S. HRG. 100-641

REVIEW OF INTERNAL REVENUE CODE PENALTIES

HEARING

BEFORE THE

SUBCOMMITTEE ON PRIVATE RETIREMENT PLANS AND OVERSIGHT OF THE INTERNAL REVENUE SERVICE

OF THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

SECOND SESSION

MARCH 14, 1988

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

85-575 WASHINGTON : 1988

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

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REVIEW OF IRS CODE PENALTIES

MONDAY, MARCH 14, 1988

U.S. SENATE, SUBCOMMITTEE ON PRIVATE RETIREMENT PLANS AND OVERSIGHT OF THE INTERNAL REVENUE SERVICE OF THE COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 9:37 a.m. in room SD-215, Dirksen Senate Office Building, Hon. David Pryor (chairman of the subcommittee) presiding.

Present: Senator Pryor.

[The press release announcing the hearing follows:]

[PRESS RELEASE #H-3 JANUARY 27, 1988]

PRYOR SUBCOMMITTEE TO HOLD HEARING ON REVIEW OF IRS CODE PENALTIES

WASHINGTON, DC.—Senator David Pryor, (D., Arkansas), Chairman of the Senate Finance Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service, announced Wednesday that the Subcommittee will hold a hearing to review Internal Revenue Code penalties.

The hearing is scheduled for *Monday, March 14, 1988 at 10 a.m.* in Room SD-215 of the Dirksen Senate Office Building.

"After years of patch-work legislation in the area of penalties, it is time for Congress to review the penalty provisions of the Internal Revenue Code in their entirety and work toward creating a rational and simplified penalty system," Pryor said.

"This hearing is just the beginning of the subcommittee's review of penalty reform," said Pryor. "I anticipate additional hearings this year to examine how Congress should best go about bringing order to this complex area of the law. I also intend to establish a private sector task force to assist the subcommittee in its work."

Pryor said it appeared that some tax penalties have become so large that an increasing number of taxpayers feel forced to compromise with the IRS over tax disputes, even though the taxpayers feel they owe no additional taxes. Taxpayers fear that the IRS can bankrupt them with penalties if they don't compromise.

Pryor also said he wanted to look into concerns that, by raising penalties so much over the past few years, Congress has begun looking to penalties as a new source of revenue rather than as an enforcement tool.

OPENING STATEMENT OF HON. DAVID PRYOR, A U.S. SENATOR FROM ARKANSAS, CHAIRMAN OF THE SUBCOMMITTEE

Senator PRYOR. The committee will come to order. I am going to proceed with a short opening statement, Mr. Secretary and Mr. Commissioner. I also will ask that we strictly observe this morning the five-minute rule, one because of our large number of witnesses, and two, because immediately after this hearing is over I am going home and going back to bed. I have, as they say, the Shanghai flu or some other flu bug that many of us have, I think, in this city.

Last year, at an Arkansas Razorback game, a gentleman stopped me at the half to ask me my advice on an IRS problem. This gentleman told me of a recent experience with IRS that, frankly, distressed me. His story troubled me because I realized that, although his situation was fundamentally unfair, under the present tax system little could be done to help him out.

This gentleman was a low-income taxpayer. He had done his best to fill out his annual income tax return. He had some difficulties understanding the instructions and, as a result, made a minor mistake, which resulted in interest and penalties being assessed against him that amounted to several times his actual tax liability.

The amount of money involved would not seem significant to most people, but to this gentleman it amounted to many months of wages and was a great burden to him and to his family.

What troubled me most about this man's story, Mr. Commissioner and Mr. Secretary, was that the punishment seemed way out of proportion to the crime. The man obviously did not mean to defraud the Government; and his educational level would seem to excuse any negligence, and yet his punishment was, I think, particularly harsh.

His story and many, many others I have heard since then captured my attention. After some research, I discovered that the Congress has never performed—never performed—a comprehensive review of the many penalties in the Internal Revenue Code. I think that we can all agree that it is time for Congress to do exactly that and to take a very close look at the penalty system that we now have in place.

That is why we are here this morning, to begin to discuss what we can do to improve this area of our tax code. A proper system of penalties is an essential enforcement tool that helps to make our voluntary tax system work; but we must not allow our penalty system to become so heavy handed or revenue driven that we leave taxpayers bankrupt and hopeless.

As Austin O'Malley once said "In levying taxes and in shearing sheep, it is well to stop when you get down to the skin."

During this second session of the 100th Congress, I intend to hold a series of hearings on the issue of penalties. Today the subcommittee will consider both the role that penalties should have as well a the role that the IRS should play in implementing those penalties.

We hope also to begin to identify those problem areas. We have a very distinguished lineup of witnesses who, I am sure, will provide us with many interesting observations.

During the second hearing, the subcommittee will address at that time specific problems that taxpayers are having with penalties—the mechanics of those penalties—and any problems that the IRS is having in administering those particular penalties.

At that time, it may be appropriate to consider the gamut of informational reports that businesses are required to file, whether certain of those reports can be simplified and whether additional guidance from the IRS would be in order.

In the final hearing that we plan to hold, we will review reports from various interested groups, including the subcommittee's Private Sector Penalty Task Force and the General Accounting Office. We hope at that time to have specific solutions and recommendations regarding the problems that we will begin to identify this morning.

I would like to point out that there are now, I believe—at last count—about 150—I repeat, 150—penalties in the IRS Code that can be assessed against taxpayers. One of the roles of penalties is to discourage noncompliance among taxpayers, which is, I think, a very legitimate goal.

On the other hand, the IRS is not subject to any sanctions for unjustified actions that they take. It seems to me that there is an imbalance here that should be corrected and addressed. The Taxpayer's Bill of Rights, for example, would go a long way in restoring a proper balance in this area.

Today, however, we address the issue singularly of penalties. The subcommittee has assembled a prestigious group of witnesses from throughout America to explore the policy implication of the present penalty system.

One of our witnesses today is Professor James Childs from the University of Akron. He has conducted a study, which I think ties in closely with the story I told at the beginning of my statement. He and his students from the Tax Clinic there have studied our Federal tax forms to determine what level of education is required to adequately understand those penalties.

He will point out, for example, that a statutory notice of deficiency requires a reading grade level 1.6 years higher than that for the Wall Street Journal. If the complexity of our forms stacks the deck against taxpayers at the outset, it is obvious, as with my friend from Arkansas, that penalties can disproportionately affect lower income, less educated taxpayers.

It seems then that improvements can be made and should be made, not only by restructuring the existing penalty system, but also by simplifying forms and instructions so that they are understandable to most American taxpayers.

The avalanche of mail that I have received within this last year in support of the Taxpayer's Bill of Rights has included many complaints about the penalty system. One story in particular has come to my attention concerning Section 6702, the penalty for frivolous filing of tax returns.

Congress enacted this penalty to penalize people who plead the Fifth Amendment on their return or who do not fill out the form correctly because they do not believe the Sixteenth Amendment was properly ratified. However, it has come to my attention lately that the Internal Revenue Service also brings this $500.00 penalty against people who write critical notes to the Internal Revenue Service on their tax returns, even though the return is correctly filled out and signed.

I don't know if, in our society, that is the best way for the tax collector to treat these situations.

Let me cite, if I might, the example of Donna Todd, a grandmother from Montana. She recently sent in a correctly filed return to the IRS. Donna Todd wrote on the form: "Signed involuntarily under penalty of statutory punishment."

The IRS, upon receiving Donna Todd's tax return with her money, imposed a $500—a $500—frivolous return penalty against Donna Todd. When she refused to pay the $500.00 fine, the IRS seized her bank account and placed a lien on her husband's life insurance policy. A Federal court later threw out the fine.

This would be, in my opinion, a case of the IRS going beyond Congressional intent in implementing a penalty—once again, one of 150 that the IRS can impose.

We have many unanswered questions before the subcommittee to review this morning: What should be the role of penalties? How can we improve the system? What can be made more fair in the penalty system? Can we consolidate certain penalties and eliminate the stacking of penalties?

And how can we accomplish these goals while, at the same time, recognizing that there are legitimate reasons for many penalties to exist? These are very difficult questions this morning, and I hope that we can begin to answer some of those today.

Let me introduce as our first witness today the Honorable Donaldson Chapoton, the Deputy Assistant Secretary for Tax Policy of the Department of the Treasury in Washington, D.C. Mr. Chapoton.

STATEMENT OF HON. O. DONALDSON CHAPOTON, DEPUTY ASSISTANT SECRETARY (TAX POLICY), DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Secretary CHAPOTON. Thank you very much, Mr. Chairman. The Treasury Department is happy to present its views today on the review of our existing tax penalties, and to see if they need reforming or restructuring.

We have just completed a substantial revision of our Income Tax Code in the 1986 Act, and it seems that it is quite appropriate at this time to review the tax penalty system to make sure that, in light of the revisions to the Code, those penalties are still in step.

This need for review is perhaps indicated by other circumstances, such as you pointed out in your opening statement, that there are a number of indications that reassessment is necessary. When I make talks around the country, I am asked repeatedly about penalties, about their fairness, and if we are reviewing them.

Therefore, I think this review is appropriate.

The Treasury Department can simply provide a framework for the analysis and point to certain specific issues that we think might need to be addressed. I think further study is needed to determine just what revisions and what changes might be appropriate.

Let me outline briefly the nature of the penalty structure as we see it now. First, we have civil penalties applicable to taxpayers, that is, as opposed to penalties that are applicable to nontaxpayers. We need to realize the distinction.

The penalties applicable to taxpayers can be broken down into two categories: the penalty for failing to timely report and timely pay the tax, and the penalty for failure to accurately report a tax liability on the return.

The timely reporting and timely payment penalty is a simpler issue to grasp. The penalty for failure to file a tax return is 5 percent per month, up to a 25 percent maximum. The penalty for failure to pay the tax shown on the return, or actually due on the return, is one-half percent per month, also up to a maximum of 25 percent.

Perhaps some question needs to be addressed as to whether both of those penalties should apply in all cases or whether they overlap; but I think those questions are relatively simple and straightforward.

Similarly, there are so-called penalties for failing to file estimated taxes or making estimated tax payments. In our view, it is perhaps wrong to think of those strictly as penalties because the penalty that results from failing to do that properly is merely a time value or an interest factor, as opposed to strictly a penalty in the normal sense, although that interest is not deductible. So, in that sense, it is a penalty.

The more difficult questions are raised by penalties relating to the accurate reporting of tax liabilities. Again, the analysis can be broken down into two different structures.

One is a set of penalties addressed at determining the behavior and the state of mind of the taxpayer when he files his return; and these primarily are the negligence and fraud penalties. Until the 1980s, these penalties—negligence and fraud—were basically the only penalties we had for any taxpayers who failed to accurately report their tax liability.

But then, in the 1980s, several new penalties developed, which were related to the strength of the taxpayer's legal position in filing a return and taking a position. Basically, this is the understatement penalty, which can be imposed if there is not substantial authority supporting a position or clearly disclosed on the return.

In addition, there are substantial understatement penalties relating to tax shelter cases. If the principle purpose of a filing position is tax avoidance, then there must be substantial authority and a reasonable belief that the taxpayer is likely to prevail.

And similarly, there is a separate penalty for substantial overvaluation or undervaluation.

Touching on the penalties applicable to nontaxpayers, we have three basic approaches—penalties relating to the accurate withholding and deposit of taxes; penalties relating to information returns, information reporting; and penalties imposed upon preparers of tax returns and promoters of tax shelters.

With that brief overview, let me mention the way we see that the current system should be assessed.

We are aware that there are a number of concerns. One is with the structure of the penalties. We don't think there should be any rush to judge if the structure is incorrect; but we are getting questions about whether the structure is too complex. We think that should be reviewed.

Another is the interrelationship of the various penalties: whether there are gaps in the penalties or whether they overlap, and the severity of the penalties, whether they are appropriate to the conduct that we encourage. In addition, the administration of penalties needs to be considered. This is generally broken this down into several categories: whether the penalties are applied in a uniform manner among all taxpayers and all IRS auditing districts and agents across the country; and whether penalties are asserted too frequently or ignored too often.

There are three issues the Administration has heard a lot about. One is the computerized assertion of penalties. We think the computer is making our system work better, but we need to make sure it is not imposing an unfair burden on some taxpayers.

Second, we need to make sure there are no overlapping or large penalties that distort the resolution of tax disputes so that the penalty itself does not become more a part of the tax at issue, but simply is a penalty to encourage proper conduct.

