net tax benefits arising from a corporate tax shelter, there existed at least a 75-percent likelihood that the tax treatment of the net tax benefits would be sustained on its merits if challenged. A reasonable tax practitioner would not have believed that there existed at least a 75-percent likelihood that the tax treatment would be sustained on its merits if challenged. Z Co. claims the tax benefits arising from the transaction on its return. The IRS challenges the claimed tax benefits; Z Co. loses in court and is subject to an understatement penalty.

X is subject to the section 6701 penalty because: (1) X knew, or had reason to believe, that the corporate tax shelter could result in an understatement of Z Co.'s tax liability, (2) X advised that, with respect to the net tax benefits arising from the tax shelter, there existed at least a 75-percent likelihood that the tax treatment would be sustained on its merits if challenged, and (3) a reasonable practitioner would not have believed that there existed at least a 75-percent likelihood that the tax treatment would be sustained on its merits if challenged.

Example 2: L, an attorney, renders an opinion to Z Co. that, with respect to the tax benefits arising from a corporate tax shelter, there existed at least a 75-percent likelihood that the tax treatment of the net tax benefits would be sustained on its merits if challenged. A reasonable tax practitioner would not have believed that there existed at least a 75-percent likelihood that the tax treatment would be sustained on its merits if challenged. Z Co. consults with M, another attorney, for a second opinion. M renders an opinion that it is "more likely than not" that Z Co. would prevail on the merits if the IRS were to challenge the tax benefits. Z Co. enters into the transaction but does not disclose the transaction. The IRS challenges the claimed tax benefits; Z Co. loses in court and is subject to an understatement penalty.

L is subject to the section 6701 penalty because: (1) L knew, or had reason to believe, that the corporate tax shelter could result in an understatement of Z Co.'s tax liability, (2) L advised that, with respect to the net tax benefits arising from the tax shelter, there existed at least a 75 percent likelihood that the tax treatment would be sustained on its merits if challenged, and (3) a reasonable practitioner would not have believed that there existed at least a 75-percent likelihood that the tax treatment would be sustained on its merits if challenged. M is not subject to penalty because M did not advise Z Co. that it would have at least a 75-percent chance of prevailing.

Example 3: Same facts as in Example 2, except that Z Co. complies with the disclosure requirements with respect to the corporate tax shelter. The IRS challenges the tax benefits; Z Co. loses in court and is subject to the reduced 20-percent understatement penalty (because it satisfied the disclosure requirements). For the reasons described in Example 2, L is subject to the section 6701 penalty, whereas M is not. The fact that Z Co. is subject to a lower understatement penalty does not alter the result; L's opinion was intended to mitigate an understatement penalty if relied on by Z Co.

Example 4: Promoter P presents Z Co. with a proposal to enter into a corporate tax shelter that P has reason to believe could result in an understatement of Z Co.'s tax liability. P also provides Z Co. with a third-party opinion letter from Y which provides that, with respect to the net tax benefits arising from the corporate tax shelter, there existed at least a 75-percent likelihood that the tax treatment of the net tax benefits would be sustained on its merits if challenged. A reasonable tax practitioner would not have believed that there existed at least a 75-percent likelihood that the tax treatment would be sustained on its merits if challenged. Z Co. claims the tax benefits on its return. The IRS challenges the claimed tax benefits; Z Co. loses in court and is subject to a 40-percent understatement penalty.

Promoter P is subject to the section 6701 penalty. P knew, or had reason to believe, that the corporate tax shelter could result in an understatement of Z Co.'s tax liability. Moreover, by virtue of providing the third-party opinion letter to Z Co., P has implicitly advised Z Co. that there existed at least a 75-percent likelihood that the tax treatment of the net tax benefits would be sustained on its merits if challenged. Depending on the facts of how the opinion letter was provided to promoter P, as well as Y's knowledge of the use of the opinion, Y also may be subject to the section 6701 penalty.

(iii) Enjoining promoters

The Joint Committee staff recommends modifying the authority to enjoin promoters of abusive shelters or the aiding and abetting of the understatement of tax liability (sec. 7408) to clarify that the traditional equity factors such as irreparable injury and likelihood of success on the merits need not be considered once the government has satisfied the statutory requirements.

(iv) Registration requirements

The Joint Committee staff recommends several modifications to the registration requirements for confidential tax shelter arrangements. The present-law requirement that an arrangement be offered "under conditions of confidentiality"[569] would be eliminated and replaced with a requirement that the arrangement (or the tax analysis supporting the arrangement) is reasonably expected to be presented to more than one potential participant. In addition, the present-law threshold regarding promoter fees would be increased from $100,000 to $1 million in aggregate fees[570] expected to be received from the specific arrangement and all similar arrangements. Thus, the definition of a "tax shelter" for purposes of section 6111(d) would include (and thus to require disclosure of) any arrangement in which (1) a significant purpose of

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[569] Sec. 6111(d)(1)(B).

[570] "Fees" includes gross fees (unreduced by any expenses of producing them) and any other amounts received by the promoter and related parties.

the arrangement is the avoidance or evasion of Federal income tax,[571] (2) the arrangement (or the tax analysis supporting the arrangement) is reasonably expected to be presented to more than one potential participant, and (3) the tax shelter promoter (or a related party) reasonably expects to receive aggregate fees of at least $1 million from the arrangement and all similar arrangements.

For arrangements that are reasonably expected to be described by a tax shelter indicator,[572] certain additional information must be included in the tax shelter registration. The additional information would include (1) the claimed tax treatment of the arrangement and a summary of authorities for the position(s) to be taken, (2) the calculations for the arrangement under a reasonable set of hypothetical facts (including any calculations used to determine that the arrangement is described by a tax shelter indicator), and (3) the reason(s) the arrangement is reasonably expected to be considered a tax shelter because of the presence of a tax shelter indicator (disclosed by checking a box or boxes beside the appropriate tax shelter indicator).

The present-law penalty for failing to register a confidential tax shelter (i.e., 50 percent of the total fees, increased to 75 percent if the failure to register is intentional) would be expanded to apply to all corporate tax shelters that must be registered under section 6111.

New registration filing deadlines would apply to all corporate tax shelters that must be registered under section 6111. The tax shelter registrations must occur no later than the earlier of: (1) the earliest day on which there is a reasonable belief that the promoter intends to present the promotional or marketing materials to more than one potential corporate participant, or (2) the day on which the presentation to the second potential participant occurs. If the promoter does not register and is not a U.S. person, the potential participant must register unless there is notification within 90 days of nonparticipation.

With respect to arrangements that are reasonably expected to be described by one or more tax shelter indicators, registration requirements would be effective 90 days after the date of enactment.

(v) Regulation of professional conduct of practice

The Joint Committee staff recommends that explicit statutory authorization for Circular 230 be provided in Title 26 of the United States Code and include authorization for the imposition of monetary sanctions (not to exceed 100 percent of the aggregate fees associated with the sanctioned conduct).

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[571] This includes, but is not limited to, arrangements that would be described by one or more of the tax shelter indicators.

[572] A reasonable set of hypothetical facts would be used to determine whether an arrangement is reasonably expected to be described by a tax shelter indicator. Any set of hypothetical facts presented to a potential participant must be considered for this purpose.

The Joint Committee staff further recommends that Circular 230 be revised to reflect fully the recommendations contained in this study.[573] Specifically, Circular 230 should be revised to: (1) update the relevant definitions (such as tax shelter and tax shelter opinion), as appropriate; (2) govern the practice of any individual who issues an opinion with respect to a corporate tax shelter or is required to register a corporate tax shelter under section 6111; (3) require the publication of the name of any practitioner who receives a letter of reprimand; (4) authorize the Director of Practice to impose fixed monetary sanctions for a violation of the Circular 230 standards; (5) require an automatic referral to the Director of Practice upon the imposition, or the consideration of the imposition, of any of the practitioner penalties; and (6) require the Director of Practice to notify the proper authorities of the State that licensed the practitioner of any disbarment, suspension (including voluntary suspension), letter of reprimand, or monetary sanction imposed on the practitioner (and the underlying basis for the disciplinary action).[574]

More generally, the Office of Director of Practice should institute procedures that result in the dissemination of more information regarding its enforcement efforts to the general public. It should also be encouraged to implement such programs and policy changes as may be appropriate in furtherance of the goals of greater visibility and respect within the tax community.

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[573] The Joint Committee staff recommendation also includes revising Circular 230 to implement the higher standards applicable to practitioners (generally unrelated to corporate tax shelters) discussed previously in this study.

[574] Practitioner organizations such as the ABA and AICPA would be encouraged to revise their respective member guidance to reflect the recommendations contained in this study as may be appropriate.

IX. OVERVIEW OF PENALTY AND INTEREST REGIMES IN SELECTED FOREIGN COUNTRIES[575]

A. Overview

Most foreign countries utilize penalty and interest provisions in the administration of their tax systems. Thus, just as the United States uses penalty and interest provisions to promote voluntary compliance with the Federal tax laws, so do most foreign countries utilize such provisions.

The discussion that follows provides a brief overview of the primary penalty and interest provisions in selected foreign countries. As the tax systems of each of the countries involved differs from the U.S. Federal tax system, this discussion draws no conclusions as to the efficacy of these countries' penalty and interest rules vis-a-vis the United States. However, this discussion does allow a broad overview of the way in which other countries approach imposition of penalties and interest as a means of securing compliance with the tax laws.

B. Argentina

In general

Argentina has a system of taxation that includes national and provincial tax systems. The principal national taxes imposed in Argentina are: (1) a general progressive income tax levied on individuals and legal entities; (2) a net wealth tax; (3) a value-added tax; (4) an excise tax on specified articles; and (5) import duties.

The assessment and collection of taxes is normally based on signed returns filed by the taxpayers. Taxpayers with taxable income are required to file annual returns unless (1) their income is derived solely from employment with one employer and the tax has already been withheld or (2) taxable income is less than allowable allowances.

In the case of corporations and other entities (such as partnerships and sole proprietorships) that maintain accounting records, tax returns must be filed within 5 months from the end of the entity's fiscal year. Individuals and estates must file returns in June of the year following the tax year, which is the calendar year. In addition, individuals and estates are required to file a sworn return every year listing their goods and liabilities as of the end of December of the year to which the income tax return relates. This return must include goods located or utilized outside of Argentina. Individuals, legal entities, and estates are required to report all of their movable and immovable property, which is subject to registration.

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[575] This Part of the document is based, in part, on information provided by the Congressional Research Service, Law Division, Library of Congress.

Individuals and other legal entities are required to make estimated tax payments during the tax year. In the case of individuals and estates, 11 monthly estimated tax payments are required starting in the July of the tax year. The estimated payment for each month is equal to a percentage of the tax assessed for the preceding tax year reduced by certain tax incentives and withholding payments. Corporations and other legal entities are required to make 11 monthly estimated tax payments beginning in the 6th month of the tax year; each payment equals a percentage of the tax assessed for the preceding tax year minus withholding taxes.

Any balance of payments due must be paid with the filing of the tax return for the year. The tax administration may authorize the payment of such balance in installments, with interest up to 3 percent monthly.

Penalties and interest

In general.--The tax administration has the authority to verify the accuracy of returns filed by taxpayers and can required the filing or new returns or additional information. If a taxpayer does not file a return or if the return is not correct, the tax administration may determine taxable income and calculate the taxes due. The assessment will include taxes due, fines, and compensatory interest. The tax administration may permit the spreading of payments due through installment payments.

Interest.--Under the Argentinian tax system, simple interest is assessed at a rate of 3 percent per month from the date that taxes were due, but not paid. If, however, the Treasury is required to file a judicial claim to collect taxes due, punitive interest is assessed at a rate of 4 percent per month from the date the judicial claim is filed.

Penalties.--The failure to file a tax return as required by the tax administration is subject to a fine of $168.82 pesos[576] in the case of individuals and $338.13 pesos in the case of corporations and other legal entities.

The failure to pay taxes due by not filing a tax return or filing an incorrect return is subject to a fine of 50 to 100 percent of the tax due. An additional fine of $150 to $2,500 pesos is imposed for failure to comply with other administrative duties. In the case of a general failure to comply with general regimes of information by third parties, the fine ranges from $2,500 to $45,000 pesos. The fines may be reduced if they are paid within 15 days after notice is received.

Fraudulent omissions are subject to a fine of two to 10 times the amount of the tax due and may be subject to imprisonment.

[576] $1 (peso) = US$1 (dollar).

C. Canada

In general

Income taxes and other taxes are imposed and collected in Canada at the federal, provincial, and municipal levels. The federal government assesses and collects taxes primarily under the Income Tax Act. In addition, Canada imposes a Goods and Services Tax ("GST") that is similar to European VAT systems. In Newfoundland, Nova Scotia, and New Brunswick, the GST has been blended with a provincial sales tax and is referred to as a Harmonized Sales Tax ("HST"). Excise taxes are imposed on a limited number of products produced in Canada such as spirits and tobacco.

All of the provinces impose income taxes on individuals and corporations. The income taxes imposed on individuals are collected by the federal government by agreement with the provinces (other than Quebec).

Estimated tax payments are due quarterly. There are three options for calculating the amount due:

- The government calculates required installments and mails out reminders twice a year (one month before the due date of the 1st and 3rd installments). The first two installments are based on information from the next-to-last year's returns. The last two installments are based on the last years' return information. The amount of the last two installments includes an adjustment for the difference what the taxpayer paid for the first two installments and what the taxpayer would have paid if those installment had been based on the last year's return information.

- The taxpayer pays 25 percent of the previous year's net liability on each installment date.

- The taxpayers pays 25 percent of the current year's estimated liability.

Penalties and interest

Interest.--Compound daily interest is charged with respect to unpaid income taxes of individuals beginning on May 1 of the year following the tax year.

Interest may be imposed on the failure to satisfy estimated tax requirements. No interest is charged on installment payments if the taxpayer pays the government determined amounts on each of the due dates. Interest is charged if payments made under either of the other two alternatives are less than the actual liability. The interest rate is variable, reset quarterly, and compounded daily. Interest below $25 is waived.

Penalties.--The penalty for failure to file and late filing of an income tax return varies based on a taxpayer's previous compliance history. For the first offense, the penalty is a 5 percent of tax due with the return plus an additional 1 percent for each month payment is delayed up to 12 months. Thus, the maximum penalty is 17 percent. For repeat offenders (i.e., taxpayers who were assessed late filing penalties for any of the 3 preceding years), the penalty is 10 percent of the tax due with the return plus 2 percent for each month payment is delayed. The maximum penalty for repeat offenders is 30 percent.

The penalty for failure to make estimated tax payments is imposed if interest on the payments exceeds $1,000. The penalty is 25 percent of the interest that would have been charged if the taxpayer had made no installment payments at all. The maximum penalty is 50 percent of the portion of the interest that exceeds $1,000.

The penalty for failure to provide information required by a form is $100 (provided any deviation from information required to be shown on the form affects the taxpayer's substantive obligations or is calculated to mislead.)

The failure to provide a Social Insurance Number to a person required to file an information return is $100.

The penalty for a failure to file an information return (including a partnership return) is $100 plus $25 for each day of delay. The overall maximum penalty is $2,600. The penalty for a repeated failure to file a partnership return applies when the penalty for failure to file an information return (described above) has been assessed against a partnership for the current year and for any of the 3 previous years and a demand for the returns has been made. The penalty is $100 per month per partner. The maximum penalty is $2,400 per partner.

The penalty for failure to file an information return on transactions with related nonresident persons $1,000 for each month of delay. The maximum penalty is $24,000.

A penalty is assessed against a taxpayer who has omitted income in the current year and in any of the 3 preceding years. The penalty is 10 percent of the omitted income. Aside from the previous omission requirement, this is a "no-fault" penalty. A first-time omission of income (or a repeated omission after more than three years) is not subject to penalty unless the omission is knowing or grossly negligent.

A knowing or grossly negligent understatement of income is subject to a penalty of 50 percent of the tax deficiency that results from the omission, but not less than $100. The term, "gross negligence" has been interpreted to mean simple carelessness in situations where the taxpayer knew or should have known the income was omitted.

A tax shelter penalty is assessed for selling unregistered shelter interests or interests on which the registration information was false or misleading. The penalty is 3 percent of the cost of each tax shelter interest sold, but not less than $500.

Abatement of penalties and interest.--Abatement of penalties and interest is permitted when noncompliance results from one of the following:

- Natural or man-made disasters such as flood or fire.
- Civil disturbances or disruptions, such as postal strikes.
- Serious illness or accident.
- Death in the immediate family that causes serious emotional or mental distress.
- Inability to pay beyond the taxpayer's control. For example: loss of employment accompanied by financial hardship.
- Inability to conclude a reasonable payment arrangement because too much of each payment would go to penalties and interest. In such cases, penalties and interest can be waived in whole or in part provided agreed upon payments are made on time in accordance with the taxpayer's ability to pay.

D. Czech Republic

In general

In the Czech Republic, individuals are subject to a progressive income tax, social security contributions, taxes on property and inheritance and gift tax. Corporate taxpayers and other legal entities are subject to corporate income tax, social security contributions and taxes on immovable property (land tax and building tax). A value-added tax is imposed on all domestic supplies and on importation of goods.

A taxpayer who has a yearly income exceeding 10,000 crowns[577] must calculate the tax, file a tax return, and pay the tax by March 31 following the end of the tax year. Returns are filed only by taxpayers who have income other than from employment. Income tax on employment income is withheld by the employer and constitutes full payment of the tax. Taxpayers paying more than 10 million crowns of income tax per year, pay 1/12th of the tax every month, and those paying more than 100,000 but less than 10 million crowns, pay the tax quarterly. Final settlement is made by March 31, of the year following the tax year.

Penalties and interest

The penalty for failure to file a tax return is 10 percent of the tax due. The penalty for late filing and payment of the tax due is 0.3 percent of the tax due per day.

Failure to comply within a set time with a tax administration request other than of a monetary nature is subject to successive fines for noncompliance which may not, however, exceed 2 million crowns in the aggregate. Such fines for noncompliance apply to the registration of businesses, information required from banks and insurance businesses and other persons in possession of information necessary for imposition of the tax, etc.

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[577] 35 crowns equals about $1 (United States).

Tax avoidance is punishable by imprisonment from six months to three years or by a fine. Imprisonment from one to eight years may be imposed when the offense is committed with another two persons, if it involves the breaking of an official seal, or if considerable loss is caused. The punishment is imprisonment from five to twelve years if loss of great value results. The assessment of no tax may be considered considerable loss, and the loss of great value means a loss exceeding 1 million crowns.

In order for a person to be prosecuted, an intentional act which causes the tax administration not to assess the tax or assess it only to a smaller extent must be present. This would involve the submission of false statements on the strength of which the tax administration would assess no tax or a smaller tax.

E. France

In general

Individual taxpayers are subject to a progressive income tax, social security contributions, inheritance and gift taxes, and a value-added tax. Corporate taxpayers and other legal entities are subject to corporate income tax, a business tax, payroll taxes, and a value-added tax.

Every individual subject to income tax is required to complete an income tax return each year in which he supplies information regarding his income for the preceding year. Individuals domiciled in France must file their returns no later than the last day of February of the year following the taxable year to which the returns relate. Certain types of income, such as real property income, foreign source income, capital gains, agricultural, industrial and commercial income must be reported on separate tax forms. The date of filing for individuals domiciled abroad varies as a function of the country of residence. It is, for example, April 30 for individuals residing in Europe and May 15 for residents of Africa and North America.

The taxpayer is not obligated to calculate the amount of income tax owed. This task is carried out by the administration based upon the information supplied by the taxpayer on his return. He does not tender any payment at the time of filing his return. Partial payments must be made on February 15 and May 15 of the year following the taxable year in question. Each payment is equal to one-third of the income tax paid by the taxpayer the prior taxable year. The balance of the income tax due for the taxable year in question must be paid upon receipt of a request which is sent out after September 1 of the year following such taxable year. The request indicates the amount of tax remaining unpaid and the deadline for payment of such balance. The taxpayer may elect to have his income tax withdrawn each month from his bank account.

Penalties and interest

In general.--Administrative tax penalties combine two features: an interest charge of 0.75 percent, and a flat penalty equal to a percentage of the taxes owed. Fines may also be imposed for violation of formalities requirements or specific offenses. The administrative tax authorities may

only impose and enforce pecuniary penalties, and the grounds for charging such penalties must be stated in the decision.

Interest charges and flat penalties are imposed on a taxpayer in the following situations: (1) for failure to file a tax return or late filing of a tax return; (2) for late payment of tax; (3) as a result of insufficient, inexact or incomplete information in a tax return; and (4) in connection with a unilateral reassessment procedure resulting from obstruction by the taxpayer or third parties.

Failure to file a tax return or late filing.--The taxpayer is subject to an interest charge of 0.75 percent of the tax owed for each month that has passed since the return was initially due, plus a flat penalty equal to 10 percent of the amount due. The interest charge ceases to accrue upon either the last day of the month during which the tax return was filed or the last day of the month during which a notice of reassessment was received by the taxpayer. The 10 percent flat penalty is increased to 40 percent if the taxpayer fails to file his tax return within thirty days of receipt of a notice from the tax administration and to 80 percent if he does not file his tax return within thirty days after receipt of a second notice.

Late payment of tax.--The taxpayer is subject to an interest charge of 0.75 percent of the unpaid tax. It is calculated from the first day of the month following the month during which the tax was due until the last day of the month during which payment is made. An additional 10 percent penalty is imposed if the taxpayer does not pay before the fifteenth day of the second month after receipt of a collection notice.

Insufficient, inexact or incomplete information resulting in a underpayment of tax.--The penalties imposed vary according to whether or not the taxpayer acted in good faith or bad faith or fraudulently.

If the taxpayer acted in good faith, no penalty will be imposed if the amount of taxable income which was not reported does not exceed 5 percent of his taxable income as reported. If it does exceed 5 percent, a late payment fee of 0.75 percent of the unpaid tax per month will be imposed. In addition, no penalty or late payment fee is imposed where the taxpayer directed the administration's attention to the issues of tax law he resolved to his own advantage by expressly noting them on his tax return or on an annexed document.

When the tax administration establishes that the taxpayer filed a tax return in bad faith, it will impose an interest charge of 0.75 percent of the tax due per month and a penalty equal to 40 percent of the unpaid tax. This penalty is increased to 80 percent if the taxpayer has been guilty of deception or abuse of process.

Unilateral reassessment procedure resulting from obstruction by the taxpayer or third parties.--A taxpayer is subject to an interest charge of 0.75 percent of the tax owed per month and a penalty equal to 150 percent of such tax when the tax administration is obliged to proceed with a unilateral reassessment procedure because it has been unable to audit the taxpayer records because of obstruction on the part of the taxpayer or a third party.

F. Germany

In general

Individuals are subject to a progressive income tax, gift tax, inheritance tax, turnover tax and, in certain instances, a church tax.

Not all German individuals who earn a substantial income are required to file a tax return. In particular, most wage earners are exempt from the duty to file a return, unless they have significant income from other sources than wages have been paid wages by more than one employer during the tax year, or are dual income spouses of a certain wage level. For wage earners who need not file a return, the tax liability is satisfied through the withholding of income tax by the employer, who determines the tax of each employee on the basis of tables and rates that take the family status of the employee into consideration.

German individuals who must file an income tax return do not self-assess the tax owed by them. Instead, the tax return asks merely for the pertinent data necessary to determine the extent of the tax liability. The taxpayer provides these data within five months after the end of the tax year. The tax authorities then determine the amount of the tax by assessment. Consequently, the German taxpayer does not include payment of his tax in his income tax return. Instead, the payment is due one month after the assessment has been mailed to the taxpayer.

Usually there is a substantial time lag between the filing of the return by the taxpayer and the assessment, during which period the authorities examine the return and may ask for additional information or review the taxpayer's books. Delays of several years between filing and assessment are not uncommon. However, the taxpayer rarely has to pay the whole tax after the assessment; instead, the taxpayer has to make advance payments estimated and imposed by the tax authorities, throughout the tax year, often on a quarterly basis. At the time of assessment, the taxpayer either receives a refund or must make an additional payment, depending on whether he overpaid or underpaid through the advance payments,

Penalties and interest

In general.--Penalties and interest charges for late filings of tax returns and similar infractions are provided. There is a differentiation between non-punitive interest charges, coercive enforcement tools to ensure taxpayer compliance, and criminal penalties for tax evasion. Interest charges and compliance penalties are imposed and collected by the administrative tax authorities. However, criminal penalties for tax evasion are imposed by the courts.

Interest is imposed only as prescribed by law in the situations described below. Interest is charged at the rate of 0.5 percent for each full calendar month. Partial months are not included in the computation, and the amount on which interest is owed is rounded down to the next lower Deutsche Mark (DM) 100 (U.S. $60). In each instance, interest is charged by a specific administrative decision.