Let me mention in closing that we need to keep in mind that penalties are only one of several compliance tools. Others include the audit process, with which we are familiar; the taxpayer assistance process; the computerized reminder process, which we think is very important; and of course, the withholding of income tax at the source.

All of these should dovetail with the penalty system, and we think together will make the whole system work a lot better. Thank you very much, Mr. Chairman.

Senator PRYOR. Mr. Secretary we appreciate your attendance and your testimony this morning before the committee. I will ask you a few questions in a moment, but I would like to hear next from Mr. Lawrence Gibbs, who is the Commissioner of the Internal Revenue Service.

As a personal note, I want to thank Mr. Gibbs at this time. Each time this committee has asked Mr. Gibbs to come forward and appear, he has been more than willing. He has been very honest with us; he has been very open and most cooperative. Mr. Lawrence Gibbs, the Commissioner of the Internal Revenue Service. Thank you, Mr. Gibbs.

[The prepared statement of Secretary Chapoton appears in the appendix.]

STATEMENT OF HON. LAWRENCE GIBBS, COMMISSIONER OF THE INTERNAL REVENUE SERVICE, WASHINGTON, DC, ACCOMPANIED BY CHARLES H. BRENNAN, DEPUTY COMMISSIONER (OPERATIONS) AND RICHARD C. STARK, ASSISTANT TO THE COMMISSIONER

Commissioner GIBBS. Thank you, Mr. Chairman. I am pleased to be here this morning to comment on the penalty structure in our Internal Revenue Code. I have with me, to my right, Charles Brennan, our Deputy Commissioner for Operations.

Senator PRYOR. Welcome, Mr. Brennan.

Commissioner GIBBS. And on the other side of Mr. Chapoton, Richard Stark, Assistant to the Commissioner, who is the Chairman of our IRS Penalty Task Force.

Senator PRYOR. Mr. Stark, you are welcome. Commissioner Gibbs. I will have a short oral statement, and then the three of us will be happy, along with Mr. Chapoton, to answer any questions that you may have. I do have a written statement that I would like to ask be included in the record.

Senator PRYOR. The entirety of you statement will be placed in the record, Mr. Commissioner.

Commissioner GIBBS. Thank you, Mr. Chairman. Our tax system in this country is remarkable. It works, and by and large, it works well. Because it works well, everyone in this room and indeed across our nation benefits.

In order for our tax system to continue to work, it requires the respect, confidence, and support of all of us, whether we are from the private-sector, as taxpayers, practitioners, or members of the media, or whether we are from the public sector, a tax legislators or tax administrators.

Now, in order for the system to command respect and confidence and support, its rules must be understood, believed to be fair and enforced. Why? Because in order for people to comply with the tax laws, they must be both able and willing to do so.

Now, it is no secret that over the last 15 years compliance with our tax laws has declined as have confidence, respect, and support for the system itself; and I believe that history will record that all of us in the public and private sector share in the blame for this decline.

Over the last 15 years, taxpayers generally have become more aggressive as have tax practitioners, particularly as the impact of high marginal tax rates, fueled by periodic inflation and the absence of economic sanctions encouraged participation in the so-called audit lottery and underground economy.

During the last decade, Congress responded to the signs of growing noncompliance with a seemingly endless array of ad hoc economic sanctions and openly encouraged the Internal Revenue Service to us them to punish and deter noncompliance and, more recently, to increase revenue.

In this connection, I would like to quote from the Report of the Joint Committee on Taxation on the 1984 Deficit Reduction Act where Congress specifically instructed that, and I quote: "The Service should assert, without hesitancy, in appropriate circumstances the penalties that Congress has provided, In particular, * * * the negligence and fraud penalties are not being applied in a large amount of cases where their application is fully justified."

IRS has responded, particularly in the tax shelter area, with tough regulations and even tougher administrative and litigating positions, adding a number of penalties together in particular instances and providing computer-generated penalty assessments and collection notices.

Tensions in the system have increased to the point of frustration, anxiety, and distrust on both sides of the table, even to the point that taxes often have become high drama and good press for the print and electronic media.

And yet, Mr. Chairman I see signs of hope beginning to emerge. With the passage of the 1986 Tax Reform Act, we have reduced marginal tax rates, broadened the tax base, and reinforced it with strong alternative minimum taxes; and most importantly, with the passive activity losses and other provisions in the 1986 Act, we have virtually eliminated tax shelters.

We are beginning to be as concerned about people's ability to comply with our tax laws as we have been with their willingness to comply in the past. This is indicated by better funding of the Internal Revenue Service programs in the taxpayer assistance and education area growing emphasis on the need to simplify the tax law and make it more administrable, and hopefully a willingness to get to root cause of problems before making legislative and administrative changes that attempt to solve the problems.

We at the Internal Revenue Service are emphasizing the importance of providing quality and service, doing the right job right and not just collecting dollars.

Finally, I am pleased and heartened by the cooperation that we have received over the past year from taxpayers, practitioners, Congress, and the media, working together to help us at the Internal Revenue Service prepare to carry out tax reform in the context of the current filing season and over the next several years.

Because of many of my concerns over the past 15 years and my hopes with the events of the last two years, I convened a group within the Internal Revenue Service last yea to review the structure and administration of the penalty provisions in the Internal Revenue Code. The purpose of this review is threefold: first, to attempt to identify a set of principles from which to build a sound framework for the administration of penalties; second, to identify existing penalties that require or permit modification, consolidation, or repeal; and third and finally, to identify IRS practices and procedures that should be changed or improved to facilitate and make more equitable our administration of the penalty provisions.

Our task force is well into its work, and we hope to begin reporting on its findings by the end of this fiscal year. The task force is made up of a broad cross section of Internal Revenue Service employees from our field and national office functions; and they are working closely with their counterparts in the private sector: representatives of the American Bar Association Taxation Section, the AICPA Tax Division, Tax Executives Institute, the National Society of Public Accountants, the National Association of Enrolled Agents, and other similar professional, academic, and business groups.

We look forward to working with the excellent task force that you, Mr. Chairman, have appointed as well. I began my comments by commenting that our tax system is remarkable.

Let me close by observing that, in the coming year, we expect that our gross Federal tax revenues in this country will exceed one trillion dollars for the first time in our nation's history—a truly remarkable achievement. But even more remarkable is that, out of the trillion dollars, we expect to pay American taxpayers some $90 billion in tax refunds largely based on their returns that they prepare and send to us and before we ever verify the accuracy of those returns.

Mr. Chairman, our tax system does indeed work in this country. I look forward to working with you and the other members of Congress in the coming months to find ways to make it work even better. I think that the penalty area is a good place to start.

I congratulate you for holding this hearing and for getting all of us that are involved in the system together to see if we can't make it work a little bit better.

Senator PRYOR. Mr. Commissioner, we thank you not only for attending but also for you excellent testimony.

Inasmuch as you have spoken this morning about the task force that you and the Service have appointed to look at the whole issue of penalties, I, too, have just appointed a private sector task force, consisting of 21 members. We announced that, I think, about ten days ago; and at the appropriate place in the record, we will not only print the names of those individuals of the Service's task force, but also those individuals whom we have named as the task force from our appointed list. They will appear at the appropriate place in the record.

[The prepared statement of Commissioner Gibbs and the names of participants on the task forces appear in the appendix.]

Senator PRYOR. We thank you for your testimony.

First, a few questions for Mr. Chapoton. Mr. Secretary, I would like to ask: Do you believe that there is any danger in the stacking of penalties? Are we stacking more and more penalties on top of taxpayers? And if so, what is the Treasury Department's position on this issue?

Secretary CHAPOTON. Mr. Chairman, as I indicated in my statement, I think that issue should be reviewed and studied carefully. There is stacking of some penalties. The question of whether that is inappropriate or overly burdensome is something that I frankly would like to reserve judgment on. We are looking at it, and we are working with Commissioner Gibbs and the IRS.

Senator PRYOR. Mr. Gibbs, do you have a position on the stacking of penalties?

Commissioner GIBBS. Mr. Chairman in instances that I have reviewed, I think there are times from the instances that I have seen that the addition of various penalties in a particular situation is not only appropriate but was certainly intended by Congress.

I think there are other times that it puts a very difficult task on the administrator when the penalties would otherwise be appropriate, but seem to arrive at results that are burdensome with respect to the magnitude of the omission or act that underlies the substantive change.

How we change this is, in my opinion, a difficult thing to address; but I agree with Mr. Chapoton. I think it is something that we should look at.

Senator PRYOR. Later in this hearing, we will introduce into evidence a situation of a taxpayer who had a $6.52 deficiency. The IRS attached penalties which were stacked and amounted to over $400 upon this taxpayer. Now, is this fair?

Commissioner GIBBS. Mr. Chairman could I comment on that? I think that one of the things you need to be very careful about when we get into the penalty section is to be sure that the penalty is indeed related to the dollar amount of the deficiency. Let me explain what I am talking about.

In the area of the withholding taxes that a employer will withhold and pay over to the Internal Revenue Service, we have two different types of penalties. We have a penalty for the failure to make a timely payment. That was recently increased by the Congress in the 1986 Act from five percent to ten percent of the amount that is due, if the amount is late.

We also have other penalties that are applicable if the full amount is not ultimately paid. In some instances that I have seen, you have situations where the notice will indicate that the dollar amount of the deficiency is quite low, and taxpayers have erroneously concluded that we have penalized the amount of the deficiency when, in fact, we have penalized only the lateness or tardiness of the payment itself.

And that is something that we must distinguish between because I have noticed that in several instances.

Senator PRYOR. Mr. Secretary, moving away from the stacking issue, what would be the Department of the Treasury's position on the abatement of penalties and interest by the IRS when the IRS has given incorrect information to the taxpayer? Does the Treasury Department have a position on this issue?

Secretary CHAPOTON. Mr. Chairman, the Treasury has not developed a position on that issue, but we know it is an important question that needs to be addressed. We need to be slow to criticize when a taxpayer takes a position on the advice of the IRS taxpayer assistance program. We must realize that that program is designed to aid taxpayers in filing correct returns.

It is the difficult to police or check the accuracy of the advice that is given or if the taxypayer used that advice correctly. It is also difficult to say that the Service is barred from imposing a penalty or interest charges when the tax is understated.

Senator PRYOR. Mr. Secretary, we see from the chart the tremendous escalation—an explosion actually—of penalties being assessed against the taxpayer. Most of those, I think, would probably be in the two areas of fraud and negligence.

I believe that the description of tax penalties prepared by the Joint Committee on Taxation specifically for this hearing provides a useful guide to some of these penalties and some of the new penalties.

Now, are these penalties being applied due to Congressional mandate or due to the IRS' ability to apply those penalties because of new statutory provisions, or is the IRS inferring that the Congress wants to increase revenues and, therefore, they are going after more penalties? I wonder if you might discuss that?

Secretary CHAPOTON. Mr. Chairman, we hope it is not the latter, that revenues should be increased from the collection of penalties.

Senator PRYOR. Would you say that again, Mr. Secretary?

Secretary CHAPOTON. I said we certainly hope that there is not any reaction or attitude on the part of IRS agents in the field—and I can assure you that it is not the attitude of Commissioner Gibbs or the IRS administrators—that penalties should be used as a means of raising revenue

The purpose of penalties is to encourage proper conduct. If taxpayers comply with the law, that will produce additional revenue. If taxpayers are lax or careless or intentionally fraudulent in filing their tax returns, penalties will discourage that conduct and will increase revenues.

But our approach and the approach of the IRS is not to obtain revenue from the penalties. I don't know what has caused the increase in the level of penalties collected. I know there has been an increase in the perçentage amount of penalties and that would produce increased revenue.

We had anticipated that the increased revenue would be from improved conduct and compliance.

Senator PRYOR. From our studies—and I don't know that that chart would reflect this exactly, but from our studies—we show in the area of individual negligence penalties a 338 percent increase between 1987 and 1986. We show a 1,300 percent increase between 1987 and, I believe, 1979.

So, it appears to me that penalties are either getting a lot tougher or much more arbitrarily enforced or that we, as a Congress and as a Government—the Treasury Department and the IRS—are saying we have to have more penalties to increase revenues. I don't know which would be the worse.

Commissioner GIBBS. Could I comment, Mr. Chairman?

Senator PRYOR. Yes, Mr. Commissioner.

Commissioner GIBBS. I specifically tried to address this in my opening statement. My own opinion is that, as you look over the last 10 to 15 years, you find a combination of factors. You find that taxpayers have become less compliant; that is really what our studies tell us.

Senator PRYOR. They have become less?