Most types of interest on taxes are not punitive in character, and the law reflects this in several ways. Interest payments are not cumulative: for situations in which several types of interest would be due on the same tax, the law provides that interest be payable only once. No interest is imposed for defaults on interest payments. Moreover, the taxpayer can claim a deduction for interest paid on taxes, with the exception of interest owed for tax evasion.

Interest on deficiencies.--Since 1990, German taxpayers have had to pay interest on the deficiency between the assessed amount of their taxes and their advance payments. As a rule, the obligation to pay interest commences 15 months after the end of the tax year; however, an additional interest-free period of 21 months is granted for first time assessments of certain agricultural income. Interest is due at an earlier time if the assessment reflects loss carryovers or other circumstances of earlier tax years. Interest is payable until the assessment becomes final; however, interest payments may not be imposed for longer than four years.

This so-called full interest for owed taxes also applies to other taxes that are imposed by assessment, in particular, the corporate income tax, the trade tax, and the value added tax. Moreover, interest is not imposed only on the taxpayer but also on the government. If the advance payments amount to an overpayment of the assessed tax, then the government must pay interest on the refund on the same terms as a taxpayer would on the tax owed.

If the government grants the taxpayer an extension on the time of payment of the tax, interest is imposed for the duration of the extension.

Interest relating to criminal evasion.--Interest is payable on a deficiency resulting from a criminal tax evasion. The interest can be imposed on the beneficiary of the evasion, yet the professional tax preparer is also liable. The tax authorities can impose the interest if they are convinced that a criminal tax evasion took place; a criminal conviction is not required. The payment period runs from the time of the evasive act, or from the time when the evaded taxes would have been due, whichever occurs later, until the evaded tax has been paid.

Interest for suspended taxes.--Interest is payable on a tax if its collection was suspended by an unsuccessful legal action or other delaying motion of the taxpayer. The interest can be imposed on the disputed amount from the time that the legal action became pending until termination of the collection suspension. Similarly, the government has to pay interest on a tax reduction that was imposed by a final court decision.

Penalty for late filing.--The local tax office may impose a penalty for late filings, if a taxpayer fails to file a return or files late without having obtained an extension. The penalty depends on the circumstances of the case, including facts such as the degree of culpability of the taxpayer, the length of time involved, the amounts involved, and the economic situation of the taxpayer. No penalty is imposed if there were excusable circumstances. The penalty may not exceed 10 percent of the tax as established by assessment, nor may it exceed the sum of DM 10,000 (U.S. $6,000).

Penalty for failure to pay a tax.--The penalty for nonpayment or late payment of a tax aims at compelling the taxpayer to pay taxes on time. This penalty can be imposed for assessed income taxes as well as for withheld wages; in the latter case, the employer is subject to the penalty, which is owed by operation of law, an administrative decision is not required for its imposition. The penalty amounts to 1 percent of the owed tax for each calendar month or fraction thereof during which the delay persists. Penalties and interest charges are not cumulative.

Other coercive measures.--German law provides for three types of coercive measures: fines, the performance of the required act at the expense of the person obliged to perform it, and the performance of the required act by the tax authorities themselves. The coercive fine may not exceed the amount of DM 5,000 (U.S. $3,000), but it may be imposed for several infractions during the same proceeding. If the coercive fine cannot be collected from the taxpayer, the court may convert it to a prison sentence of up to two weeks.

The employment of all coercive measures must be proportional to the aim that is to be achieved, and the taxpayer may not be harassed unnecessarily. The measures are intended to lead to compliance without a punitive effect. In particular, the privilege against self-incrimination must be respected, and a statement under oath cannot be requested through coercive means. In practice, the coercive measures are rarely used in Germany.

Discretion of tax authorities.--Tax authorities have a great deal of discretion in assessing penalties and interest. Except as a penalty for late payments, interest payments are imposed only if the authority imposes them by an administrative decree. Moreover, the authorities may reduce the tax on an equitable basis in certain cases.

G. Hungary

In general

The main taxes imposed in Hungary include a corporate income tax, tax on participation in the proceeds of state property, an individual income tax, a general turnover tax, a consumption tax, an inheritance and gift tax, a tax on the transfer of ownership, and municipal taxes.

Hungary operates a self-assessment taxation system under which taxpayers calculate their own tax liability and make advance payments throughout the year. The tax year corresponds with the calendar year. At the end of the year, taxpayers must prepare tax returns for submission to tax authorities. Tax returns must be filed by March 20th in the following year. The information that must be submitted is quite limited; however, detailed audits are periodically carried out by the tax authority.

Certain individuals are not required to file tax returns, including those who declare to their employers that they derive income either only from single employment or they derive employment income from a similar employer and/or derive income from independent services, whereby the taxable income is determined using the option of a lump-sum deduction of expenses of 10 percent of turnover.

Penalties and interest

Interest.--Interest (referred to as a delay surcharge) is charged on the late payment of tax. Interest is charged from the date on which any payment should have been made until the date on which it was actually made. This delay surcharge is 1/365th of twice the prime rate applied by the central bank for each calendar day of delay. The delay surcharge is not due for any period of delay if the taxpayer had a reasonable excuse for not paying the tax on time. The tax authority has the authority to mitigate the surcharge.

Penalties.--In order to encourage voluntary compliance, the Hungarian tax system uses a punitive penalty regime under which little differentiation is made between serious offense and cases of minor delay or innocent mistake.

A self-correction mechanism is available to taxpayers. Under this system, if a taxpayer corrects a mistake made in the filing of a return or payment of taxes, the taxpayer is required to pay a self-correction surcharge.

In the case of tax deficiency, a penalty equal to 50 percent of the tax deficiency is assessed. The tax penalty applies also if a taxpayer submitted an application for subsidies or reclamation of tax without being entitled thereto. No tax penalty may be assessed for that part of tax deficiency which has been incurred because of a false tax certificate issued by an employer or payer.

The rate of tax penalty may be reduced in the case of a particularly justifiable circumstance, if it is evident from the circumstances that the taxpayer or his representative has proceeded with due care that could be expected of him in the given situation.

Default fines are imposed for late performance or nonperformance of various statutory obligations. These include the failure to register for tax purposes, to submit an annual balance sheet or profit and loss account, to keep relevant records, to meet an obligation to issue invoices or similar documents, to submit a return by the filing date, and to submit a correct return. The default fine for not meeting the obligation of return and reporting related to the acquisition of property varies from 5 percent to 100 percent of the unpaid duties depending on circumstances.

On the basis of the request of the taxpayer, the tax authority may reduce or cancel the tax, fine, or interest liability payable by that physical or legal person, if payment thereof seriously endangers the livelihood of the taxpayer and his close relatives living with him, or if the payment makes impossible the economic activities of a legal entity or of another organization.

H. Ireland

In general

All Irish taxes are either collected by deduction at source or are subject to self assessment. The principal taxes collected by deduction at source are: (1) deposit interest retention tax

("DIRT"), which is applied to interest paid by most deposit institutions; (2) pay as you earn ("PAYE"), which is a payroll deduction tax on wages; and (3) pay related social insurance ("PRSI"), which is a social security payroll tax.

Because most income tax on wages is collected under PAYE and interest on bank accounts is subject to withholding under the DIRT, most individual taxpayers do not have to file income tax returns. Returns may be needed for taxpayers who hold more than one job (although this may sometimes be avoided by making adjustments to withholding). Returns are required for the following individuals: (1) self-employed individuals; (2) investment income recipients (including capital gain recipients); and (3) owner-directors of companies. In addition, every company is required to file a corporation tax return for each accounting period.

Other taxes, such as VAT, gift and inheritance taxes, stamp duties, etc., are on a self assessment system.

Blank forms are mailed in April to anyone the government considers liable to file a return. But failure to receive returns does not excuse failure to file. Taxpayers who need to file but do not receive returns are required to request them. The return is designed to collect sufficient data for the government to calculate the taxpayer's liability. Taxpayers can make their own calculations, but are not required to do so.

Estimated income tax is known as Preliminary Tax. It is paid in a single payment, which is due November 1st each year. Since the tax year begins April 6 and ends April 5, this Preliminary Tax payment is due a little more than 7 ½ months after the start of the tax year. Any balance due after the return is filed must be paid by the following April 30, nearly 13 months after the close of the tax year. In general the Preliminary Tax must equal the lower of two figures:

- 90 percent of the current tax year's liability or
- 100 percent of the previous tax years' liability.

Preliminary tax payments may be spread out over the year in equal monthly installments rather than being paid in a single lump sum at the beginning of November. To qualify for this option, the taxpayer must authorize the government to directly debit his or her bank account once a month. Taxpayers who authorize direct debit need only pay the lowest of <u>three</u> figures:

- 90 percent of the current tax year's liability,
- 100 percent of the previous tax years' liability, or
- 105 percent of the next previous tax year's liability.

The government usually calculates the amount of Preliminary Tax each year. A taxpayer who disagrees with the government's figure can notify the government of the amount he or she considers correct and pay on that basis. A taxpayer who does not notify the government of such a disagreement and simply pays preliminary tax based on his or her own calculation will be subject to interest calculated on the basis of the government's Preliminary Tax calculation.

Returns are due January 31, more than 9 months after the close of the tax year. However a taxpayer who files early is better able to determine the amount of his or her Preliminary Tax liability for the following year.

Penalties and interest

In general.--Self assessment under the Irish tax system operates by a system of penalties and interest. These sanctions arise in the event of a failure to make a timely return of income and gains and failure to make a timely or adequate payment of the tax due.

Interest.--Interest on underpayments of tax is charged at a rate ranging from 0.5 percent to 1.25 percent per month of underpayment.

Penalties.--In the case of returns up to two month late, the penalty imposed is 5 percent of the tax liability, not to exceed £10,000. In the case of returns more than two months late, the penalty imposed is 10 percent of the tax liability, not to exceed £50,000. Failure of a company to submit a return for any accounting period within nine months after the end of the period results in a penalty equal to 10 percent of the tax due for the accounting period plus the limitation of certain tax relief provisions.

There is normally a one week grace period for returns received after the due date. But this is a discretionary guideline. It will not be allowed if there is an indication of abuse, such as a tax preparer filing returns for all of his or her clients within one week after the filing date. A similar discretionary grace period applies in assessing the higher 10 percent surcharge for returns received within two months and one week after the filing due date.

I. Japan

In general

Japan imposes a variety of taxes, including individual and corporate income tax, a consumption tax, social security taxes, inheritance and gift taxes, registration taxes, land value tax, and local and miscellaneous.

Income tax is paid by self assessment unless it is withheld at source. Under this system, each taxpayer must file a return and pay the tax due at the same time. Income tax on wages, salaries, interest, and dividend is withheld by payers of such income who are required to remit withholding tax on behalf of the taxpayer.

Income tax is assessed on a calendar year basis and a final return for the annual income (except very small income) is to be filed by March 15 of the following year. Normally, about two-thirds of the total tax estimated on the basis of ordinary income of the preceding year must be prepaid in two equal installments in July and November. The difference between tax due and the

prepaid amount should be paid at the time of filing a final return by March 15 of the following year.

Penalties and interest

In general.-Interest charges are collected as delinquent tax or interest tax, and penalties are imposed as administrative penalties in the form of additional tax or penalty tax. These interest charges and administrative penalties are collected by the tax authorities. Criminal penalties are imposed against tax evasion by the court with the term of penal servitude and the amount of fine.

Interest charges.--In case a taxpayer does not pay tax by the due date, he must pay, in addition to the principal tax, a delinquent tax at the interest rate of 14.6 percent per annum for a period of the day following the due date to the actual payment date. The above rate, however, is reduced to 7.3 percent per annum if a delinquent tax is paid within two months from the day following the due date.

If the late filing of tax is allowed by a tax office for a period provided in the Income Tax Law, a taxpayer has to pay interest tax for this period instead of the delinquent tax. As a rule, this interest is computed at the rate of 7.3 percent.

Penalties.--Penalties are imposed as administrative penalties in the form of additional tax or penalty tax as follows:

(1) Penalty tax for deficient return - 10 percent or 15 percent of the increased amount of tax resulting from a correction or an amended return, when the original final return was filed on or before the due date.

(2) Penalty tax for no return - 15 percent of the amount of tax determined by a tax office or shown in a final or amended return, when the original return was filed after the due date.

(3) Penalty tax on withholding - 10 percent of the amount of tax determined by the notice of a tax office, when the original return was not filed on or before the due date.

(4) Heavy penalty tax - In the case of fraud, this tax is collected at the rate of 35 percent of the amount of tax as penalty for tax evasion under (1) and (3) and 40 percent under (2) above.