Commissioner GIBBS. Taxpayers have become less compliant, Mr. Chairman. That is what the studies show. Certainly, in the 1970s, it was generally thought that this indicated an unwillingness on the part of taxpayers to pay their tax obligation when you had the opportunity to play the audit lottery. And the concept behind the audit lottery was that, if your economic down side was low enough—that is to say, there weren't interest and penalty provisions—then it made sense to do that from the taxpayer's standpoint.

I think we have also seen, over the last 15 years, practitioners become more aggressive. Indeed, with the previous changes to Circular 230 addressing practitioner conduct, I think that was a major concern, not only by the Internal Revenue Service and the Treasury, but also by the professional organizations that police the conduct.

I think it is also fair to say that, if we take a look at the 1981 Act, the 1982 Act, the 1983 Act, the 1984 Act, and the 1986 Act, that Congress has indeed been concerned about the noncompliance and has added penalty after penalty after penalty, and then in the 1984 and 1986 Acts increased those penalties substantially, not only the substantive portion of the penalties but also the time-sensitive interest features of the penalties.

As I indicated in my opening statement, I think it is also true that, in an effort to reduce the noncompliance, the Internal Revenue Service has administered these new provisions in a very stern and forceful manner. I think it is a combination of things, with taxpayers, practitioners, Congress, and the Internal Revenue Service all involved.

That is why I think that it is hopeful that all of us are stepping back and taking a look at how we may work together to make penalties work properly.

Senator PRYOR. If I might at this point, I think it would be appropriate to point out that the numbers and percentages I just read, Mr. Commissioner, were only in the fraud and negligence areas, the massive increase; and I stand to be corrected. I don't know that the Congress in the past five years has addressed fraud and negligence to increase those to any great degree. Am I wrong?

Commissioner GIBBS. The time-sensitive feature that has been added, does have an impact—a very substantial impact—in terms of the amount of those penalties.

Senator PRYOR. I think, though, in the area of the civil penalties that probably 1984, relative to some of the tax shelter abuses, were some of the major increases. Am I correct in that statement? I think in the 1984 Tax Reform Act.

Secretary CHAPOTON. I think that is correct, Mr. Chairman.

Senator PRYOR. And then we come along to 1987, and I might say that that was done at 2:20 in the morning, as we usually do a lot of major stuff when we should not. We increased the substantial understatement penalty to 25 percent; and we doubled the penalty for underpayment of Social Security and employment taxes, I believe, in the 1987 legislation. So, we are going to see another explosion.

Commissioner GIBBS. Could I comment on another very significant change? Do not forget the presumptive negligence penalties that became applicable in 1984 for any failure to include in gross income a dividend or interest payment reported on a Form 1099. In the 1986 Act, the penalty was extended to all items reported on information returns.

So from the standpoint of the changes that have been made in the negligence and the civil fraud areas, I think they have been rather substantial in the last several years, Mr. Chairman.

Senator PRYOR. Now, I have made a lot of speeches about the IRS. Sometimes it may be a little bit overstated—some of my statements—and I plead guilty to that, a little hyperbole that politicians usually engage in sometimes. I have stated that sometimes we seem to know more about the inner workings of the KGB than we know about the Internal Revenue Service as American citizens.

That may be true; I don't know, but it sounds good, anyway, and I would just make that statement. [Laughter.]

Now, I want to ask another question.

Commissioner GIBBS. Mr. Chairman, with my hearing schedule, I would say we are learning more and more and more about the Internal Revenue Service.

Senator PRYOR. Well, we are bringing a little sunshine in. Now, let's take this little grandmother from Montana. Here she comes along and she says "I don't owe this; I am under protest" and whatever. And she sends this little note saying she doesn't like it; and at IRS, someone says, "Okay, you owe an extra $500 for a frivolous statement on your income tax return."

Now, who makes that decision? Where is that made? Is that made in the Audit Division? Is that made in the Collection Division? Where is that actually made in the inner workings of the Service?

Commissioner GIBBS. Mr. Chairman, it depends on what type of penalty it is. Congress has distinguished between two types of penalties.

One is a penalty that is treated as an addition to tax, where the taxpayer is entitled to a notice of deficiency and has the right to take an administrative appeal and ultimately go to the tax court.

There is another category of penalties called an assessable penalty where the penalty can actually be assessed without providing a notice of deficiency. The 6702 penalty from the example in your opening statement as I understand it, is in the latter category; and for that reason, it may well be that that particular penalty—and I don't know the facts of the case; I will be glad to take a look at them and submit a more formal statement—but with respect to the assessable penalties, sometimes those are generated on computer notices out of the service centers.

In this case, it may have been an examining agent who talked to the taxpayer who was involved, but there would be a determination either in the district or in the service center with respect to whether the particular penalty would be applicable and then the taxpayer would be sent a statement.

Senator PRYOR. If that little lady had lived in Arkansas and not Montana, or in New Jersey and not Montana, and had written the same statement on her tax return, would the same penalty have been assessed to her, or is this an arbitrary decision of the IRS?

Commissioner GIBBS. Mr. Chairman, again I will be happy to review the facts of the case.

Senator PRYOR. I don't think she wants you to review the facts of the case. [Laughter.]

I don't think she wants to flag her tax return.

Commissioner GIBBS. You know, when we get into the area of penalties, one of the things that I have found as a practitioner and also as a tax administrator is that people do tend to understand—they may not like it, but they do understand—that additional taxes are sometimes owed and interest is added. When you start adding penalties, Mr. Chairman, you introduce an element of emotion into the case.

And I think it is very important, in order to get to the bottom of some of these specific instances, that we do take a look at the facts. Because if the Internal Revenue Service has overreached, then we ought to be willing to admit that, to stand up and apologize, and set the case right.

By the same token, if it is the taxpayer who, for one reason or another, made a mistake and is answerable for a penalty, then that is something we also need to know.

Senator PRYOR. Mr. Commissioner, I think the Congress is largely responsible for this whole mess. I think the Service is somewhat responsible. I think we can all take an equal share of the guilt, and I am willing to bear our share.

But I do feel that in the area of "frivolous returns" and this particular penalty, I think it grants to the Internal Revenue Service a very wide latitude of power and the ultimate possibility of abuse against the taxpayer. And I think that this is something that is of the highest priority to reexamine as we look into the penalty area.

I do seek the cooperation of not only you but also the task force that you and your colleagues have appointed, and this will also be addressed in the task force that I myself have recently appointed in the area of penalty reform.

Now, we have talked about the stacking of penalties Mr. Commissioner; and I am wondering if I might begin to wind down this panel's discussion of the issue of penalties, if we might basically respond to this question. The stacking of penalties has given the Internal Revenue Service a tremendous latitude, a tremendous opportunity to stack one penalty on top of another penalty; and before you know it, the taxpayer gives up and, out of frustration, either doesn't pay his tax or decides to leave the country, or whatever happens.

Now, are you concerned about the stacking issue? Is this something that is arbitrary in the IRS?

Commissioner GIBBS. Mr. Chairman, as I indicated earlier in my response to an earlier question, I am concerned about the issue from two standpoints. One, I think it is important that a penalty not be so low that it simply will not be enforced; and I think it is also important that a penalty not be so high that it is perceived to be unfair.

In some instances, you may require the addition of multiple penalties in order to avoid the former problem—being too low. In other instances, particularly with the ad hoc way in which the penalties have been added and increased over the last several years, we now may have situations where the penalties when aggregated are so high that they appear to be unfair.

Senator PRYOR. Mr. Commissioner, let me also ask about the task force that you have appointed on penalties. What would be the thrust of the study of this particular group that you appointed? And what is the reason for the appointment of this task force?

Commissioner GIBBS. Mr. Chairman, the reason for the appointment of the task force was again based on my concerns about the escalating tensions in the system over the last 15 years and, as I indicated, also my hopes in light of the events of the last several years and particularly the fact that you have appointed a task force; there are also a number of task forces in the private sector that are looking at these.

And it seems to me we have both the obligation and the opportunity here to take a hard look—a constructive look—at the penalty situation. That was the reason for forming the group; and as I indicated, the purpose of the group really is threefold. We are taking an in-depth look to see if we can first come up with a set of principles that would form the framework for a penalty system.

Second, it will try to identify specific penalties where perhaps we could modify them, consolidate them, or even repeal them if they are no longer necessary. And finally, and perhaps most importantly from our standpoint take a look at our own internal practices and procedures to see if we can't change and improve them to facilitate and make fairer our administration of the penalty provisions at the Internal Revenue Service.

Senator PRYOR. Thank you, Mr. Commissioner. I have one final statement, if I might. During the February 16th hearing, and also in a letter to you, Mr. Commissioner I did request weekly updates of certain aspects of the 1987 filing season

Now, today is March 14th, and we have not heard from the Service yet about our request for weekly updates. We hope that those weekly updates will be forthcoming so that we can continue monitoring the 1987 filing system and especially as we move toward the April 15 deadline. Please, if you would, I would very much appreciate that weekly update.

Commissioner Gibbs. Mr. Chairman, I apologize that you have not received them; and indeed, I am astounded because the news has basically been very good since the last time we were together.

The receipts are about where we were this time last year. The refunds are up by about $50 on the average refund. The errors are down.

We have projected about 10 to 15 percent above last year because of this new Act, and they are running at about 2.5 percent above last year.

In addition, the telephone accuracy of our telephone assisters has been trending upwards. So, we will have that information to you, and I will see that we provide it to you on a weekly basis; and I apologize that you have not received it previously.

Senator PRYOR. Thank you, sir. I will ask if you would respond to written questions that I may not have had time to ask this morning, Mr. Commissioner and Secretary Chapoton.

Senator PRYOR. Let me just say finally that I had the privilege some weeks ago of speaking to about 500 collection officers of the Internal Revenue Service here at the Shoreham Hotel; and I am taken, Mr. Commissioner, by what you said that the Internal Revenue Service and our system of taxation requires respect, confidence, and support. I told these collection officers at this meeting some weeks ago that we, the Congress and the Internal Revenue Service have the same problem. We are losing the confidence of the American people.

We are losing their respect and we are losing their support. For us to exist, whether it is the tax collector or the Congress of the United States, we have got to have those three ingredients there and those three characteristics. I am very glad that you recognize this, Mr. Commissioner. I want to applaud you also for what you stated—and I think in every public statement that you make—and that is that the taxpayer must be treated as a customer. I applaud that, and I think many of us in the Congress applaud that.

In the next several weeks and months ahead, we are going to be examining the issue of penalties. I think that we have created some sort of a monster here, and I think many taxpayers consider this to be very arbitrary. They get a statement from the Internal Revenue Service, and it says: You have a $6 deficiency and a $400 penalty; but there is no explanation. There is no justification for that; and we are going to change that some way.

We are either going to change it by regulation, or we are going to change it by law. If we pass, for example, the Taxpayer's Bill of Rights, we are going to change it in that piece of legislation. One way or the other, we are going to start together trying to restore that respect, confidence, and support that you speak of.

Mr. Secretary and Mr. Commissioner, I thank you. This will conclude this panel.

Commissioner GIBBS. Thank you, Mr. Chairman.

Secretary CHAPOTON. Thank you, Mr. Chairman.

Senator PRYOR. We have our next panel that I will call at this time. We have four members of this panel, the Honorable Henson Moore; Mr. Donald Alexander; Mr. James Childs; and Mr. Thomas Nee.

Gentlemen, we are very pleased that you have come this morning to testify before the IRS Oversight Subcommittee of the Finance Committee. Once again, I would like to suggest that we abide by the five-minute rule. The full body of your respective statements will be placed at the appropriate place in the record.

Our first witness is the Honorable W. Henson Moore, who is a member of the Taxation Committee of the U.S. Chamber of Commerce in Washington, D.C. Congressman Moore, we appreciate very much your being here this morning, and we look forward to hearing your statement.

STATEMENT OF HON. W. HENSON MOORE, MEMBER, TAXATION COMMITTEE, U.S. CHAMBER OF COMMERCE, WASHINGTON, DC

Mr. MOORE. Thank you, Mr. Chairman. We certainly appreciate the opportunity to be here, and we compliment you for your leadership on the important issues of the Taxpayer's Bill of Rights and penalty reform.

Comprehensive reform of the penalty system is long overdue. In the opinion of our members, the complexity, overlap, and unfairness of many of the approximately 150 penalties now in effect has eroded taxpayers' trust in our voluntary tax system; and as a result, it may have jeopardized the Internal Revenue Service's ability to perform its stated function.

Congress is not without fault in this area. There have been five major tax bills in the last decade—in this decade alone—and during my years on the House Ways and Means Committee, it taught me that Congress was under constant and tremendous pressure to develop new ways to raise revenue.

Unfortunately, as demonstrated by the proliferation of penalties in recent years, increasing penalties has been one of the ways that the Congress has turned to reach the increasing demand to raise revenue.

A reexamination of the role that penalties should play is essential. The U.S. Chamber of Commerce understands that tax penalties are an appropriate vehicle to deter certain types of behavior and to ensure compliance with the tax laws. Penalties also allow the Government to recover a certain amount of the administrative costs it incurs from those who are in noncompliance.

However, penalties that are perceived to be arbitrary, excessive, or unfair have a detrimental impact on the voluntary tax compliance by promoting disrespect for the tax collection procedures. However well intentioned, 150 distinct penalties unnecessarily complicate the system in itself.

The system is nearly impossible for taxpayers and practitioners to understand and the IRS to administer. The overlap of the penalties also fosters uncertainty and can result in the imposition of unreasonably high penalties for relatively minor offenses.

This is often because of a lack of coordination between the substantial underpayment penalty and the negligence and fraud penalties. The IRS' inability to administer effectively and uniformly the existing penalties is an obvious consequence of the system. The IRS Commissioner's 1986 Annual Report indicates that in 1985, 48 percent of the amount of penalties was ultimately abated. In 1986, that is up to 53 percent.

These figures indicate that the IRS is either being overzealous or heavy-handed in its collection efforts, or inappropriately imposing penalties, perhaps using them as negotiating tools.

During the hearings on the Taxpayer's Bill of Rights, we heard evidence that this may indeed be the case. Such practices could largely be prohibited by the enactment of the Taxpayer's Bill of Rights and appropriate penalty reforms.

The Tax Administration Subcommittee of the Chamber's Taxation Committee is working to identify penalties that are particularly burdensome to taxpayers.

A preliminary review has shown that serious problems exist with the negligence penalties, the failure to file penalties, the payroll deposit penalties, and the substantial underpayment penalties. Presently, if any portion of an underpayment is due to negligence, the five percent negligence penalty is applied to the entire underpayment.

Thus, if a taxpayer negligently underpays only $1, but the underpayment in question was $1 million, the negligence penalty would be applied to the entire $1 million. This is a manifestly unjust result.

Several dozen penalties relate to failure to file information reports. For example, the penalty for failing to disclose a $100 transaction on a 1099 form is the same as for failing to disclose a $1 million transaction. Moreover, the penalty for not filing a report is the same as for filing it late.

This provides incentive for a taxpayer not to comply if he or she has missed the filing deadline by even a day or two. It seems more logical for the penalty to increase as the period of noncompliance grows.

Federal payroll tax deposit penalties are of particular importance to our small business membership. The kind of frustration that they feel is exemplified by the IRS notice attached to our testimony. A two cent underpayment led to a $400 penalty—clearly an unreasonable result.

The other major problem is the substantial understatement penalty of Section 6661. The Tax Reform Act increased this penalty from 10 percent to 20 percent prospectively. The 1986 Budget Reconciliation Act increased the penalty another five percent to 25 percent and made it retroactive.

This raises serious issues as to when the penalty stops being a penalty and becomes instead a revenue raiser. It is impossible to justify a 150 percent retroactive increase in a penalty applying to behavior that took place three years earlier. Such a practice leads to inexorable consequences and arguably is unconstitutional as a violation of due process.

Vast improvements in the system can and must be made. On behalf of the Chamber, Mr. Chairman, we certainly appreciate and support your efforts to try to bring about some sort of coordination of this effort.

Senator PRYOR. Mr. Moore, we thank you for your statement. We thank you also for bringing to this committee's attention this particular tax liability of two cents owed by a taxpayer in our country, and we find that the Internal Revenue Service has assessed this taxpayer with a two cent liability a $400.29 penalty.

Now, this is the point of absurdity that many taxpayers find gives them reason to lose faith, I would say, in our tax collection system.

Now, let me ask you: Are there any indications of additional penalties that might be so outrageous as this, Congressman Moore, that you would like to supply for the record? If so, we would leave the record open for any more situations that you have.

Congressman MOORE. Mr. Chairman, as these come to our attention, we will certainly deliver them to the committee. In this particular case, this businessman sent this to us voluntarily and asked us not to reveal his name. After receiving a $400.29 penalty for a two cent underpayment, he is afraid if his name came out, he might receive some other kinds of additional penalties.

So, he has asked us to keep his name confidential; but as we receive these, we will certainly forward them to the committee.

Senator PRYOR. Congressman Moore, I have stated this before this committee before, and you did make mention of the Taxpayer's Bill of Rights that I have been involved with for a year and a half.

I received a letter from a man in California, and he said: "Dear Senator Pryor, Please add my name to the list of supporters of the Taxpayer's Bill of Rights. Signed, Anonymous." [Laughter.]

They don't want to flag their name with the Internal Revenue Service, and we have received that. Also, Congressman Moore, let me make just a personal note here.

I want to thank you, not only as representing the U.S. Chamber of Commerce, and not only large businesses, but more importantly thousands and thousands of small business people throughout America. I want to thank you— that is, your organization—for supporting the Taxpayer's Bill of Rights legislation.

I think we have just about as wide ranging an array of support for this bill as I have ever seen. We have not only—I might say to our colleagues here—the support of the U.S. Chamber of Commerce, but also the American Civil Liberties Union. When you get the support of a broad section like that, I am just very hopeful and optimistic that there will be a positive result, resulting in the passage of that legislation.

Because of support of organizations like yours, Chairman Bentsen has announced the scheduling of a markup on the Taxpayer's Bill of Rights this coming Friday.

So, we do thank you, Congressman Moore, for your statement. The full body of your statement will be placed in the record.

Senator PRYOR. Our next witness is a friend of mine of long standing. He is a very fine Arkansan, Mr. Donald C. Alexander, Esquire. He is the former Commissioner of the Internal Revenue Service. We have discussed the IRS on many occasions; I will still call you Mr. Commissioner.

We look forward to your statement and the full body of your statement will be placed in the record.

Mr. Alexander.

[The prepared statement of Congressman Moore and the information appear in the appendix.]

STATEMENT OF DONALD C. ALEXANDER, ESQUIRE, CADWALADER, WICKERSHAM & TAFT, WASHINGTON, DC

Mr. ALEXANDER. Thank you very much, Mr. Chairman. I don't propose to read any of my statement. As I said in my statement, I think this is a very healthy and fine thing that your subcommittee, and you particularly, are doing in looking into the penalty structure.

It deserves careful and searching consideration; and I would like to ask my friend Henson Moore, whether that penalty of $400 was abated. Was that abated, Henson?

Congressman MOORE. We don't know yet. The date of the penalty notice is February 22, 1988.

Mr. ALEXANDER. I think it will be. I think it will join the abatement numbers up there. One of the problems, as you pointed out earlier, Mr. Chairman, is that penalties now, to a much greater extent than when I was around the tax shop, are imposed by computers; and computers, like human beings, can make mistakes.

Senator PRYOR. Let me ask you something, Mr. Alexander. Was this a mistake by a computer? Or was this an arbitrary decision by someone in the Internal Revenue Service who imposed this $400 penalty on a two cent liability.

Mr. ALEXANDER. Mr. Chairman, I don't know the facts, but I hope the facts will be brought out; and I have an idea the taxpayer will be getting an abatement. I believe, sir, that this penalty would have been imposed by a computer which is taught to compare two figures. And if one figure, the amount paid, is less than the other figure, the amount due, the penalty is a matter of mathematics thereafter.

Now the Internal Revenue Service is working on something called artificial intelligence. I would like to scratch the "artificial" and just make it "intelligence"——[Laughter.]

I think that is a very fine thing they are doing, and I am sure that, under the leadership of Commissioner Gibbs for whom I have vast respect, that if errors like this are going to continue, they are going to be held to a minimum.

And when an error like that occurs, I hope it will be corrected promptly; and I am very glad to see that the Commissioner has no given authority to Problem Resolution Officers to not only ask that things be done but direct that things be done.

And that, of course, is one of your fine initiatives, Mr. Chairman.

Now, you pointed out at the beginning of this hearing that penalties are an essential enforcement tool to make our system work. I agree with that. There has to be a genuine down-side risk; and when I was with the Internal Revenue Service in the middle 1970s, there wasn't.

Commissioner Gibbs is quite correct in his description of the problems that we faced then and the problems that the Internal Revenue Service has faced more recently.

Now, the response of the Congress and the response of the Service has been to add penalty on penalty, and we do have a number of penalties that overlap. We have some that don't. Now, if all 150 overlapped, that of course would be absurd.

Let's take Section 5871; it is in Joint Staff's fine pamphlet on penalties and it applies to those that deal in machine gun and hand grenades and bombs. Now, that is not your ordinary, run-of-the-mill taxpayer, Mr. Chairman.

And many more of the penalties that are listed in this 150 are regulatory penalties, and they were put in the law in an effort to try to assist the Internal Revenue Service to carry out regulatory responsibilities with respect to employee plans—pension plans, benefit plans—and exempt organizations without jerking the exemption.

Revoking the exemption of a pension plan is about the worst thing you can do; but if that is your only regulatory mechanism, that is the only option left open to you. Then, you have to do it to stop abuses; I did it a couple of times when I was around the shop.

We have a much better scheme, a much better penalty system now; and I hope that that doesn't get lost in the review of what should be reviewed; the overlap of the late payment, late return, negligence, fraud, and substantial understatement penalties.

But a strong system of penalties proportionate to the offense is necessary, and it is also necessary that there be penalties applicable to those that give shabby tax advice or sell shabby tax merchandise. And a few in the tax preparing community and in the investment community do those things.

So, Mr. Chairman, as you review our penalty structure, as you make it less complex, as you improve it, I hope you will bear in mind—as I am sure you will—that it is exactly as you described. A sound system of penalties is essential to the integrity of our tax system.

Senator PRYOR. I think, Mr. Alexander, that what we have to make sure of is that we have a sound system. That is what this hearing is about. I don't know if it is sound any longer. We are beginning our study of that, and we may have some questions for you in just a moment, Mr. Alexander.

[The prepared statement of Mr. Alexander appears in the appendix.]

Senator PRYOR. Our next witness this morning is Mr. James Childs, Professor of Law, Director of the Tax Clinic Program at the Center for Taxation Studies, University of Akron, Akron, Ohio. Do we call you Professor Childs, Dr. Childs, or what?

Mr. CHILDS. Just Jim would be fine, Mr. Chairman. [Laughter.]

Senator PRYOR. I think you operate a very unique institution there, your tax clinic. Is this the only one in the country like it?

Mr. CHILDS. No, sir. Thanks to Commissioner Gibbs and prior commissioners—a program that just doesn't have real wide acceptance in the United States—we operate a clinic that handles audits, collections, and tax litigation through a contract with the U.S. Tax Court and licensing through the Director of Practice of the Internal Revenue Service for low income taxpayers.

Senator PRYOR. And these are law students that you have?

Mr. CHILDS. These are law students and graduate business school students.

Senator PRYOR. And did any of them come with you today?

Mr. CHILDS. I have 15 of them with me, and I would appreciate the chairman's indulgence if I allow two of the students to present what fresh minds can come up with in terms of problems and fresh minds not tied to the years of being a technician, like I am, can come up with.

STATEMENT OF JAMES W. CHILDS, ESQUIRE, PROFESSOR OF LAW, DIRECTOR OF THE TAX CLINIC PROGRAM, CENTER FOR TAXATION STUDIES, THE UNIVERSITY OF AKRON, AKRON, OH, ACCOMPANIED BY CYNTHIA DAVIS, AND E. EARLE BURKE, STUDENTS, UNIVERSITY OF AKRON SCHOOL OF LAW

Mr. CHILDS. We are grateful to be here. And because of the clinic and because of what you are doing, we have a solution that will give Commissioner Gibbs the opportunity to go down in history as the commissioner who brought simplicity to instructions, and your committee simplicity to the structure and improved compliance.

If people can voluntarily comply at the low end of the economic spectrum, they are not going to feel so lousy about the system. So, with your permission, I would like to yield to two students.

Senator PRYOR. Mr. Childs, you may do that. This is a little out of the ordinary. They are not on the witness list; but under the circumstances, I don't know that Washington needs anything more than a few fresh ideas and we can certainly tolerate that.

Mr. CHILDS. I would like to introduce them to you

Senator PRYOR. We won't take from Mr. Nee's time. If Mr. Nee does not mind yielding for this purpose, Mr. Childs you may bring your students up.