Criminal penalties.--If a taxpayer fails to meet a tax obligation, without reasonable cause, i.e., by neglecting to file a tax return or making a incorrect tax return by omitting any taxable income, a criminal penalty is imposed. The following are typical offenses and their penalties:

- Tax evasion (including concealment or destruction of properties in possession of a taxpayer with the intention of evading the payment of delinquent tax) - imprisonment for a term not to exceed five years of a fine not to exceed 5 million yen.

- Filing no return - imprisonment for a term not to exceed one year or a fine not to exceed 200,000 yen.

- False reply to tax examiner - Imprisonment for a term not to exceed one year or a fine not to exceed 200,000 yen.

J. Sweden

In general

Sweden imposes a system of individual and corporate income taxes. In addition to the income tax, Sweden imposes a value-added tax, a tax on social security contributions, a net wealth tax, an inheritance and gift tax, stamp duties, a real estate tax, and a special revenue tax.

The Swedish National Taxation Board is responsible for matters concerning the Swedish taxation system. Each county has a taxation authority under which there are several local taxation offices. Every taxation office has a taxation committee, which is the preliminary instance for decision-making regarding taxation.

An income tax return may be in the form of a simple written declaration, a special written declaration, or be transmitted electronically. Every individual whose annual income has been at least 24 percent of the established "base amount," which is calculated annually on the basis of changes in the consumer's price index, must file an income tax return. There are also other factors such as income of capital or the tax on capital which may necessitate filing an income tax return.

However, a person whose sole income derives from a universal pension and its supplements is not obligated to file an income tax return, unless the total amount exceeds 134 percent of the base amount for a person who is married and 151.5 percent for other persons. However, whenever the taxation authority requires a person to file an income tax return, that person must comply even if his income is within the limits mentioned above. Individuals in receipt of business income must file returns by March 31 of the year following the tax year.

A simple declaration of income is usually completed directly by the taxation authority on the basis of the available information. Such information is supplied by the various entities making the payments for the work performed or the interest paid on the capital or the like. The completed form is sent to the taxpayer for his signature. If the completed form is correct, the taxpayer signs and returns it to the authority. In case a taxpayer has had other income not included in the completed form or finds that certain items are incorrect, the taxpayer corrects the completed form and sends it back to the tax authority. Except for those who need not file a tax return in conformity with the above-mentioned rule, whoever who does not receive a completed simple tax return must file a special income tax return.

According to the provisions of the 1997 Law on Payment of Taxes, an income tax declaration must be filed at certain specified dates with respect to various types of tax returns. However, under certain circumstances an extension may be granted.

Employers are required to deduct tax from their employees' salaries and benefits and pay such amounts to the local tax authorities monthly.

The taxation authority decides whether a person owes taxes or should receive a refund. The payable taxes must be paid to the account of the taxation authority which has determined the amount of taxes to be paid. If an extension has been granted, the taxation authority may also grant an extension for the payment of the due taxes. If a person has paid more than what the final taxation decision indicates, he\she will receive a refund. However, if this person is owes money for back taxes or similar debts, for instance, the amount of refund will be deducted accordingly.

Penalties and interest

Interest.--A taxpayer must pay interest on the amount of money he owes or receive interest for the amount which is due him. The interest is calculated on the basis of so-called "base interest."

Interest is calculated on the basis of 125 percent of the base amount, both for the taxes which had to be paid during the year the income was earned and the tax which must be paid after a final taxation determination has been made. However, up to an amount of 20,000 SK (ca US$2,500) is exempted from the payment of interest for the period between February 13 and May 3 in the taxation year.

However, if taxes must be paid because of a discretionary estimation, the payable interest will be calculated on the basis of an interest composition constituting the base interest plus 15 percent units.

If the payment of interest for the time after the date the payment should have been made is not made in time, the interest is calculated on the same basis as above. However, for up to an amount of 10,000 SK (ca US$1,250) the interest is calculated on an interest composition corresponding to the base interest. The same rule applies when the enforcement authority acts to collect the debt.

The payable interest is charged on a monthly basis.

The taxation authority is empowered to exempt a taxpayer from the payment of interest, either partly or fully, if it finds good reasons for granting such exemption.

Penalties.--Swedish laws contain three types of penalties in connection with taxation: penalty for late filing, penalty for tax avoidance, and penalty for tax evasion.

The first two categories, i.e. penalty for late filing and penalty for tax avoidance, are sanctioned through administrative and financial measures. Tax evasion is sanctioned by means of a special criminal law, entitled "Tax Violation Law."

Penalty for late filing.--A person who neglects filing an income tax return within the specified time limits will be charged a late filing fine, which is 1000 SK (ca US $120) for legal persons and 500 SK (ca US $60) for natural persons. If the tax return is not filed at the latest by August 1, of the tax year, the fine will be four times the assessed fine for each category of taxpayer.

Penalty for tax avoidance.--A tax addition will be charged if the taxpayer either in his income tax return or in any other relevant writings has furnished incorrect information. Additional tax will be charged only if the taxpayer himself or his legal representative has given the incorrect information.

Incorrect information may, for instance, be an income item which has not been included or an income which has been estimated at a lower amount, or an expense item which has been counted for at a higher level. The additional tax in such cases is 40 percent of the income tax which should have been charged if the incorrect information had been accepted. However, if the correction has been made by available means, such as an income tax return from the past year, the additional tax will be 20 percent. If the correction has been achieved by means of the control reports coming from various entities making the payments, no additional tax will be charged.

Additional tax will also be charged when the payable tax is made by discretionary estimation.

The Tax Law also contains provisions to the effect that, in charging additional taxes, due consideration must be given to the taxpayer's age, state of health, lack of experience or other factors which make the furnishing of incorrect information excusable.

Penalty for tax evasion.--The Tax Violation Law contains provisions on the criminal penalty for tax fraud and gross negligence. The penalty is a fine or up to six years imprisonment, depending on the nature of the conduct and the amount of the tax involved.

K. United Kingdom

In general

The United Kingdom imposes an individual and corporate income tax, a capital gains tax, an inheritance tax, a value-added tax and other indirect taxes, and a stamp duty.

Most individual taxpayers do not file returns. The tax is paid through withholding on their wages and bank account interest (called “pay as you earn” or PAYE). Self employed people and others with income not covered by PAYE must file returns.

Taxpayers are required to make estimated tax payments during the year. The government determines the amount of required payments on account. Payments are due in two installments, January 31 during the tax year, and July 31 following the close of the tax year. There is no penalty for failure to make payments on account when due, but interest is charged. Any payment on

account that is not paid by the time the government determines the tax become part of the balance due on the return.

In 1996, the United Kingdom introduced a self assessment system. Under this system, taxpayers may self assess by including a calculation of tax liability on their tax return. Alternatively, the taxpayer may file the tax return only and permit Inland Revenue to calculate the tax due.

The tax year ends April 5 of each year. The government generally sends blank returns to taxpayers with a specified due date. Tax returns are normally due by Jan. 31 of the following year. If the government mails a taxpayer's return forms later than October 31 following the close of the tax year, the due date is three months from when the taxpayer receives the return. The return is designed to supply the government with sufficient information to calculate the taxpayer's liability. Taxpayers can calculate the liability themselves if they choose to, but are not required to.

Penalties and interest

Incentive for filing early.--If a taxpayer files his return by Sept. 30 after the close of the tax year, and balance due is below £1,000, the balance due need not be paid in a lump sum. Instead it can be spread out and paid as part of the subsequent year's withholding under the PAYE system.

Interest.--Interest rates on underpayments of tax are calculated by reference to base rates. Interest accrues automatically on tax paid late, even if the amount of the underpayment is not known at the due date of the payment. Repayments incur interest charges from the due date of the payment to the date the tax was paid.

Late payment penalty.--If a personal balancing payment is unpaid more than 28 days after the filing date of the return (i.e., after February 28), a surcharge of 5 percent is automatically imposed. An addition 5 percent surcharge is imposed with respect to a balancing payment remaining unpaid six months after the filing of the return. An appeal may be may for abatement for reasonable excuse (see below).

Basic late filing penalty.--The basic late filing penalty is £100 if the return is not filed by the due date. Additional late filing penalties equal £100 if the return is still unfiled six month after the due date and 100 percent of the year's tax liability if the return is still unfiled 12 months after the due date.

Special penalty for taxpayers deemed recalcitrant.--Once a taxpayer misses the original due date, the government can request an independent tribunal, the "Appeal Commissioners," to impose a daily penalty of up to £60 a day. This is used in extraordinary situations.

Penalties may also be charged for failing to keep adequate records in support of the tax return.

Abatement for "reasonable excuse".--Penalties may be abated for "reasonable excuse." The statute does not define reasonable excuse. The following are examples that may be considered acceptable:

- The taxpayer did not receive blank forms from the government
- The return was delayed or lost in the mail, assuming it was mailed in time to be received by the deadline. Generally there would have to have been some related event such as a fire or flood at the post office where the return was mailed or a prolonged strike
- Tax records lost as a result of fire, flood, or theft
- Serious illness. This generally must be serious enough to interfere with the taxpayer's handling of his or her other business and private affairs
- Death of a close relative or domestic partner shortly before the deadline, provided the taxpayer had previously taken any necessary steps to have the return ready on time.

The following are not considered reasonable excuse:

- In general any event that did not interfere with the taxpayer's handling of his or her other business and personal affairs
- The tax return was too difficult
- Pressure of other work
- Tax consultant's failure
- Unavailability of necessary information. Ordinarily, the taxpayer should supply an estimate of the missing data along with an explanation as to why only estimated information is available.
- Government's failure to send a reminder. NOTE: The government does normally send a reminder shortly before the first penalty date, but absence of a reminder is not reasonable excuse. The due date is shown on the return when the taxpayer receives it.

APPENDICES

APPENDIX A1.--Internal Revenue Code Penalty Provisions[1]

Description of Penalty	Code Section	Calculation of Penalty	Waiver Available?
1. Low-income housing credit penalties	42		
a. Failure to file initial certification when building eligible for credit is placed in service.	42(l)(1)	Low income housing credit is denied for the taxable year in which building was placed in service.	Yes, if such failure is due to reasonable cause and not to willful neglect.
b. Taxpayer's failure to file required annual reports.	42(l)(2)	$100 per failure (same penalty as under §6652(j)).	Yes, if such failure is due to reasonable cause and not to willful neglect.
c. Housing credit agency's failure to file required annual reports.	42(l)(3)	$100 per failure (same penalty as under §6652(j)).	Yes, if such failure is due to reasonable cause and not to willful neglect.
2. Medicare+Choice MSA	138		

[1] Penalties are listed in ascending order by Internal Revenue Code section. This list does not include the following penalty provisions: (1) International related penalty provisions (see Appendix A2); (2) pension and employee benefit related tax penalty provisions (see Appendix A3); (3) Exempt organization penalty provisions (see Appendix A4); and (4) estate and gift penalty provisions (see Appendix A5). This list also does not include criminal penalties.

APPENDIX A1.--Internal Revenue Code Penalty Provisions (Continued)

Description of Penalty	Code Section	Calculation of Penalty	Waiver Available?
a. Funds distributed from MSA are not used for eligible medical expenses, and the fund does not maintain a minimum asset value.	138(c)(2)	A penalty equal to 50% of the amount determined under the following formula: The amount of misused distributions *reduced by* -- (1) The MSA plan's assets (valued at fair market value on the last day of the calendar year preceding the taxable year the misdirected payment is taxable) *minus* (2) 60% of the MSA plan's deductible on January 1 of the year in which the misdirected payment is taxable.[2]	Yes, if account holder becomes disabled within the meaning of §72(m)(7), or dies.
3. Arbitrage	148		
a. If arbitrage bond proceeds invested in bonds yielding excess interest, and issuer elects to pay the "penalty" provided by §148(f)(4)(C)(vii) rather than rebate the excess interest to the federal government, failure to make such payment is subject to penalty.	148(f)(4)(C)(x)	50% of the amount required to be paid plus interest at the rate established under §6621 for tax underpayments.[3]	Yes, the Secretary may waive all or any portion of the penalty.

[2] Under this formula, if the year end market value of the plan's assets exceeds 60% of the plan deductible, the penalty is reduced. If the excess equals or exceeds the year's misused distributions, the penalty is zero.

[3] Certain elective payments described as penalties in §148(f) are not treated as penalties for purposes of this study. See, for example, §§148(f)(4)(C)(vii) and 148(f)(7).