Mr. CHILDS. Ms. Cynthia Davis, a senior law student and Master in Tax student from Bridgeport, Ohio; and Mr. E. Earle Burke, a senior law student who hopes to go to the N.Y.U. Masters in Tax Program from New York City.

And I would like Ms. Davis to speak first.

Senator PRYOR. Ms. Davis, you have the floor.

STATEMENT OF CYNTHIA DAVIS

Ms. DAVIS. Thank you.

Senator PRYOR. We have this warning system, as you can see here; and if you would, please abide by that. Thank you.

Ms. DAVIS. Yes, sir. We at the University of Akron Tax Clinic believe that there is a need for the Taxpayer's Bill of Rights. However, we question what the good of a Taxpayer's Bill of Rights would be to taxpayers who don't or cannot understand the rights that they are given.

We propose that simplified tax forms would accomplish two purposes: first, to raise and collect the desired revenues and, second, to make taxpayers in general happy.

There are, as previously stated many, many times, over 150 different penalties in the Internal Revenue Code. I would like to refer your attention to pages 1 through 12 of our written testimony.

These penalties can range from fines to imprisonment or both. These penalties are assessed, collected, and paid in the same manner as tax deficiencies and interest. Interest begins running from the date of demand until the tax accrued interest and penalties are fully paid. Interest is not viewed as a penalty, but as compensation for the Government's being deprived of the use of money.

Some penalties are interest sensitive, and the daily accrual of interest on these penalties indicates a revenue yield policy. Again, your attention to pages 14 and 15. They will show examples of how a combination of interest and penalties can drastically increase the amount owed by the taxpayer, even multiplying the amount of the deficiency by as much as 530 percent over a ten-year period.

Penalties on top of penalties indicate a revenue yield policy. These penalties are supposedly assessed to reimburse the Government for the expense of investigation and litigation.

A lack of clear Congressional guidance, however, tends to result in IRS agents applying all penalties to taxpayers who do not have qualified representation. The average low income taxpayer does not have the necessary funds to acquire such services. Please see pages 15 through 17.

A major problem is that a lack of reading skills prevents many taxpayers from complying with the tax laws. The reading level of most IRS publications is extremely high in relation to the written material that low income taxpayers come into contact with.

As measured by the Frye Readability Formula, a form 1040EZ instruction booklet requires an 8.45 grade reading level. This is even more difficult to read than our studies found for a Form 1040, which seems to make no sense to us whatsoever.

The reading level required for Statutory Notice of Deficiency is an 8.7 grade reading level. It should be noted that the March 3, 1988 Wall Street Journal required only a 7.1 grade reading level. Please see the record for 19 through 21.

We suggest that the Internal Revenue Service should write instructions for the Forms 1040, 1040A, and 1040EZ ideally between the second and fourth grade levels. The University of Akron Center for Taxation Studies would be pleased to offer to provide technically correct instructions for such forms, written at a reading and understanding level ideally between grades two and four.

We would like to work within the time frame established by the Internal Revenue Service and believe we could do so for the next tax year if you were to pass legislation in November, which may be highly unlikely at this time, but we do hope to be able to have that done.

According to the U.S. Department of Education, only the following percent of the population possesses an 8.45 grade reading level: Blacks, 19.8 percent; Hispanics, 37 percent; persons with less than a high school education, only 11 percent; and high school graduates 50.2 percent. The study indicates the majority of low income taxpayers will find it difficult, if not impossible, to comprehend and thus comply with the Federal income tax laws. See page 19 through 21.

We suggest two alternatives to help remedy these problems. At a minimum, representation should be provided to a taxpayer before penalties and interest are assessed. One possibility is to adopt the ombudsman concept, which you, Senator Pryor, yourself have suggested. Another is to establish tax clinics like ours nationwide.

These clinics would be licensed and supervised by the Director of Practice for the IRS. A third alternative is using retired professionals in a senior citizens clinic structure; and a fourth possibility would be a combination of all three.

We propose that if a taxpayer cannot afford representation, or pro bono representation is not available, the penalty system should be altered with respect to those income taxpayers.

We have encountered several cases in our clinic where taxpayers have missed the 90 day deadline. There are sad stories for everyone, but it is very commonplace. We feel that they should be given special treatment as far as what would be required of them.

If a taxpayer can demonstrate the inability to pay the penalties and interest, we propose the penalties and interest should be automatically abated at the audit level.

Part of the justification for this proposal is the fact that a substantial number of these low income taxpayers cannot at this time, and probably never will, be able to pay.

Mr. Chairman, I now yield to E. Earle Burke.

Senator PRYOR. Thank you, Ms. Davis. Mr. Burke.

STATEMENT OF E. EARLE BURKE

Mr. BURKE. Thank you, Ms. Davis. Mr. Chairman, we contend that in order to assess penalties and interest, the IRS should be required to notify taxpayer they can be held responsible for tax deficiency. This could be accomplished by requiring all notices to be sent out by certified mail. Please refer to page 26 of our written report.

The low personal exemption amounts in the Code enable the IRS to impose levies on a substantial portion of the taxpayer's weekly wages. The IRS policy precludes collection as well as increasing Federal social service expenditures. Since the IRS will not levy against unemployment compensation or welfare benefits, this provides an economic incentive for the taxpayer to opt out of the job market and onto the public dole.

The current exemption amounts bear no reasonable relationship to what the taxpayer needs to basically survive. By increasing the exemption amount, the Government will not only encourage a return to employment but will also make at least a portion of the deficiency collectible, generating future revenue. I would like to once again refer you to pages 26 and 28.

Unrepresented low income taxpayers often do not fully understand their rights under the existing Statutory Notice of Deficiency. In case of a divorce, for example, the IRS might send the taxpayer's notice to one spouse or ex-spouse. When a joint return is involved, the IRS is permitted to send a single joint notice of deficiency to the last known address. This is true unless either spouse has notified the District Director that separate residences have been established.

Even then, errors may occur, and the IRS may still send a single notice; and one of the taxpayers will not be notified. Thus, after 90 days, the taxpayer loses the right to litigate in court, unless full payment of the due amount is paid.

This can be construed as a denial of due process which guarantees the right of access to the courts, regardless of economic status. Often, even the $60 filing fee intimidates the low income taxpayer who considers this equivalent to a small fortune. I refer your attention to pages 26 through 33 of the text.

Certain assessments may be made without the taxpayer receiving any notice of deficiency. Thus, no assessment made under these circumstances may be litigated in tax court since notice of deficiency is a jurisdictional requirement. However, the Code specifically states that notice of assessment in these situations is not notice of deficiency. Further explanation for this can be found on page 34.

The revenue yield from penalties results in a regressive economic impact on the low income taxpayer. Often, just to pay the tax, installment payments must be arranged. However, without qualified representation, the low income taxpayer may not even be aware of this option. I would like to refer your attention again to pages 35 to 36.

When the penalty system was originally enacted, it was created to enforce the collection of taxes. However, since 1981, legislative history indicates a trend towards using penalties as a revenue raiser.

Abuses by high income taxpayers have brought about a number of new penalties. Unfortunately, the low income taxpayer has been caught in this net. The stacking of penalties generally works as a deterrent to abuses by high income taxpayers; but since the low income taxpayers usually lack the necessary skills to understand the tax system, they are often penalized merely for failure to comprehend.

Mr. Chairman, we submit to you five possible solutions. First, interest sensitive penalties should have a floor placed on them. In that way, the low income taxpayer with a minimal standard of living would be exempt. This would reduce the administrative cost of collection and minimize the regressiveness. This suggestion, while raising revenue, would also deter flagrant abuse of the tax law by high income taxpayers, as well as introducing some progressivity into the system.

Second, abatement of the second or higher noninterest penalties should be an audit level function in the case of the low income taxpayer. These floor levels should be set by Congress and indexed. Stacked penalties should be automatically abated if, after the levy, the taxpayer does not have sufficient income to pay the primary deficiency. I would like to refer you to page 39 in the text.

Our third suggestion is that the mandatory service of a qualified representative be provided at the time of audit or, at the very least, before wage levies are imposed.

A fourth possible solution is that a higher amount of the taxpayer's income should be exempt from the wage levy, with the exempt amount being indexed by Congress for inflation.

The fifth and final option is to obtain bankruptcy relief for all taxpayers for the interest and penalties.

I would like to point out that it is obvious to everyone here that returns could be made simpler; and we believe that, by simplifying the returns, it would also generate revenues for the Service.

There is no simple solution, other than this one, which would provide not only increased revenues but change taxpayers' attitudes about the tax system in general.

Mr. Chairman, this concludes our prepared remarks. We offer into the record our written testimony.

On behalf of Professor James Childs, Director of the Tax Clinic, Professor Creme, Director of the Center for Taxation Studies, The University of Akron, and the Tax Clinic law students, we thank you for the opportunity to appear and be heard.

Senator PRYOR. Mr. Burke, thank you. Ms. Davis, thank you. Professor Childs, I have just a question or two. You can all answer these questions if you want to.

We will then call on Mr. Nee. He is enjoying your statements as much as I am; so he doesn't mind waiting just a minute. [Laughter.]

Is it the thinking or the thrust of the studies done at your center that the lower income taxpayer today is not represented very well? Is that right? Does he have improper representation or no representation?

Mr. CHILDS. No representation, Mr. Chairman, unless there are clinics like ours; and there are very few of them. Yet we know that Commissioner Gibbs has encouraged these clinics all over the country.

Maybe Congress needs to put a little push on this; maybe it is the funding of scholarships for clinics. I don't know. But it seems to be a low cost way of providing outside representation for low income taxpayers. We turn people away every day.

Senator PRYOR. You turn taxpayers away every day?

Mr. CHILDS. We just can't handle the case inventory and handle it well.

Senator PRYOR. Ms. Davis. Mr. Burke.

Mr. BURKE. Yes, Mr. Chairman, I would also like to comment on that. I would like to point out that the State of Ohio, through Governor Celeste and the Ohio Board of Regents, has established the Tax Center; and it is no funded by the Federal Government. It doesn't cost the Government anything.

Mr. CHILDS. Our clinic is totally funded by the taxpayers of the State of Ohio.

Senator PRYOR. It is not federally funded?

Mr. CHILDS. It is not federally funded, not one penny of it. It is funded by the taxpayers of the State of Ohio to assist Federal taxpayers.

Senator PRYOR. And not only do you assist Federal taxpayers, you also conduct studies about some of the items or areas that you have mentioned this morning. Is that within your scope?

Mr. CHILDS. Correct. Part of the research has to be in areas of how the tax laws apply. Student have to learn the procedure as well as the substance.

Senator PRYOR. I think your reading level indicators here are very fascinating today, that you have brought before the committee. For example, you stated that it takes more to read an IRS form than the Wall Street Journal?

Ms. DAVIS. Yes, Mr. Chairman, that is correct.

Senator PRYOR. A higher reading level? Is that correct?

Mr. CHILDS. And that is the EZ, is a very misnamed form. [Laughter.]

Senator PRYOR. You know, we sit up in this town all the time, and we lose sight so often of our goals. How can we simplify the income tax forms? How can we do that?

Mr. CHILDS. We are talking more about the instructions. The English and educational people who worked with the clinic—and as a matter of fact, we had a Ph.D. in the clinic who had been a school superintendent for 30 years; so that was a big help. Dr. Bronstrup said that we would be able to do it if we concentrated on cutting down the number of words per sentence and eliminating as many multisyllabled words as possible.

Now, I know if you use the word "taxpayer" and you use it three times in 100 words, you are probably going to blow your scale. But there are ways to do it, and there are linguists in the country; we just need to get them all to Akron, and I think in about three months we could have them out for you.

Senator PRYOR. You know, there is an interesting position in the Internal Revenue Service—at least I always find it interesting; and I am not making light of it. I guess it is a necessity, but we have within the Internal Revenue Service a position. And this is the title: The Director of Forms.

Maybe you ought to have the Director of Forms of the Internal Revenue Service come to the University of Akron and spend a day or two with you and you could talk to him about this thing.

I think this is the kind of input that we need coming up the line to Washington because the 1988 forms, I think, are an absolute horror story for many of us. I am just hoping and praying we all get through April 15.

Mr. CHILDS. We see cases occurring, starting with the W-4, which has the highest reading level requirement of any form we tested. And if the taxpayer does not get the W-4 right with the employer, they are underwithheld.

The normal low income taxpayer then comes down to April 15 and owes $200 or $300; he does not have the credit or the Visa or the MasterCard to be able to get the money to send it in.