APPENDIX A1.--Internal Revenue Code Penalty Provisions (Continued)

Description of Penalty	Code Section	Calculation of Penalty	Waiver Available?
4. Medical savings accounts	220		
a. Failure of MSA trustee to file required report detailing number of MSA accounts opened, identity of participants, etc.	220(j)(4)(C)	Same penalty as provided under §6693(a) *except* $25 per failure, not to exceed $5,000 per trustee.	Yes, for reasonable cause.
5. Drawback	5134		
a. Failure to comply with drawback requirements re: tax paid on distilled spirits used for non-beverage purposes.	5134(c)(2)	$1,000 for each failure to comply, not to exceed the amount of drawback claim.	Yes, for reasonable cause.
6. Intentional removal or defacement of brewer's marks or brands from barrel or container	5675	$50 per barrel or container.	No.
7. Penalties relating to the payment and collection of liquor taxes	5684		
a. Failure to pay gallonage taxes.	5684(a)	5% of unpaid tax.	No.
8. Civil penalties relating to tobacco	5761		
a. Willfully omitting things required or doing things forbidden by chapter 52.	5761(a)	$1,000 plus costs of civil action suit.	No.
b. Failure to pay tobacco taxes under Ch. 52.	5761(b)	5% of unpaid tax plus other penalties provided in this title.	No.
9. Returns relating to cash received in trade or business	6050I		

APPENDIX A1.--Internal Revenue Code Penalty Provisions (Continued)

Description of Penalty	Code Section	Calculation of Penalty	Waiver Available?
a. Structuring transactions to evade reporting requirements.	6050I(f)(2)	Same as §6721(e)(2)(C) penalties.	Yes, if such failure is due to reasonable cause and not to willful neglect (§6724(a)).
10. Procedures for taking partnership adjustments into account	6242		
a. Partnership liable for penalties	6242(b)(3)	Electing large partnership subject to same penalties as individuals.	Yes, to same extent as individuals.
b. Failure to pay amounts pertaining to partnership adjustments.	6242(c)(3)	10% of underpayment.	No.
11. Surrender of property subject to levy	6332		
a. Failure to surrender property subject to levy.	6332(d)(2)	50% of the value of the property or rights to property not surrendered.	Yes, for reasonable cause.
12. Failure to file tax return or to pay tax	6651		
a. Failure to file required return.	6651(a)(1)	5% of tax due per month for each month or part of month return is late, not to exceed 25%.	Yes, if such failure is due to reasonable cause and not to willful neglect.

APPENDIX A1.--Internal Revenue Code Penalty Provisions (Continued)

Description of Penalty	Code Section	Calculation of Penalty	Waiver Available?
b. Failure to pay tax as shown on return by date due.	6651(a)(2)	½% of tax due for each month or fraction of month payment is delayed, not to exceed 25%. For months during which installment agreement is in effect, ¼% of tax due for each month or fraction of month payment is delayed, not to exceed 25%.[4]	Yes, if such failure is due to reasonable cause and not to willful neglect.
c. Failure to pay tax that should have been shown on return but was not paid (1) within 21 calendar days after notice and demand, or (2) within 10 business days after notice and demand if amount is $100,000 or more.	6651(a)(3)	.5% of tax due for each month or fraction of month payment is delayed, not to exceed 25%. For months during which installment agreement is in effect, ¼% of tax due for each month or fraction of month payment is delayed, not to exceed 25%.[5]	Yes, if such failure is due to reasonable cause and not to willful neglect.
d. Fraudulent failure to file.	6651(f)	15% of tax due for each month or fraction of month return is late, not to exceed 25%.	Yes, if such failure is due to reasonable cause and not to willful neglect.
13. Failure to file information returns, registration statements, etc.	6652		

[4] Effective for determining additions to tax for months beginning after December 31, 1999.

[5] Effective for determining additions to tax for months beginning after December 31, 1999.

APPENDIX A1.--Internal Revenue Code Penalty Provisions (Continued)

Description of Penalty	Code Section	Calculation of Penalty	Waiver Available?
a. Failure to file statement relating to certain dividend payments totaling less than $10 by due date.	6652(a)(1) and (a)(2)	$1 per statement not filed, not to exceed $1,000 per calendar year.	Yes, if such failure is due to reasonable cause and not to willful neglect.
b. Employee's failure to report tips to employer.	6652(b)	50% of FICA due on unreported tips.	Yes, if such failure is due to reasonable cause and not to willful neglect.
c. Failure to file information in connection with deductible employee contributions.	6652(g)	$25 per participant for each year not filed, not to exceed $10,000.	Yes, if such failure is due to reasonable cause and not to willful neglect.
d. Failure to file annual certification of continuing eligibility under §142 exempt facility bond provisions re: residential rental projects.	6652(j)	$100 per failure.	Yes, if such failure is due to reasonable cause and not to willful neglect.
e. Failure by small corporation whose shareholders may qualify for 50% capital gain exclusion under §1202 to file annual report.	6652(k)	$50 per report, per year; $100 per report, per year for negligent or intentional disregard of filing requirements.	Yes, if such failure is due to reasonable cause and not to willful neglect.
f. Failure by corporation to file report with respect to change of control, recapitalization, or other substantial change in capital structure.	6652(l)	$500 per day, not to exceed $100,000.	Yes for reasonable cause.
14. Failure to pay stamp tax	6653	50% of underpaid tax in cases of willful failure to pay or willful attempt to evade.	No.

APPENDIX A1.--Internal Revenue Code Penalty Provisions (Continued)

Description of Penalty	Code Section	Calculation of Penalty	Waiver Available?
15. Failure by individual to pay estimated income tax	6654	Interest, applied to the amount of underpayment for the period of underpayment *except* -- (1) if tax shown on return is less than $1,000 (§6654(e)(1)), or (2) if there was no tax liability for the preceding taxable year (§6654(e)(2)).	Yes, if failure occurs due to: (1) casualty, disaster, or other unusual circumstances and imposition of penalty would be against equity or good conscience (6654(e)(3)(A)); or (2) taxpayer (i) retired after becoming 62, or (ii) became disabled in the year payments were due or the preceding year, and (iii) underpayment due to reasonable cause and not to willful neglect (6654(e)(3)(B)).
16. Failure by corporation to pay estimated income tax	6655	Interest, applied to the amount of underpayment for the period of underpayment *except* -- if tax shown on return (or, if no return filed, the tax that should have been shown) is less than $500.	No.

APPENDIX A1.--Internal Revenue Code Penalty Provisions (Continued)

Description of Penalty	Code Section	Calculation of Penalty	Waiver Available?
17. Failure to make timely deposit of taxes	6656	Penalty is percentage of amount required to be deposited, ranging from 2% to 15%.	Yes, if such failure is due to reasonable cause and not to willful neglect. Exceptions are available for certain first time depositors.
18. Payment of taxes with "insufficient funds" check or money order	6657	(1) 2% of amount of check or money order; or (2) if check is less than $750, the lesser of the amount of the check or $15.	Yes, if check tendered in good faith and with reasonable cause to believe it would be paid.
19. Accuracy-related penalty for underpayment of tax required to be shown on return	6662	20% of that portion of understatement that is traceable to certain errors or misstatements; 40% for gross valuation misstatements.	Yes, if such understatement is due to reasonable cause and taxpayer acted in good faith with respect to underpayment (6664(c)).
20. Civil fraud	6663	75% of that portion of the tax understatement that is determined to be attributable to fraud.	Yes, if such understatement is due to reasonable cause and taxpayer acted in good faith with respect to underpayment ((6664(c)).

APPENDIX A1.--Internal Revenue Code Penalty Provisions (Continued)

Description of Penalty	Code Section	Calculation of Penalty	Waiver Available?
21. Failure to collect and pay over tax, or attempt to evade or defeat tax	6672		
a. Failure by third parties to collect, truthfully account for, and pay tax or attempt to evade or defeat tax.[6]	6672(a)	Penalty equal to the total amount of tax evaded, or not collected, or not accounted for and paid over.	Yes, for certain voluntary board members of tax-exempt organizations.
22. Sanctions and costs awarded by courts	**6673**	Up to $25,000 if court proceedings instituted for delay, taxpayer's position is frivolous or groundless, or taxpayer unreasonably failed to pursue administrative remedies. If counsel in a case multiplies the proceedings unreasonably and vexatiously, counsel must pay excess costs.	No.
23. Fraudulent statement or failure to furnish statement to employee	6674	$50 per failure.	No.
24. Excessive claims with respect to the use of certain fuels	6675	The greater of (1) 2 times the excessive amount; or (2) $10.	Yes, for reasonable cause.

[6] This penalty allows the IRS to hold individuals personally liable for 100% of any employment taxes that were not paid as long as the individual was a "person required to collect, truthfully account for, and pay over" any tax imposed by the Internal Revenue Code.

APPENDIX A1.--Internal Revenue Code Penalty Provisions (Continued)

Description of Penalty	Code Section	Calculation of Penalty	Waiver Available?
25. Providing false information with respect to withholding forms	6682	$500.	Yes, (1) if reasonable basis for statement, or (2) if taxes imposed under subtitle A for the taxable year are equal to or less than the sum of credits against such tax plus payments of estimated tax.
26. Understatements of taxpayer's liability by income tax preparers	6694		
a. Understatement due to unrealistic positions.	6694(a)	$250 per return.	Yes, for reasonable cause and person acted in good faith, or if taxpayer's liability is not understated.
b. Understatement due to willful or reckless conduct.	6694(b)	$1,000 per return, reduced by amounts paid under §6694(a), if any.	Yes, if taxpayer's liability is not understated.
27. Penalties with respect to the preparation of income tax returns for other persons	6695		
a. Failure to furnish copy of return to taxpayer.	6695(a)	$50 per failure, not to exceed $25,000 per calendar year.	Yes, if such failure is due to reasonable cause and not to willful neglect.

APPENDIX A1.--Internal Revenue Code Penalty Provisions (Continued)

Description of Penalty	Code Section	Calculation of Penalty	Waiver Available?
b. Failure of tax return preparer to sign return.	6695(b)	$50 per failure, not to exceed $25,000 per calendar year.	Yes, if such failure is due to reasonable cause and not to willful neglect.
c. Failure of tax return preparer to furnish identifying number.	6695(c)	$50 per failure, not to exceed $25,000 per calendar year.	Yes, if such failure is due to reasonable cause and not to willful neglect.
d. Failure of tax return preparer either to keep copies or to retain a list of prepared returns.	6695(d)	$50 per failure, not to exceed $25,000 per return period.	Yes, if such failure is due to cause reasonable cause and not to willful neglect.
e. Failure of tax return preparer to file correct information returns.	6695(e)	$50 for (1) each failure to file required return under §6060 (§6695(e)(1)), and (2) each failure to include required item (§6695(e)(2). Not to exceed $25,000 per return period.	Yes, if such failure is due to reasonable cause and not to willful neglect.
f. Tax return preparer's negotiation of client's refund check.	6695(f)	$500 per check.	No.
g. Failure of tax return preparer to comply with due diligence requirements in determining eligibility for earned income credit.	6695(g)	$100 per failure.	No.
28. Penalties with respect to liability for tax regulated investment companies	6697		

APPENDIX A1.--Internal Revenue Code Penalty Provisions (Continued)

Description of Penalty	Code Section	Calculation of Penalty	Waiver Available?
a. Penalty for incurring increased tax liability due to deficiency dividend under §860.	6697(a)	Amount of interest on any part of tax understatement that is traceable to the deficiency dividend, not to exceed 50% of the amount of deficiency dividend allowed by §860(a) for taxable year.	No.
29. Failure to file timely partnership return or failure to provide information required under §6031	6698	$50 per each partner for any portion of the taxable year, for each month (or part thereof) the failure continues, not to exceed 5 months.	Yes, for reasonable cause.
30. Promotion of abusive tax shelters	6700	The lesser of $1,000 or 100% of the gross income derived or to be derived, per entity or arrangement.	Yes, with respect to gross valuation overstatement, if there was a reasonable basis for valuation and that it was made in good faith.
31. Aiding and abetting understatement of tax liability	6701	$1,000 per document, except $10,000 per document if document relates to a corporation.	No.
32. Filing of frivolous income tax return	6702	$500 per return.	No.
33. Willful failure by broker to provide notice to payors relating to backup withholding	6705	$500 per failure.	No.

APPENDIX A1.--Internal Revenue Code Penalty Provisions (Continued)

Description of Penalty	Code Section	Calculation of Penalty	Waiver Available?
34. Failure to furnish required information regarding OID	6706		
a. Failure to show information on OID instrument.	6706(a)	$50 per failure.	Yes, if such failure is due to reasonable cause and not to willful neglect.
b. Failure of OID instrument issuer to report required information to IRS upon issuance.	6706(b)	1% of the aggregate issue price of issue price, not to exceed $50,000 per issue.	Yes, if such failure is due to reasonable cause and not to willful neglect.
35. Failure to furnish information regarding tax shelters	6707		
a. Failure to register tax shelter or filing false or incomplete information.	6707(a)(1)	The greater of -- (1) 1% of aggregate investment in shelter, or (2) $500.	Yes, for reasonable cause.
b. Confidential arrangements.	6707(a)(3)	The greater of -- (1) 50% of fees paid to all promoters (75% if such act is *intentional)*, or (2) $10,000.	Yes, for reasonable cause.
c. Failure of seller to furnish tax shelter ID number to investors.	6707(b)(1)	$100 per failure.	No.
d. Failure of investor to include ID number on tax return.	6707(b)(2)	$250 per failure.	Yes, for reasonable cause.
36. Failure to maintain list of investors in potentially abusive tax shelter	6708	$50 per failure, not to exceed $100,000 per calendar year.	Yes, if such failure is due to reasonable cause and not to willful neglect.

APPENDIX A1.--Internal Revenue Code Penalty Provisions (Continued)

Description of Penalty	Code Section	Calculation of Penalty	Waiver Available?
37. Penalties with respect to mortgage credit certificates	6709		
a. Because of negligence, material misstatements in verified written statements are made in connection with certificate issuance.	6709(a)	$1,000 per certificate.	No.
b. Fraudulent misstatements in verified written statements made in connection with certificate issuance.	6709(b)	$10,000 per certificate.	No.
c. Failure to file required reports with IRS with respect to mortgage credit certificate.	6709(c)	$200 per failure, not to exceed $2,000.	Yes, if such failure is due to reasonable cause and not to willful neglect.
38. Improper disclosure or use of information by tax return preparer of information furnished for return preparation purposes	6713	$250 per disclosure or use, not to exceed $10,000 per calendar year.	No.
39. Dyed fuel violations	6715		
a. Holding, selling, or using dyed fuel for a use that is known (or should be known) to be taxable, or willfully altering or attempting to alter the strength or composition of any fuel dye or marker.	6715(a), (b)	The greater of (1) $1,000, or (2) $10 per gallon of the dyed fuel involved. For multiple violations, $1,000 times the number of prior penalties for repeat violators.	No.

APPENDIX A1.--Internal Revenue Code Penalty Provisions (Continued)

Description of Penalty	Code Section	Calculation of Penalty	Waiver Available?
40. Failure to file correct information returns	6721		
a. Failure to file required information or failure to file by required date.	6721(a)	$50 per failure, not to exceed $250,000 per calendar year, except if: (1) Compliance within 30 days--$15 per failure, not to exceed $75,000 per calendar year (§6721(b)(1)). (2) Compliance after 30 days but filed on or before August 1--$30 per failure, not to exceed $150,000 per calendar year (§6721(b)(2)). Lower limits apply to small businesses.	Yes, if such failure is due to reasonable cause and not to willful neglect (§6724(a)). No penalty if return is filed without all required information but failure corrected on or before August 1. Number of information returns not to exceed the greater of -- (1) 10, or (2) ½ of 1% of total number of returns required to be filed for calendar year.

APPENDIX A1.--Internal Revenue Code Penalty Provisions (Continued)

Description of Penalty	Code Section	Calculation of Penalty	Waiver Available?
b. Intentional disregard of filing requirement or correct information reporting requirement.	6721(e)	The greater of $100[7] per failure or 10% of the aggregate amount of items to be reported.	Yes, if such failure is due to reasonable cause and not to willful neglect (§6724(a)).
41. Failure to furnish correct payee statements	6722		
a. Failure to furnish payment statement on or before due date, and/or failure to include required information.	6722(a), (b)	$50 per failure, not to exceed $100,000 per calendar year.	Yes, if such failure is due to reasonable cause and not to willful neglect (§6724(a)).
b. Intentional disregard of filing required payee statements.	6722(c)	The greater of $100 per failure or 10% of the aggregate amount of items to be reported.[8]	Yes, if such failure is due to reasonable cause and not to willful neglect (§6724(a)).

[7] Exceptions to this rule: §6721(e)(2)(B) failure to file correct returns under §§6045(a), 6050K, or 6050L, incur a penalty of $100 per failure or, if greater, 5% of aggregate amount that should have been reported correctly, or §6721(e)(2)(C) failure to file correct return required under §6050I(a), results in a penalty equal to the greater of $25,000, or the amount of cash received in such transaction to the extent it does not exceed $100,000. Also, penalty ceilings of subsection (a) do not apply and no penalty reduction for delayed compliance.

[8] Exceptions to this rule: Applies to payee statements other than those required under §§ 6045(b), 6041A(e), 6050H(d), 6050J(e), 6050K(b), or 6050L(c). Under §6722(c)(1)(B), failure to file required statements under §§6045(b), 6050K(b), or 6050L(c), results in a penalty of $100, or, if greater, 5% of the aggregate amount of the items to be reported correctly. In addition, penalty ceilings of subsection (a) do not apply.

APPENDIX A1.--Internal Revenue Code Penalty Provisions (Continued)

Description of Penalty	Code Section	Calculation of Penalty	Waiver Available?
42. Failure to comply with other specified information reporting requirements	6723	$50 per failure, not to exceed $100,00 per calendar year.	Yes, if such failure is due to reasonable cause and not to willful neglect (§6724(a)).
43. Required payments for entities electing not to have required taxable year	7519		
a. Failure of partnership or S corporation to make full payment required under §444 in connection with an election to file returns based on a taxable year that is not the entity's required year.	7519(a), (f)(4)(A)	10% of underpayment.[9]	Yes, if such failure is due to reasonable cause and not to willful neglect.
b. Willful failure to comply with requirements of this section.	7519(f)(4)(C)	§444 will cease to apply.	No.

[9] For purposes of determining interest under §7519(f)(3), any payment required by this section will be treated as a tax.

Description of Penalty	Code Section	Calculation of Penalty	Waiver Available?
44. Failure of mine operator to make required payments to certain UMWA benefit plans	9707	$100 per failure for each day of noncompliance period.	Yes, (1) If such failure is due to reasonable cause and not to willful neglect if the penalty is determined to be excessive relative to the failure; or if such failure is corrected during the 30-day period beginning on the first date that (2) does not apply. (2) For any period that none of the persons responsible for such failure knew, or exercising reasonable diligence would have known, that such failure existed.

Appendix A2.–International Penalty Provisions

Description of Penalty	Code Section	Calculation of Penalty	Waiver Available?
1. Failure of a nonresident alien individual to file a return	874(a)	Disallowance of deductions and credits (except secs. 31, 33, & 34).	No.
2. Failure of a foreign corporation to file a return with respect to income effectively connected with a U.S. trade or business	882(c)(2)	Disallowance of deductions and credits (except secs. 33 & 34).	No.
3. Willful failure to report international boycott activity	999(f)	Not more than $25,000, imprisonment for not more than one year, or both.	No.
4. Failure of an agent to furnish a notice of a false affidavit relating to the withholding tax on dispositions of U.S. real property interests	1445(d)(2)	Amount of tax required to be withheld, limited to the amount of compensation the agent derives from the transaction.	No.
5. Failure of a U.S. person to furnish information relating to controlled foreign corporations and controlled foreign partnerships	6038(b)	$10,000 per year with further $10,000 penalties for every 30-day period (or fraction thereof) late beginning 90 days after the Secretary mails notice, limited to $60,000 in the aggregate.	Yes, for reasonable cause.

Appendix A2.–International Penalty Provisions (Continued)

Description of Penalty	Code Section	Calculation of Penalty	Waiver Available?
6. Failure of a U.S. person to furnish information relating to controlled foreign corporations and controlled foreign partnerships	6038(c)	10% reduction in foreign taxes available for credit with further 5% reductions for each 3-month period (or fraction thereof) late beginning 90 days after the Secretary mails notice, limited to the greater of $10,000 or the income of the foreign business entity. This penalty is reduced by any penalties imposed under section 6038(b).	Yes, for reasonable cause.
7. Failure to furnish information or maintain records with respect to 25 percent foreign-owned U.S. corporations	6038A(d)	$10,000 per year, per occurrence with further $10,000 penalties for every 30-day period (or fraction thereof) late beginning 90 days after the Secretary mails notice.	Yes, for reasonable cause; de minimis exceptions apply.
8. Failure to appoint a reporting corporation (25 percent foreign-owned U.S. corporation) as an agent of a foreign related party (after being requested to do so), or to substantially comply with a summons for tax information	6038A(e)	Determination of the deductions and costs for a transaction based upon information available to the Secretary.	De minimis exceptions apply.
9. Failure of a U.S. person to furnish information relating to transfers to foreign persons	6038B(c)	10% of the fair market value of the property transferred, limited to $100,000 unless due to intentional disregard; gain will also be recognized by the transferor.	Yes, if such failure is due to reasonable cause and not to willful neglect.

Appendix A2.–International Penalty Provisions (Continued)

Description of Penalty	Code Section	Calculation of Penalty	Waiver Available?
10. Failure to furnish information or maintain records with respect to foreign corporations engaged in a U.S. trade or business	6038C(c)	$10,000 per year, per occurrence with further $10,000 penalties for every 30-day period (or fraction thereof) late beginning 90 days after the Secretary mails notice; no penalty can be asserted until regulations that describe the specific reporting requirements are issued.	Yes, for reasonable cause; de minimis exceptions apply.
11. Failure of a foreign corporation engaged in a U.S. trade or business to be appointed as an agent of a foreign related party (after being requested to do so), or to substantially comply with a summons for tax information	6038C(d)	Treatment of the transactions based upon information available to the Secretary; no penalty can be asserted until regulations that describe the specific reporting requirements are issued.	De minimis exceptions apply.
12. Failure to provide a statement concerning resident status (passports or permanent resident visas)	6039E(c)	$500 for each failure.	Yes, if such failure is due to reasonable cause and not to willful neglect.
13. Failure of a U.S. person to file information relating to gifts from foreign sources exceeding $10,000	6039F(c)	5% of the amount of the gift per month, limited to 25%, is imposed on the U.S. gift recipient; the tax consequences of the gift receipt by the U.S. person is determined by the Secretary.	Yes, if such failure is due to reasonable cause and not to willful neglect.
14. Failure to provide a tax return statement for the year of termination by an individual losing their U.S. citizenship	6039G(d)	Greater per year of 5% of section 877 tax or $1,000 (limited to 10 years).	Yes, if such failure is due to reasonable cause and not to willful neglect.

Appendix A2.–International Penalty Provisions (Continued)

Description of Penalty	Code Section	Calculation of Penalty	Waiver Available?
15. Failure of a foreign person to file a return with respect to holding direct investments in U.S. real property interests	6652(f)	$25 per day, limited to the lesser of $25,000 or 5% of the value of the U.S. real property interests per year; no penalty can be asserted until regulations that describe the specific reporting requirements are issued under section 6039(C).	Yes, if such failure is due to reasonable cause and not to willful neglect.
16. Substantial or gross valuation misstatements	6662(e), (h)	20% of the understatement of tax attributable to a substantial valuation misstatement. 40% in the case of a gross valuation misstatement.	Yes, if such understatement is due to reasonable cause, the taxpayer acted in good faith, and certain additional requirements are satisfied.
17. Failure to file information with respect to reportable events of certain foreign trusts	6677(a)	35% of the gross value of the property involved in the reportable event, with further $10,000 penalties for every 30-day period (or fraction thereof) late beginning 90 days after the Secretary mails notice, limited to the gross value of the property involved in the reportable event.	Yes, if such failure is due to reasonable cause and not to willful neglect.

Appendix A2.–International Penalty Provisions (Continued)

Description of Penalty	Code Section	Calculation of Penalty	Waiver Available?
18. Failure of U.S. person to file certain foreign trust returns	6677(b)	5% of the gross value of the assets attributable to such U.S. beneficiary, with further $10,000 penalties for every 30-day period (or fraction thereof) late beginning 90 days after the Secretary mails notice, limited to the gross value of the property involved in the reportable event.	Yes, if such failure is due to reasonable cause and not to willful neglect.
19a. Failure of a U.S. citizen or resident who is an officer, director, or at least a 10-percent shareholder to file returns with respect to a foreign personal holding company	6679, 6035	$1,000 per failure.	Yes, for reasonable cause.
19b. Failure to file returns relating to organizations or reorganizations of foreign corporations or relating to certain acquisitions of such stock	6679, 6046	$10,000 with further $10,000 penalties for every 30-day period (or fraction thereof) late beginning 90 days after the Secretary mails notice, limited to $60,000 in the aggregate.	Yes, for reasonable cause.
19c. Failure of a U.S. person to file returns with respect to certain interests in foreign partnerships	6679, 6046A	$10,000 with further $10,000 penalties for every 30-day period (or fraction thereof) late beginning 90 days after the Secretary mails notice, limited to $60,000 in the aggregate; no penalty can be asserted until regulations that describe the specific reporting requirements are issued.	Yes, for reasonable cause.