But trying to be an honest and complying taxpayer he sends in a form with a balance due. What happens is you then have an assessable penalty—the failure to pay penalty—and about 18 months later when that interest sensitive penalty and the failure to pay notice comes back to the taxpayer it is a horrendous amount, when actually they couldn't pay the tax in the first place.

It is our contention, and we don't find any statistics that the Service puts out that show this, that of the $30 billion that are considered receivables, a fair percentage are really illusory because, insofar as they arise from the low income taxpayer, they are never going to be collected in full; and there is no way a taxpayer can ever get free of them.

If there was a way to get free and say "I have paid my tax and my interest," maybe another solution is to provide a system where there is a voucher that you send in if you don't have the money, which goes with your return and authorizes the Service to do a voluntary wage garnishment, so to speak, of so much per week over the next 52 weeks, in addition to adjusting the W-4—that is, automatically adjusting the W-4—for the next year

We see people day in and day out who try and comply and get caught in this net.

Senator PRYOR. Mr. Childs, we appreciate this. We are going to allow Mr. Nee to go forward with his statement. Then, if you would remain at the witness table, we will have some more questions.

Before we go to Mr. Nee, Mr. Childs, might you have stand your other students whom you brought with you from the University of Akron. Do you have other students in the hearing room?

Mr. CHILDS. Yes.

Senator PRYOR. Good. We appreciate this. Thank you very much. It has been a refreshing breeze this morning. Thanks.

Mr. CHILDS. Thank you, Senator.

Senator PRYOR. And a real contribution, not only your findings but also the solutions you are recommending. Mr. Thomas Nee, President of the Tax Executives Institute of New York. Mr. Nee, we thank you for appearing this morning, and we look forward to your statement.

Mr. NEE. Thank you, Senator.

Senator PRYOR. We also express our appreciation for your delaying your statement momentarily to hear from the Tax Institute panel.

[The prepared statement of Mr. Childs appears in the appendix.]

STATEMENT OF THOMAS M. NEE, PRESIDENT, TAX EXECUTIVES INSTITUTE, WASHINGTON, DC.

Mr. NEE. Thank you, Mr. Chairman. It is obvious that Mr. Childs' pride in his students is well founded.

Senator PRYOR. Yes.

Mr. NEE. I will briefly summarize the main points made in our written statement. I am appearing here today as the President of Tax Executives Institute, which comes to this hearing from a vantage point different from those of most of the other witnesses appearing before the subcommittee.

We represent the corporate tax community and are only tangentially involved with individual tax rules and penalties. As a professional organization we are firmly committed to maintaining a tax system that works, one that is both administrable and can be complied with.

Mr. Chairman, in order to achieve the goal of a rational and simplified penalty system, there must first be a consensus on what the proper role of penalties should be in the tax system. In other words, the philosophical or, if you will, moral basis of civil penalties must be established.

In this regard, TEI's recommendation can be summarized as follows. Civil tax penalties should be exacted only for a deviation from a standard of conduct that is timely established and promulgated either by Congress or the Treasury Department and the Internal Revenue Service.

If the Internal Revenue Code's current penalty provisions were judged against this principle, it would be found wanting in several respects. There are several reasons for this.

First and foremost, the rapidity and magnitude of substantive changes in recent years has rendered it very difficult, if not impossible, to discern a clear standard of conduct with respect to some areas of the Internal Revenue Code. Since 1981, tax legislation has come especially fast and furious.

In total, more than 6,000 subsections of the Code have been changed in less than seven years. The cumulative effect of legislative change has been staggering, not only for taxpayers, but for the Government itself. When the rules are constantly changing and becoming more complex, the resulting confusion and uncertainty threaten the very existence of our self-assessment system.

We are not suggesting that the substantive tax laws should be made static. Rather, we submit that, in light of the frequency and magnitude of such changes, fewer and more equitable penalties and penalty assertions are warranted.

Mr. Chairman, penalties should have a single goal: to encourage compliance by punishing voluntary, rather than wholly inadvertent, deviations from the prescribed and existing standard of conduct.

Where a penalty is enacted or increased on a retroactive basis, it cannot promote compliance.

Mr. Chairman, although TEI is still in the process of preparing a detailed analysis of the Code's specific penalty provisions and developing legislative recommendations, we do wish to set forth at this time our principal preliminary recommendations.

First the penalty for substantial understatement of income tax liability, Section 6661, should be repealed. There should be no penalty in the absence of negligence or fraud—that is, when the taxpayer does not engage in any proscribed conduct. To impose essentially no-fault penalties under such conditions is contrary to the American sense of fair play.

Second, the penalties for negligence and fraud should be toughened; and the definitions of culpable conduct, whether it be negligence or fraud, should be clarified, either by statute or by implementing regulations.

The Code should be amended to send a very clear message: not only will taxpayer misconduct not be tolerated, but it will be severely punished.

Third, to ensure that clear administrable and cost sensitive standards of conduct are being enacted, the IRS as the enforcement agency should be required to testify before Congress, both on its ability to administer and on the taxpayer's ability to comply with all proposed legislation.

In addition, greater public participation in hearings on specific tax legislative proposals should be encouraged.

Fourth, the Code's penalties should be reorganized into broad penalty categories, with there being a gradation of penalties within certain groupings based on the severity of the taxpayer's infraction.

And fifth, the penalty provisions should be placed within a single chapter or subchapter of the Internal Revenue Code with cross references to and from substantive areas where appropriate.

Mr. Chairman, Tax Executives Institute appreciates this opportunity to present our preliminary views on the necessary reform of the Internal Revenue Code's civil penalty provisions, and we would be pleased to respond to any questions you may have.

Senator PRYOR. Mr. Nee, thank you. We just heard from the previous witnesses, from a group who represents generally the lower income class of taxpayer. I assume, Mr. Nee, that you would probably represent or be speaking for the higher income taxpayers, some of the business executives. Would that be a correct assumption?

Mr. NEE. Mr. Chairman, TEI members work for the largest corporations in the country. Consequently, we are generally concerned with business, rather than individual, tax rules.

Senator PRYOR. Do you disagree with anything the previous witnesses have stated?

Mr. NEE. No, I don't. I think that the problems that they have described, in fact, do exist; and they should be addressed. I believe the problems that we face, in many respects, are similar because they come from the same root cause—which is the complexity of the legislation that we have been faced with over the past five to ten years.

Senator PRYOR. You are recommending that we repeal, I believe, the substantial underpayment penalty; and I assume this would apply more to the higher income individual than the lower income individual. Is this correct

Mr. NEE. Yes, Mr. Chairman. This penalty, for the most part, concerns us where it is being imposed in the case of large corporations. The penalty, as was mentioned this morning, has recently been raised—on a retroactive basis—to 25 percent. The penalty is imposed in a no-fault environment on an essentially mechanical basis; once the adjustments exceed a certain level, the penalty can be imposed.

For example, the tax liability of most of our corporations runs into the millions and hundreds of millions of dollars; and the threshold level for imposition of this penalty is $10,000 in respect of corporate taxpayers.

Senator PRYOR. Mr. Childs, do you have any comment on Mr. Nee's statement, or the statements of any of the other witnesses?

Mr. CHILDS. No. I agree with the statements that have been made by the other witnesses. Our problem, I think, is somewhat unique, but it all gets down to the complexity. We are finding forms that we test that graduate accountants are going to have trouble reading and understanding.

And it seems like when you add law on top of old law, you don't repeal the old law, but yet you add new law in different areas, that you are building a house of topsy. It is just growing. It is incredibly difficult, for instance, to teach Tax I any more. We almost need three courses in it.

Senator PRYOR. Another distinction, if I might add, between the group that you speak for and the group that Mr. Nee speaks for is that Mr. Nee's clients can afford to pay an attorney; they can afford to pay a Certified Public Accountant or a tax specialist in a particular area. The people that you speak for cannot.

And yet, we almost come to the same conclusion; we have a system that needs some reform and change. Am I correct?

Mr. CHILDS. Yes. Very definitely, at the low end and at the high spectrum. This is probably one time that you will see low income taxpayers and the extremely rich on the same side of the witness table. [Laughter.]

Senator PRYOR. Now, to Mr. Childs' immediate right, we have a former Commissioner of the IRS. Mr. Alexander, how do you tie into these statements that both of these individuals have made this morning?

Mr. ALEXANDER. Mr. Chairman, I am four square opposed to complexity. I hope there won't be all these frequent changes. I wish we had an understandable, comprehensible law. We worked on the 1040A, before we had the EZ, to try to make it understandable because one of my predecessors said it could be read easily by fifth graders; and I didn't make that mistake. I made many but not that one.

I think that the professor's initiative is a very fine one, and I am sure that Commissioner Gibbs will give it very careful attention. And the Director of Forms, whom you mentioned, will be trying to solve the problem of how to use the word "dependent." It is a kind of long word, but I am sure that Mr. Childs has a better word for it.

As far as the Section 6661 penalty is concerned, in my statement—and I will repeat it here—I have to differ from my distinguished friend on the left. I think you need it; I think you need it to counter the needle in the haystack approach. If there is a haystack, somewhere there is a needle. If the needle happens to be a $10 million aggressive tax position, the IRS will have to find it.

Now, I think that Section 6661 serves a necessary function. I do not favor the increase in that penalty from 20 percent to 25 percent, particularly when that occurred in such a way as to have the retroactive effect described by Henson Moore. How can a taxpayer be deterred? How can conduct be improved by a penalty if the penalty is enacted after the conduct has taken place? It is impossible. I think that was a bad idea. It is a bad idea to put money amounts on penalties because, if the system worked perfectly, the penalties produce zero.

But this penalty is a pretty good ingredient in our law. It should be clarified. There ought to be some rulings interpreting it; the regulations don't go far enough. There is a lot of confusion out there, and confusion is bad.

Senator PRYOR. Thank you, Mr. Alexander. Congressman Moore, do you have any parting comments?

Congressman MOORE. Mr. Chairman, the only parting comment I would have is the fact that most Americans, I think, are trained to believe in a system of fair play and fairness. When they get a form—which we submitted to you—sent to them, whether it is generated by a computer or a humanoid, it doesn't make any difference. The point is that that taxpayer goes through the ceiling and says: This is patently unfair. If he had gotten a bill for, let's say, $5. It says you underpaid and you broke the law, and we are going to give you a penalty commensurate with your breaking of the law, I think that taxpayer would accept it and pay it, and there would be no problem.

If the taxpayer was intelligent, if he had a tax counsel, he probably would call the IRS, raise sand over this and enter the 53 percent of the penalties that have been abated. If he happens to be maybe an average taxpayer, as Mr. Childs is talking about, he may just send in the money. If he has the money, he may pay it; and therein you find the real unfairness in the system.

A lot of people get these forms and are scared to death. So, they go ahead and pay it, fearing their bank account seized or their home will be seized or whatever.

What I am leading up to is a conclusion and that is that I don't think we have entered into the penalty structure an element of fairness, of having the penalty have some proportion to the offense that has been committed. When you have a penalty that is the same—whether you are one day late or you don't file—that is what I am talking about.

When you have a penalty that applies a percentage to a $1.00 negligence underpayment to the entire underpayment, regardless of whether the rest is negligent or not, that is what I am talking about.

And so, what I think we don't have here is enough latitude evidently, either on the part of the IRS or on the part of the law to allow the people who are fixing the penalties to do so commensurate with the offense that has been committed. It seems like it is a stated automatic thing, regardless of the time that you haven't filed, or regardless of the amount you haven't paid, or you negligently underpaid, or whatever.

I think that is where the whole thing goes astray, and you begin to get the crazy stories and the crazy things happening that cause people to begin to believe the IRS is being unfair.

Senator PRYOR. I received a letter recently, Congressman Moore, from a constituent that said: "Dear Senator Pryor, Would you please put me in touch with a human being in the IRS?" [Laughter.]

All right. That said a lot to me. I am looking once again at our two cent tax underpayment and our $400.29 penalty. I think if on this form there was a statement such as "If you have any questions, call John Doe or Jane Smith"—whoever the Revenue agent might be—who signed off on such a penalty, that would be helpful.

If it was computer generated, still the human being ought to look at such penalties as this before they go out, to increase, I think, the credibility of our tax gathering system. If there was a personal name on there that they could call back—and I don't know what would have been up here in this spot marked out—but it probably would have been an 800 number; and I am afraid it would be busy all the time.

But if there could be an individual sort of taking responsibility for such a penalty, I think it would return the human aspect to the Service that I think we are losing in the computer age.