Appendix A2.–International Penalty Provisions (Continued)

Description of Penalty	Code Section	Calculation of Penalty	Waiver Available?
20. Failure of a foreign corporation to file a personal holding company tax return	6683	10% of tax liability per year.	Yes, if such failure is due to reasonable cause and not to willful neglect.
21. Failure to file returns or supply information with respect to a domestic international sales corporation or a foreign sales corporation	6686	$100 per failure to supply FSC or DISC information, limited to $25,000 per year; $1,000 per failure to file a DISC return.	Yes, for reasonable cause.
22. Failure to file certain information relating to bona fide residents of U.S. possessions	6688	$100 per failure.	Yes, if such failure is due to reasonable cause and not to willful neglect.
23. Failure to file a notice of a foreign tax redetermination or notice required by section 404A(g) (relating to foreign deferred compensation plans)	6689	5% of deficiency per month (or fraction thereof), limited to 25%.	Yes, if such failure is due to reasonable cause and not to willful neglect.
24. Failure to disclose treaty-based return positions	6712	$1,000 ($10,000 for corporations) per failure.	Yes, for reasonable cause, and the taxpayer acted in good faith.
25. Failure to comply with the requirements of section 4374, relating to liability for tax on policies issued by foreign insurers	7270	Double the amount of the tax.	No.

Appendix A3.--Pension and Employee Benefit Related Tax Penalty Provisions

Description of Penalty	Code Section	Calculation of Penalty	Waiver Available?
1. Failure of group health plan to satisfy COBRA[1] health care continuation coverage requirements	4980B	Generally $100 per day; lesser of $100 per day or $2,500 ($15,000 for more than de minimis failures) for failures that are not corrected before the date a notice of examination of income tax liability is sent to the employer and that occurred or continued during the period of examination. Imposed on plan administrator, group health plan, or employer.	May be waived for failures due to reasonable cause and not to willful neglect to extent payment of tax would be excessive relative to failure. No tax on failure during any period for which neither employer, plan, nor plan administrator knew, or exercising reasonable diligence would have known, that the failure existed. No tax on any failure due to reasonable cause and not to willful neglect if corrected within 30 days after the first date employer, plan, or plan administrator knew, or exercising reasonable diligence would have known, that the failure existed.

[1] Consolidated Omnibus Budget Reconciliation Act of 1985.

Appendix A3.--Pension and Employee Benefit Related Tax Penalty Provisions (Continued)

Description of Penalty	Code Section	Calculation of Penalty	Waiver Available?
2. Failure of group health plan to meet HIPAA[2] requirements relating to limitations on preexisting condition exclusions, prohibitions on denial of coverage based on health status, and guaranteed renewability of health insurance coverage	4980D	Generally $100 per day; lesser of $100 per day or $2,500 ($15,000 for more than de minimis failures) for failures that are not corrected before the date a notice of examination of income tax liability is sent to the employer and that occurred or continued during the period of examination. Imposed on plan administrator, group health plan or employer.	May be waived for failures due to reasonable cause and not to willful neglect to extent payment of tax would be excessive relative to failure. No tax on failure during any period for which neither employer, plan, nor plan administrator knew, or exercising reasonable diligence would have known, that the failure existed. No tax on any failure due to reasonable cause and not to willful neglect if such failure is corrected within 30 days after the first date employer, plan, or plan administrator knew, or exercising reasonable diligence would have known, that the failure existed.

[2] Health Insurance Portability and Accountability Act of 1996.

Appendix A3.--Pension and Employee Benefit Related Tax Penalty Provisions (Continued)

Description of Penalty	Code Section	Calculation of Penalty	Waiver Available?
3. Failure of employer to make comparable medical savings account contributions for any calendar year	4980E	35 percent of the aggregate amount contributed by the employer to medical savings accounts of employees for taxable years of such employees ending with or within the calendar year. Imposed on employer.	May be waived for failures due to reasonable cause and not to willful neglect to the extent payment of tax would be excessive relative to failure.
4. Failure to file Form 5330 (Return of Excise Taxes Related to Employee Benefit Plans), 941 (Employer's Quarterly Federal Tax Return), or 945 (Annual Return of Withheld Federal Income Tax) when due	6651(a)(1)	5 percent of tax due for each month or part of month filing is late, up to 25 percent. Imposed on plan, employer, or disqualified person.	May be waived for failures due to reasonable cause and not to willful neglect.
5. Late payment of tax due with Form 5330, 941, or 945	6651(a)(2)	½ percent of tax due for each month or part of month filing is late, up to 25 percent. Imposed on plan, employer, or disqualified person.	May be waived for failures due to reasonable cause and not to willful neglect.
6. Failure to file annual registration statement required by sec. 6057(a) (Form 5500 Schedule SSA) or to include all required participants	6652(d)(1)	$1 per day per omitted participant, not to exceed $5,000 per plan year. Imposed on plan administrator.	May be waived for failures due to reasonable cause.

Appendix A3.--Pension and Employee Benefit Related Tax Penalty Provisions (Continued)

Description of Penalty	Code Section	Calculation of Penalty	Waiver Available?
7. Failure to file notification of change of plan name or plan administrator, termination of plan or merger or consolidation of plan, as required by sec. 6057(b)	6652(d)(2)	$1 for each day failure continues, up to $1,000. Imposed on plan administrator.	May be waived for failures due to reasonable cause.
8. Failure to file annual return (Form 5500 series) concerning deferred compensation plans, pension, annuity, stock bonus, profit-sharing or other funded plans, as required by sec. 6058	6652(e)	$25 per day, not to exceed $15,000 per omitted return. Imposed on plan administrator or employer.	May be waived for failures due to reasonable cause.
9. Failure to file qualified plan's annual report on certain annuity and/or bond purchase plans, as required by sec. 6047	6652(e)	$25 per day, not to exceed $15,000 per omitted return. Imposed on plan administrator or employer.	May be waived for failures due to reasonable cause.
10. Failure to file information return (Form 5500 series) concerning fringe benefit plans, as required by sec. 6039D	6652(e)	$25 per day, not to exceed $15,000 per omitted return. Imposed on plan administrator or employer.	May be waived for failures due to reasonable cause.
11. Failure to file report of employee's deductible IRA contributions, as required by sec. 219(f)(4)	6652(g)	$25 per employee per year, not to exceed $10,000. Imposed on plan administrator.	May be waived for failures due to reasonable cause and not to willful neglect.
12. Failure to notify pension recipient of right to elect not to have withholding on pension distribution, as required by sec. 3405(e)(10)(b)	6652(h)	$10 per failure, not to exceed $5,000 per calendar year. Imposed on payer or plan administrator.	May be waived for failures due to reasonable cause and not to willful neglect.

Appendix A3.--Pension and Employee Benefit Related Tax Penalty Provisions (Continued)

Description of Penalty	Code Section	Calculation of Penalty	Waiver Available?
13. Failure to give written explanation to recipient of qualified plan distribution eligible for rollover treatment, as required by sec. 402(f)	6652(i)	$100 per failure, not to exceed $50,000 per calendar year. Imposed on plan administrator.	May be waived for failures due to reasonable cause and not to willful neglect.
14. Understatements traceable to substantial overstatements of pension liabilities, i.e., actuarially determined liability reported on return is 200 percent or more of the correct amount	6662(a), 6662(b)(4) and 6662(f)	20 percent of tax understatement, increased to 40 percent for 400 percent or more overstatement of pension liabilities. Imposed on employer.	Waived if resulting tax understatement is $1,000 or less.
15. Willful failure to provide participants in funded benefit plans with certain information concerning vested benefits, as required by sec. 6057(e), or willful furnishing of false or fraudulent information	6690	$50 per failure. Imposed on plan administrator.	No exception.
16. Failure to file defined benefit plan actuarial reports (Form 5500 Schedule B), as required by sec. 6059	6692	$1,000 per failure. Imposed on plan administrator.	May be waived for failures due to reasonable cause.
17. Failure to file report relating to IRA (as required by sec. 408(i)), to SEP (as required by sec. 408(l)), to MSA (as required by sec. 220(h)), or to education IRA (as required by sec. 530(h))	6693(a)(2)	$50 per failure. Imposed on trustee.	May be waived for failures due to reasonable cause.

Appendix A3.--Pension and Employee Benefit Related Tax Penalty Provisions (Continued)

Description of Penalty	Code Section	Calculation of Penalty	Waiver Available?
18. Overstating amount of designated nondeductible IRA contributions	6693(b)(1)	$100 per overstatement. Imposed on contributor.	May be waived for overstatements due to reasonable cause.
19. Failure to file reports relating to designated nondeductible IRA contributions or IRA distributions, as required by sec. 408(o)(4)	6693(b)(2)	$50 per failure. Imposed on contributor or recipient.	May be waived for failures due to reasonable cause.
20. Failure to provide 1 or more notices for SIMPLE-IRA, as required by sec. 408(l)(2)(c)	6693(c)(1)	$50 for each day failures continue. Imposed on employer.	May be waived for failures due to reasonable cause.
21. Failure to provide 1 or more IRA statements, as required by 408(i)	6693(c)(2)(A)	$50 for each day failures continue. Imposed on trustee.	May be waived for failures due to reasonable cause.
22. Failure to provide 1 or more SIMPLE-IRA summary plan descriptions, as required by sec. 408(l)(2)(B)	6693(c)(2)(B)	$50 for each day failures continue. Imposed on trustee.	May be waived for failures due to reasonable cause.

Appendix A3.--Pension and Employee Benefit Related Tax Penalty Provisions (Continued)

Description of Penalty	Code Section	Calculation of Penalty	Waiver Available?
23. Failure to maintain records needed to file information returns on IRAs, annuities and deferred compensation plans	6704(b)	$50 per plan participant, not to exceed $50,000 per calendar year. Imposed on employer, plan administrator or insurer.	May be waived for failures due to reasonable cause and not to willful neglect. No penalty imposed on any failure attributable to a prior failure that has been penalized and with respect to which all reasonable efforts to correct have been made. No penalty imposed for pre-1993 failure if all reasonable efforts to correct have been made.

Appendix A4.--Exempt Organization Penalty Provisions

Description of Penalty	Code Section	Calculation of Penalty	Waiver Available?
1. Failure by tax-exempt organization to file required information return	6652 (c)(1)(A)	$20 for each day failure to file continues, not exceed the lesser of $10,000 or 5% of organization's gross receipts for year. For organizations with gross receipts in excess of $1 million for year, penalty is $100 per day, not to exceed $50,000.	Yes, for reasonable cause.
2. Failure by tax-exempt organization's manager to file required information return after IRS demand that return be filed by reasonable future date	6652(c)(1)(B)	$10 for each day failure continues after date specified in IRS demand, up to maximum of $5,000 imposed on all persons for failures with respect to any one return.	Yes, for reasonable cause.
3. Failure by tax-exempt organization to make annual return available for public inspection	6652(c)(1)(C)	$20 for each day failure continues, up to maximum of $10,000 imposed on all persons for failures with respect to any one return.	Yes, for reasonable cause.
4. Failure by tax-exempt organization to make exemption application available for public inspection	6652(c)(1)(D)	$20 per day imposed on person who fails to comply with public inspection requirements.	Yes, for reasonable cause.
5. Failure by certain trusts to file information return required by sec. 6034 or failure by tax-exempt organization to file information return concerning termination, liquidation, dissolution, etc.	6652(c)(2)(A)	$10 for each day failure continues, up to maximum of $5,000 with respect to any one return.	Yes, for reasonable cause.

Appendix A4.--Exempt Organization Penalty Provisions (Continued)

Description of Penalty	Code Section	Calculation of Penalty	Waiver Available?
6. Failure by trustee or organization manager to file required information return referenced in sec. 6652(c)(2)(A) after IRS demand that return be filed by reasonable future date	6652(c)(2)(B)	$10 for each day failure continues after date specified in IRS demand, up to maximum of $5,000 imposed on all persons for failures with respect to any one return.	Yes, for reasonable cause.
7. Penalty on any person (private foundation or certain other tax-exempt organizations, organizations managers, or disqualified persons) if person becomes liable for any Chapter 42 tax (other than sec. 4940 or sec. 4948(a)) by reason of any act or failure to act, and if either (a) such person at any time previously was liable for tax under any section of Chapter 42, or (b) such act or failure is both willful and flagrant	6684	Penalty is equal to 100% of the initial and additional excise taxes imposed under any section of Chapter 42 (other than sec. 4940 or sec. 4948(a)).	Yes, for reasonable cause.
8. Willful failure to make tax-exempt organization's information return and exemption application available for inspection	6685	$5,000 for each return or application.	No.
9. Failure by tax-exempt organization to disclose nondeductibility of contributions	6710		
a. Failure to disclose that contributions are nondeductible.	6710(a)	$1,000 for each day failure to disclose continues, up to a maximum of $10,000 for any calendar year.	Yes, for reasonable cause.

Appendix A4.--Exempt Organization Penalty Provisions (Continued)

Description of Penalty	Code Section	Calculation of Penalty	Waiver Available?
a. Intentional disregard of disclosure requirements.	6710(c)	The greater of $1,000 or 50 percent of the cost of the solicitations on each day the failure continues. No maximum penalty amount for a calendar year.	No.
10. Failure by exempt organization to disclose that certain information or services are available from federal government for free or for nominal charge	6711	The greater of $1,000 or 50% of the aggregate cost of the offers and solicitations that occurred on each day on which the failure occurred.	No.
11. Failure to meet disclosure requirements applicable to quid pro quo contributions	6714	$10 for each contribution for which the organization fails to make required disclosure, total penalty with respect to a particular fundraising event or mailing shall not exceed $5,000	Yes, for reasonable cause.
12. Failure to file correct information returns (applies to returns required by §6050L relating to certain dispositions of donated property, generally reported on Form 8282)	6721	Same as described in no. 41 in Appendix A1, except that intentional disregard of requirement to file correct return required by §6050L incurs penalty of $100 per failure or, if greater, 5% of aggregate amount that should have been reported correctly.	No.

Appendix A4.--Exempt Organization Penalty Provisions (Continued)

Description of Penalty	Code Section	Calculation of Penalty	Waiver Available?
13. Failure to furnish donor copies (applies to returns required by §6050L relating to certain dispositions of donated property, generally Form 8282)	6722	Same as described in no. 42 in Appendix A1, except that intentional disregard of requirement to provide donor copies incurs penalty equal to the greater of $100 per failure or 10% of the aggregate amount of items to be reported.	No.

Appendix A5.--Estate and Gift Tax Penalty Provisions[1]

Description of Penalty	Code Section	Calculation of Penalty	Waiver Available?
1. Accuracy-related penalty for substantial estate or gift tax valuation understatement	6662(g)	20% of the portion of the understatement that is attributable to a substantial estate or gift tax valuation understatement, which results when the value of any property claimed on any estate or gift tax return is 50% or less of the amount determined to be the correct value of such property.	Yes, for the portion of an underpayment for which there was reasonable cause and with respect to which the taxpayer acted in good faith. No penalty imposed unless the portion of the tax understatement exceeds $5,000.
2. Accuracy-related penalty for gross estate or gift tax valuation understatement	6662(h)	40% of the portion of the understatement that is attributable to a gross estate or gift tax valuation understatement, which results when the value of any property claimed on any estate or gift tax return is 25% or less of the amount determined to be the correct value of such property.	Yes, for the portion of an underpayment for which there was reasonable cause and with respect to which the taxpayer acted in good faith. No penalty imposed unless the portion of the tax understatement exceeds $5,000.
3. Failure to comply with IRS request to produce records, files, papers, and documents required for administration of estate tax	7269	Penalty not to exceed $500 plus costs of suit in civil action.	No.

[1] The penalty and interest provisions applicable to the estate tax apply to the generation-skipping tax for generation-skipping transfers occurring at the same time and as a result of the death of an individual. For all other transfers, the penalty and interest provisions applicable to the gift tax apply to the generation-skipping tax (sec. 2661).

Appendix A5.--Estate and Gift Penalty Provisions (Continued)

Description of Penalty	Code Section	Calculation of Penalty	Waiver Available?
4. Extension of time for payment of estate tax where estate consists largely of interest in closely held business	6166	Executor may elect to pay part of all of estate tax attributable to closely held business in 2 or more (not exceeding 10) equal installments; the date of the first installment may be no more than 5 years after the date prescribed for payment of the tax; interest must be paid during 5-year deferral period, then annually with each installment of tax. 2-percent interest rate applies to first $1,000,000 in taxable value of closely held business (in excess of unified credit effective exemption and other deductions or exclusions), interest rate on excess of $1,000,000 in taxable value of closely held business is 45% of annual underpayment rate under sec. 6621.	If an installment payment is made after its due date but within 6 months, then the 2-percent interest rate will not apply to the payment, the underpayment rate under sec. 6621 will apply to the payment, and there is a penalty of 5 percent of the amount of such late payment multiplied by number of months after due date and before payment made; if any installment is paid after 6 months, then the unpaid tax payable in installments shall be paid upon notice and demand from the Secretary of the Treasury.

Appendix B.--Overview of Comments Received by the Joint Committee Staff on Present-Law Penalty and Interest Provisions

1. In general

A number of individuals and organizations accepted the invitation of the Joint committee to comment on the operation and administration of the penalty and interest provisions of the Internal Revenue Code. The following is a brief summary, arranged by topic, of the principal comments received by the Joint Committee on Taxation.[1]

One frequent comment about all penalties was the concern about the effect on long-term voluntary compliance by the sheer number of penalties initially assessed by the IRS but subsequently abated. Another frequent comment suggested that voluntary compliance could be improved by providing penalty abatement for taxpayers who voluntarily disclose errors before their discovery by the IRS.

2. Accuracy-related penalty (sec. 6662)

Multiple comments involved the penalty relief under section 6662 for certain disclosed items unless the item involves a tax shelter. Some commentators called for the repeal of the recent change to the definition of a tax shelter (i.e., the "a significant purpose" standard) while others suggested enactment of safe harbors or the promulgation of additional IRS guidance. Regarding the "substantial authority" standard under the penalty, one suggestion was to allow taxpayer reliance on certain well known treatises, in the absence of other guidance to satisfy the standard. Another suggestion was to allow taxpayer reliance based solely on judicial decisions from the same district or circuit as the taxpayer in satisfaction of the standard.

3. Interest provisions (secs. 6404 and 6601-6621)

There were several principal suggestions relating to interest: (1) the elimination of the differential in the interest rates applied to underpayments and overpayments (sec. 6621); (2) the use of simple rather than compound interest (sec. 6622); and (3) the expansion to all taxes of the authority to abate interest accrued with respect on equitable grounds (sec. 6404). Alternatives to the elimination of the interest rate differential between underpayments and overpayments included: (1) the repeal of the higher rate of interest on certain large corporate underpayments ("hot interest") under section 6621(c); and (2) expanding the scope of interest netting under section 6621(d).

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[1] A more detailed summary of comments, organized by commentator, as well as a reprint of the comment themselves, are in Volume II of this study.

4. Failure to deposit penalty (sec. 6656)

Some commentators suggested that the failure to deposit penalty be replaced with an interest charge, perhaps at a lower effective rate. They argued that simplification and greater equity would result.

Short of the complete repeal of the failure to deposit penalty, other suggestions called for partial relief from its application. First, interim relief for the deposit penalty was requested relating to the problem of "snowballing" deposit penalties assessed under IRS computer routines which cannot be corrected until 2001. Under these computer routines, a single missed deposit may result in the automatic assessment of a penalty on all subsequent deposits. Second, relief from the deposit penalty was requested for penalties resulting from the operation of the "next banking day" deposit regulation applicable to employers with a cumulative monthly tax liability of at least $100,000. Specifically, when an employer is initially required to make less frequent deposits (e.g., monthly deposits) because it's cumulative tax liability for the month does not total $100,000, it becomes subject to penalties for failing to satisfy the next banking day rule when its cumulative tax liability for the month begins to exceed $100,000 even if it had been making deposits more frequently that previously required. The employer typically becomes liable for multiple penalties before either the taxpayer or the IRS realize that the next day banking rule applies. The proposed solution is to apply the next day banking rule with regard to undeposited taxes of $100,000 or more rather than cumulative monthly tax liability of at least $100,000. Third, several comments were received regarding the electronic funds transfer payment system (EFTPS). These comments include the suggestions that: (1) the threshold for EFTPS coverage be increased; (2) employers be notified by the IRS when they first become subject to EFTPS or are moved onto a different deposit schedule; (3) there be "window" for adjusting EFTPS deposits patterned after a similar rule for data submitted on magnetic tape; and (4) the failure to deposit penalty is excessive and should be reduced.

5. Failure to pay penalty (secs. 6651(a)(2) and (a)(3)) and failure to pay estimated income taxes penalty (secs. 6654 and 6655)

The predominant suggestion made regarding the failure to pay penalty was to repeal the penalty (secs. 6651(a)(2) and (a)(3)). Some comments suggested coupling this repeal with an increase of the interest rate on underpayments of tax under section 6621.

There were three suggestions directly relating to the penalty for failure by a corporation to pay estimated income tax. The first suggestion would provide some penalty relief and simplify the operation of the safe harbor by extending the same rules to large corporations that are now applicable only to small corporations. The second suggestion would provide penalty relief to certain foreign sales corporations ("FSCs") which are members of a consolidated group by not imposing the penalty on the FSC if no penalty would have been incurred if it were applied to the consolidated group. The third suggestion was to provide penalty relief for underpayments due to unanticipated income resulting from market fluctuations.

6. Information reporting penalties (secs. 6721-24, 6038A and 6038C)

There were several comments submitted relating to information returns. First, that the IRS relies too heavily on computer generated notices. Second, that the IRS should routinely communicate with filers regarding errors in information returns even when it determines not to impose a penalty. Third, that the IRS needs to develop more uniformity in its administration of the waiver of information penalties. Fourth, that a penalty safe harbor for filers of information returns should be enacted for filers who correctly file at least 95 percent of their returns.

Also, several comments highlighted the $10,000 penalty for each failure to file an information return imposed on certain 25-percent foreign-owned U.S. corporations under either sections 6038A and 6038C as examples of a penalty that discourages rather than encourages voluntary compliance. They suggested relief from any penalties for taxpayers who correct their filing errors before discovery by the IRS.

7. Preparer issues (sec. 6694), preparer penalties (sec. 6700), and preparer communication (sec. 6701)

One suggestion was improved coordination between the various preparer penalties and the accuracy-related penalty (sec. 6662).

8. Administrative issues

All submissions which commented on this point stated that penalty enforcement should be uniform across the operating units of the IRS and should not be separately administered by each of the four operating units of the IRS. There was also uniformity in the comments submitted that the IRS policy against using penalties as bargaining chips should be better disseminated and enforced.

Another comment suggested that the IRS create a policy that clearly defines the circumstances under which a taxpayer's address on the master file may be changed. A related comment suggested the creation of a mechanism that allows a corporate taxpayer to designate, on its tax return, a particular person or office to whom all IRS communications should be directed.

A third comment received was that companies that retain a payroll service provider should be accorded a presumption of eligibility for reasonable cause abatement or "safe harbor" relief. The IRS could overcome this presumption by showing that the company's behavior was inconsistent with reasonable cause and good faith.

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

9. Other matters

Section 6045(e) requires "real estate reporting persons" to report certain information including the seller's taxpayer identification number ("TIN") in connection with certain real estate transactions. When the IRS concludes that such TIN is incorrect, typically after the real estate reporting person has archived its files, it assesses a penalty under sections 6721 or 6722. As a matter of administrative convenience to the real estate reporting person, it was suggested that such person be permitted to prove satisfaction of the reasonable cause exception with respect to reported TINs at the time that the information returns are filed.

Another commentator suggested that four sets of penalties relating to retirement plans were excessive: (1) the 50-percent nondeductible excise tax for failure to take timely minimum required distributions from retirement plans (sec. 409); (2) the penalties and taxes imposed on parties engaging in prohibited transactions (sec. 4975); (3) the penalties imposed on plan administrators by the IRS and the Department of Labor for failure to file annual reports relating to pension activities (i.e., Form 5500 series report and attachments); and (4) the late payment penalty charge for failing to pay Pension Benefit Guaranty Corporation premiums.

A third comment urged that conscientious objection to war be recognized as "good cause" for abatement of interest and penalties incurred by taxpayers who refuse to pay taxes because of their use for military purposes.

Finally, a suggestion was made to modify the taxation of charitable remainder trusts ("CRTs") which have unrelated business taxable income ("UBIT"). Under the proposal, such taxpayers would be subject to graduated levels of tax based on the amount of their UBIT rather than the present-law rule which subjects all CRT income to tax if it has any UBIT. A related suggestion would conform the treatment of CRTs to other taxpayers for purposes of the penalty for failure to file information returns under section 6652(c).