I want to thank all the members of the panel this morning. I appreciate very much your statements and your suggestions. Once again, this is the first of several hearings on penalties; and your contribution are greatly appreciated. Thank you very much.

Our next panel is Mr. Charles Hall, Mr. Glenn White, Mr. David Silverman, Mr. Gary Rohrs, and Mr. Herbert Lerner.

We welcome our panel this morning. Our first witness is going to be Mr. Charles Hall, who is the Chairman of the American Bar Association, Section on Taxation, from Houston, Texas. Mr. Hall, we welcome you today. You have come a long way for this hearing, and the committee is very indebted to you for appearing. We look forward to your statement.

[The prepared statement of Mr. Nee appears in the appendix.]

STATEMENT OF CHARLES W. HALL, ESQUIRE, CHAIRMAN, AMERICAN BAR ASSOCIATION, SECTION ON TAXATION, HOUSTON, TX

Mr. HALL. Thank you, Mr. Chairman, and good morning. While I speak for the Section on Taxation only, it does have some 28,000 members; and quite a few of them are expert in the meaning and application of the civil tax penalties. We have a committee of those experts who have been working for some time studying the penalty situation and drafting a report. We have a preliminary report that is some 200 pages that goes into every one of these penalties and makes a number of suggestions.

Just as soon as this report is finished, we are planning to submit it to you and the committee for whatever help it may be.

Senator PRYOR. The committee would find this very useful. We thank you, Mr. Hall.

Mr. HALL. We are committed in the Tax Section to enhancing voluntary compliance. We are spending a great deal of time on it. In fact, we are hosting--as I believe the chairman knows—a compliance conference next month in Virginia to address the subject of compliance.

We feel that civil penalties are quite important in enhancing compliance, but we believe that for these penalties to be effective, they must first be understandable by the average taxpayer whose compliance behavior is to be influenced.

Second, they need to be logical and fair and perceived as such. Third we believe they definitely need to be prospective and not retroactive in application; and they should be used, finally, to promote voluntary compliance and punish noncompliance, but they should not be used to raise revenues.

We feel that if penalties are used to raise revenues, it indicates our tax system has some other problems that need addressing.

Now, why are we so concerned about the penalty structure? First of all, there are too many of them. There are some 150 civil penalties. I agree with Mr. Alexander that a number of them are needed to take care of hand grenades and weapons and that sort of thing, for example; but leaving that group aside, those that remain could still be simplified and reduced in number.

The structure is too complex. For example, there are some 13 different standards of conduct for deciding if somebody is subject to a penalty. That is too many.

Third, the penalty structure is not internally coordinated. For example, if a taxpayer commits only one act of misconduct, more than one penalty can apply, resulting in an aggregate penalty considerably larger than any of the single penalties. There simply ought to be more internal coordination.

Next, taxpayers and their representatives are now openly questioning the fairness of this structure of penalties in the light of the type of conduct that is being penalized. If we can decrease the number of penalties, reduce their complexity, coordinate them better, we ought to be able to get a better consensus and perception about fairness.

In my ten-page statement, I divide the 150 civil penalties into three broad classes: taxpayer penalties—that is things like fraud and negligence; information return penalties—that speaks for itself; and third and finally, bad conduct penalties, usually applicable to third parties—the return preparers, for example.

Then, we make specific suggestions about each of those.

At the risk of being presumptuous, if I could accomplish just one thing, or persuade you of just one thing this morning, it would be this: the fabric of our penalty structure has been woven piecemeal without coordination over a long period of time. It is uneven; it is frayed. I would like to urge and convince this subcommittee to be quite deliberate and take a lot of time to study these penalties, understand them, then redesign the structure so that it is simpler, so that it is more understandable, so that it is coordinated, and so that it effectively—effectively—encourage voluntary compliance.

I urge you to consider our long statement, which we will give to you as soon as we can; and we will be standing by to assist in any way we possibly can. Thank you, sir.

Senator PRYOR. Mr. Hall, thank you for your statement. Once again, we look forward to the recommendations. How many attorneys are in your organization, did you say?

Mr. HALL. About 28,000.

Senator PRYOR. 28,000? I will have some questions in just a moment with regard to you statement. Mr. Glenn W. White is our next witness who is Chairman of the Taxation Committee, National Association of Manufacturers, Midland, Michigan. Mr. White, thank you for coming.

[The prepared statement and the report of Mr. Hall appear in the appendix.]

STATEMENT OF GLENN W. WHITE, VICE CHAIRMAN, TAXATION COMMITTEE, NATIONAL ASSOCIATION OF MANUFACTURERS, MIDLAND, MI

Mr. WHITE. Thank you, Senator Pryor. The Code has become entirely too complex. This presents a tremendous problem for individuals and small businesses, as one might expect and as we have heard repeatedly enumerated this morning. It also presents a tremendous problem for large businesses and especially large businesses with international operations.

The law has become so complex that we don't really know what it is. As a result, accurate compliance will certainly suffer. Large and small taxpayers cannot determine what the law is, and their advisors cannot tell them what the law is, irrespective of how much we pay them.

Often, there are no rules because the Internal Revenue Service has not had an opportunity to promulgate regulations. We still have regulation projects outstanding from the 1969 Tax Reform Act.

Where there are rules, their complexity outstrips taxpayers' ability to comply. As one noted tax attorney has said, "We now have an Internal Revenue Code that is compliance proof."

We add on top of this the fact that now the penalties have become a matter of Congressional emphasis, and additional penalty collection has become a matter of revenue raising intent. We have a morass of complex traps for the unwary that often have no relationship to real issues or Governmental needs.

As has been pointed out, there are nearly 150 penalties in the Code. A year ago in testimony before Congress, the Commissioner admitted that not even he and his staff knew what all the penalties were.

On that basis, we know they cannot be administered fairly nor consistently. To the extent they are unknown to taxpayers, they cannot motivate proper behavior by taxpayers.

With this, we now have this Congressional matter of increasing the levy of penalties. The revenue estimates from the Joint Committee Report for the 1986 Act indicate that the estimated penalty collections in 1987 would be $348 million. By 1991, that number will raise to $483 million, a 40 percent increase in revenue collections.

I think that is not the proper role for penalties. Penalties should be designed to encourage compliance. This compliance should be with proper reporting requirements and with payment requirements, especially failure to pay over amounts that the taxpayer collects from others.

Penalties should be severe enough to be effective, but they should also take into account other measures. Not only is there the stacking of penalties, but there is also the issue that we have now imposed market rate interest costs on taxpayer deficiencies.

Penalties should not be designed to punish innocent error, and they should never be levied on a no-fault basis. They should not affect deficiencies not associated with the penalized activity, as the negligence penalty does today.

And they certainly should not apply where a taxpayer's good faith effort that fails has had no cost to the Government, as they do in many cases today.

Situations to which penalties apply should be clear enough that their application would meet a level at which most citizens would agree penalties should apply. They shouldn't be a "gotcha." They should be consistently applied. They should not be adopted just to make the Internal Revenue Service's audit task easier.

And the terms of compliance to avoid penalties should not be unreasonably tight. Interest in those cases may be a more appropriate exaction than penalty.

Our recommendations would be—as others have suggested— to get the penalties into a single section of the law where all of us can find the penalties easily, where penalties can be compared when they are being imposed so that we know which infractions receive which penalty so that the likelihood of entrapment is lowered.

Penalties should be gradiated by the severity of the offense, ranging from fraud to negligence; and they should apply to failure to file and failure to pay and wrongful retention of funds that the taxpayer has collected which already belong to the Government.

There should be no no-fault penalties, and there should be a rule of "no harm, no foul" as applies in football. The Government should be prejudiced before the penalty applies, and we should take into account the role of higher interest charges. Thank you very much, Senator.

Senator PRYOR. Mr. White, thank you for your testimony today. I will have a couple of questions in a moment. We will continue listening now to other members of this panel.

Next is Mr. David Silverman, member of the Government Relations Committee, the National Association of Enrolled Agents, New York. Thank you, Mr. Silverman, for your attendance and for your testimony.

[The prepared statement of Mr. White appears in the appendix.]

STATEMENT OF DAVID J. SILVERMAN, MEMBER, GOVERNMENT RELATIONS COMMITTEE, NATIONAL ASSOCIATION OF ENROLLED AGENTS, NEW YORK, NY

Mr. SILVERMAN. Thank you, Mr. Chairman. On behalf of the National Association of Enrolled Agents, whose members are tax practitioners enrolled to practice before the Internal Revenue Service, I am going to limit my testimony to the four penalty areas that our clients most frequently encounter.

Philosophically, the penalty that is most difficult to justify is the late payment penalty. This penalty, which assesses a taxpayer a half percent a month to a maximum of 25 percent, treats the inability to pay as a civil violation of the Internal Revenue Code.

The inability to pay should not be confused with the willful failure to pay; the two are separate and distinct. Bankruptcy laws were enacted in response to this distinction. Penalties should be limited to violations of law.

The second penalty that I would like to discuss is the 10 percent penalty for failing to timely deposit withholding taxes. In many instances, Mr. Chairman, this penalty appears to be working against the purpose for which it was enacted to ensure the expeditious collection of withholding taxes.

The law requires that, once an employer withholds $3,000.00 or more in withholding taxes, these funds must be transmitted to the Government by way of making a deposit at the taxpayer's local bank.

By way of an example, if on January 6 an employer has to make a $10,000 deposit and on January 6 he looks at his watch and discovers that it is 3 p.m. and the bank is closed, he has incurred a $1,000 penalty. At this point, it costs the taxpayer nothing extra to hold onto these funds for another 90 days until the end of the quarter in which to transmit these funds.

The law treats a day late the same as being three months late. We strongly urge the Congress to amend this Code section to require that the IRS take into account a taxpayer's timely compliance record together with his efforts to correct any delinquency before this penalty is assessed.

Mr. Chairman, there is probably not a penalty that has engendered as much litigation as the 100 percent penalty for the failure of a responsible person to collect and pay over withholding taxes. In its zeal to collect trust funds, IRS officers too often have indiscriminately applied this penalty.

In my 25 years of practice, I have defended bookkeepers, office managers, shop foremen, even the brother-in-law of a corporate officer from having this penalty assessed against them. This penalty has a history of being applied on a "guilty unless proven innocent" basis. We recommend that this Code section be amended so that the burden of proof is shifted from the taxpayer to the IRS before it is applied.

In concluding, I would like to discuss Code Section 6404. This section permits the Commissioner to abate an assessment of interest on a deficiency if interest is attributable, in whole or in part, to an error or delay by an officer employed by the IRS in performing a ministerial act.

However, the regulations issued under this section defeat the spirit of what Congress intended when this section was enacted. Specifically, examples 4 and 5 of the temporary regulation state that, if a revenue agent is either sent to a training course or assigned other tasks and his supervisor decides not to reassign the agent's case, such a delay is not a failure to perform a ministerial act.

Mr. Chairman, if the Service does not perceive the inability to expeditiously complete a examination to be the failure to perform a ministerial act, then the Congress should amend this Code section so that a ministerial act is precisely defined.

If I might take 30 seconds to cite an example where a taxpayer didn't owe two cents in tax, in fact he didn't owe anything, and had a $500 penalty assessed. Specifically, he incorrectly filled out the withholding exemption form. Granted, he was being underwithheld; but on April 15, he paid the exact liability that was due per his 1040. The IRS penalized him $500 for incorrectly filling out that withholding exemption.

Mr. Chairman, the National Association of Enrolled Agents applauds the work of the committee, and we would be happy to answer any questions that you might have; and we appreciate being included in your task force to study this area.

Senator PRYOR. Mr. Silverman, in the example of the $500 penalty assessed on no liability, what happened to that penalty? Was that abated? Do you recall?

Mr. SILVERMAN. The taxpayer threw up his hands and said it is just too much to fight city hall; and he paid the $500.

Senator PRYOR. So, the IRS got a windfall of $500 on that?

Mr. SILVERMAN. That is true. In our written statement, we show how the abatement process is not workable. Quite often, the IRS issues rules in which they will abate a penalty; and you cite those rules and you send a letter to the IRS, and you get back a form letter—no explanation—just that it does not meet the criteria.

And it is obvious that this was not prepared by or even seen by human eyes because it is not responsive to the abatement request. And when you figure the cost of trying to fight city hall, a lot of taxpayers just throw up their hands and say it is easier to pay the $500 than to—forgive me—make a Federal case out of this.

Senator PRYOR. Thank you, Mr. Silverman. I have a couple more questions in just a moment.

Our next witness is Mr. Gary Rohrs, Member of the Federal Taxation Committee, National Society of Public Accountants, Independence, Michigan. Mr. Rohrs?

[The prepared statement of Mr. Silverman appears in the appendix.]

STATEMENT OF GARY C. ROHRS, MEMBER, FEDERAL TAXATION COMMITTEE, NATIONAL SOCIETY OF PUBLIC ACCOUNTANTS, INDEPENDENCE, MO

Mr. ROHRS. Thank you, Senator. I appreciate the opportunity to testify here today before the Senate Finance Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service. I am from Independence, Missouri.

Senator PRYOR. Oh, I have Independence, Michigan.

Mr. ROHRS. No.

Senator PRYOR. I should have known you look like a man from Missouri.

Mr. ROHRS. We hope so.

Senator PRYOR. I apologize to you.

Mr. ROHRS. Thank you. I am an independent accountant, and I am enrolled to practice before the Internal Revenue Service. Currently, I hold a seat on the Board of Governors of the National Society of Public Accountants.

The services which I provide my clients are fairly typical of the other 21,000 members of NSPA who, for the most part, are sole practitioners or partners in moderately sized public accounting firms. NSPA provides accounting, auditing, tax preparation, tax planning, financial planning and management advisory services to over four million individuals and small business clients.

I am pleased to inform the subcommittee that NSPA's testimony has the support of the Small Business Legislative Council, of which NSPA is a member.

SBLC is a permanent independent coalition of 90 trade and professional associations that share a common commitment to the future of small business. The National Society applauds Chairman David Pryor and the other subcommittee members for conducting this hearing on a timely topic of immense importance to American taxpayers and tax practitioners.

NSPA firmly supports the desire of this subcommittee to conduct a comprehensive review of Internal Revenue Code penalty provisions.

In a paper released to the Commissioner's Advisory Group in December 1986, the IRS stated that the Federal Government assessed 22 million penalties for a total of $5.7 billion for fiscal year ending September 30, 1985. The Service also reported that 4.5 million penalties were abated that year, for a total of $2.6 billion.

Further, the IRS reported in the same paper that 19.8 million penalties were computer-generated in fiscal year 1985, which amounted to $3.8 million. The Society believes that these statistics highlight the tax penalty problem.

First, these statistics show that there is a problem with the accuracy of penalty assessments, as indicated by the fact that $2.6 billion of tax penalties were ultimately abated for fiscal year 1985. In terms of total dollars assessed, this means that 45.6 percent of all penalties assessed during fiscal year 1985 were computer generated.

The National Society also believes that the current system of tax penalties is not accomplishing its primary objective, which is generally considered to be the promotion of increased tax compliance and deterrence. Instead, the current IRS procedures have only touched the surface of the noncompliance dilemma.

There are other areas, such as the cash economy, which the IRS administrative procedures are not reaching, as there is currently no effective way of tracing such funds. Quite naturally, the members of NSPA are particularly concerned about the penalties imposed on tax return preparers. Under the Internal Revenue Code, penalties are generally imposed on preparers due to acts of negligence, willful neglect, or intentional disregard of rules and regulations.

However, misapplication of the preparer penalties by the Internal Revenue Service—if it does happen—could lead to a breakdown in the practitioner/IRS working relationship, which without any lack of emphasis is so very important to the tax compliance process.

For purposes of the subcommittee investigation, NSPA recommends that an attempt be made to combine and simplify the various penalty provisions under the Tax Code. Overlapping penalties or inconsistencies in enforcement of such penalties should be eliminated. Moreover, the trend toward using penalties as revenue raisers must be immediately stopped.

In order to improve compliance and enforcement, efforts must be made to encourage more uniform application of the penalties themselves. More specifically, the ambiguity of when penalties apply and when they are imposed should be eliminated.

The National Society strongly recommends that the Congress and the IRS conduct an immediate campaign to educate the public about the importance of tax compliance. There should be an emphasis on those civil penalties which are designed to address the taxpayer's failure to file his or her return or failure to report income; and the public should be educated and made aware of the consequences of noncompliance.

Efforts must also be made to eliminate the inconsistencies in the application of reasonable cause, negligence, and willfulness standards contained in the penalty provisions themselves. This is especially important in the area of preparer penalties. In particular, penalties should not be imposed which involve areas of the tax law where no regulations or technical guidance exist or there is no clear trend with respect to court decisions.

Reform of the current tax penalty provisions of the Tax Code is an extremely arduous task. NSPA commends this committee for conducting an investigation into such an important matter for the American tax-paying public. We also commend your efforts on behalf of the Taxpayer's Bill of Rights, which we support.

The National Society stands ready to discuss any of the above recommendations contained in this testimony. Thank you, Senator.

Senator PRYOR. Thank you very much, Mr. Rohrs. I will have a couple of quick questions in just a moment, after we hear from our final witness, Mr. Herbert J. Lerner, who is Chairman of the Federal Taxation Executive Committee, American Institute of Certified Public Accountants, Washington, DC.

Mr. Lerner, we appreciate very much your being here and look forward to your statement.

[The prepared statement of Mr. Rohrs appears in the appendix.]

STATEMENT OF HERBERT J. LERNER, CHAIRMAN, FEDERAL TAXATION EXECUTIVE COMMITTEE, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, WASHINGTON, DC

Mr. LERNER. Thank you very much, Mr. Chairman. AICPA is the national professional organization of CPAs, with more than 264,000 members in public practice, in industry, in Government, and in education. A large portion of our members are actively engaged in tax practice, and they represent millions of individuals and businesses on tax matters.

I am privileged to chair the Tax Division's Executive Committee and present the views of our association in connection with these hearings and we certainly appreciate the opportunity to do so.

We share your desire to simplify and rationalize the civil tax penalty structure. As practitioners, we are directly impacted by the present level of complexity. The AICPA Tax Division recently formed a Penalty Task Force to address this subject, and it is expected that the task force will develop its own detailed recommendations to our Executive Committee, which we will be prepared to present to your subcommittee some time before September 30, 1988.

My comments this morning are going to be in two parts. First, I would like to note four specific areas that we urge your subcommittee to examine as part of its review; and after that, I would like to describe briefly the approach that our task force is taking.

The threshold area that we think needs to be addressed very early is the appropriate role of tax penalties within the system. Others have commented on that subject today; and while there is general agreement that the principal objective of civil tax penalties should be to promote compliance on the part of taxpayers, I think there is fairly widespread disagreement that even a minor objective should be to raise revenue or to reimburse the IRS for the administrative costs of enforcement and collection.

I think our membership would have considerable concern that Congress seems to be increasingly viewing tax penalties as a source of revenue; we certainly saw that in the 1986 and 1987 Acts.

The second area is one that has received relatively little attention today, but we think it is worthy of your consideration. We suggest that you consider the relative impact of examinations as compared to penalties in encouraging taxpayer compliance.

For many taxpayers, the desire to avoid examination is probably a stronger motivating influence for tax compliance than is the complex little-understood penalty structure that is presently in place. As the IRS develops more sophisticated techniques for selecting returns for examination and more efficient methods for conducting examinations, including the document matching programs, you may well conclude that some of the existing penalties are no longer necessary to promote the kind of compliance that they were originally enacted to do; and perhaps others could be enacted which could be more simplified and less severe in light of the increased examination program.

The third area is one that seems critical to any penalty study, and that is a clear examination regarding the severity of the penalty provision and its relativeness to the seriousness of the infraction. We think special attention needs to be paid to the present situation where multiple penalties can be applied to a single infraction.

Perhaps inadvertent or careless errors or first-time offenses, for example, in the information reporting area should be dealt with a lot less severely than in other situations. Also involved in this issue is the fact that the stigma attached to being penalized, particularly for tax professionals, may outweigh the monetary cost associated with the penalty.

When one considers that the mere assertion of a penalty can call into issue the practitioner's future right to practice before the Treasury and the IRS, it is essential that the severity of the penalty be carefully matched with the seriousness of the infraction

The fourth area arises from the sheer magnitude of the tax system. Millions of individuals and entities worldwide are potential subjects to being penalized by the IRS which has tens of thousands of employees. In such an environment I think it is essential that penalties be structured in such a way that they can be administered equitably and even handedly throughout the system.

When I listened to the earlier statement regarding the dozen or so standards for imposition of penalties, it just magnifies the importance of rationalization of the system and the even-handedness of its administration.

Our task force is made up of individuals from a wide variety of practitioners from national, regional, and local firms all around the country. They are designing a practitioner survey that will reflect the opinions and experiences of our 20,000 plus members of the Tax Division of the AICPA.

The survey will focus on the administratively of the penalty system from the point of view of the practitioner, and our report will cover preparer penalties and those taxpayer penalties that our survey indicates are most burdensome or are most difficult to administer fairly and uniformly.

In conclusion, I would like to point out that we detect a widespread expectation that with Congress, the Service, and many private individuals addressing this issue at this time, the end results really have to be a meaningful improvement in this area of great concern. The expectations are now heightened. The AICPA would certainly be pleased to continue to assist in your deliberations in this area. Thank you Mr. Chairman.

Senator PRYOR. Mr. Lerner, thank you.

[The prepared statement of Mr. Lerner appears in the appendix.]

Senator PRYOR. I am looking at the panel and I see that four of the five of you—I would guess—would assist from time to time in the preparation of income tax returns.

I assume that Mr. Silverman does this, but I doubt that Mr. White does since he is representing the Association of Manufacturers. So, I assume you have someone to assist you.

Before the five of you assist, and you are out there liable, potentially, for a penalty to be assessed against you, I want to talk about these penalties against the tax preparers and those giving advice in tax preparation. Are these on the increase? Has Congress caused this? Or is this an IRS interpretation of what they think the Congress wants done?

Do you have an answer or a comment? Are they too severe?

Mr. SILVERMAN. Yes. The Director of Practice has proposed, I think under Section 6661, a substantial understatement penalty that, if a preparer doesn't explain a penalty to the taxpayer, the practitioner could face disbarment or suspension unless the preparer takes a position that the taxpayer disclose on the tax return an inconsistent or adversarial position to existing law.

There was a firestorm of controversy about this, and I think the Director of Practice is currently rethinking these proposed regulations; but they were rather severe, that is, those that could be assessed against the practitioner community.

Senator PRYOR. Is the potential liability for the tax preparer more or less than it was, lets say, 5 years ago.

Mr. SILVERMAN. They are not that great. I think they are $100 or $500. You are not talking about dollars and cents a great deal, but as Mr. Lerner had mentioned, it is by punishing someone by suspending them from practice.

Senator PRYOR. And the word gets around.

Mr. SILVERMAN. That is right.

Senator PRYOR. Mr. Lerner do you have a comment on that?

Mr. LERNER. Yes. We haven't had any substantial change in the preparer penalties since 1976. The standard at that time was intentional or willful disregard of rules and regulations, which could result in a $100 penalty, or a willful effort to understate someone's liability, which could result in a $500 penalty. Those dollars are not substantial, but I believe it is the application of the penalty that has created the problem and for which there is some concern. I don't know that I have statistics that would suggest that there is a rampant assertion of the $100 or $500 penalties.

But when the statutory language is negligent or intentional disregard—and that is interpreted to include, for example, a couple of math errors on a return, which might lead to assertion of a $100 penalty on a preparer—or transpositions, which might point to a consistent pattern—it would and probably ought to raise concern.

That is an area of concern, particularly when one's right to practice in the future is at stake through an automatic referral of asserted penalties under Section 6694 to the Director of Practice.

I think the legislative change that has really impacted practitioners is really on taxpayers. That is, the concern about maintaining the balance between your role as an advocate on the part of a taxpayer and your responsibility to the system, which has a somewhat deep wedge in it right now by virtue of a potential 25 percent substantial understatement penalty under section 6661.

And sometimes, that is rather difficult to deal with from a practice standpoint. No matter how open your attempt may be, you may find the circumstances such that the client is exposed to a very large penalty which may run down to the practitioner.

Senator PRYOR. Mr. Hall, your committee report by the American Bar Taxation Section, we hope to receive soon. Is this going to look at preparer penalties?

Mr. HALL. Yes, sir, it is. It is going to devote a large section to it, and it is going to suggest, I believe, that a lot of the tax return preparer penalties do not need too much attention; but a lot of them do—aiding and abetting penalties, the frivolous return, the valuation penalty, for example.

Senator PRYOR. And that is relatively new.

Mr. HALL. That is a relatively new penalty and one which some people think could be done away with.

Senator PRYOR. Now, I want to ask Mr. White a question. You talked about the substantial understatement penalty. You think that is inappropriate and should not be in the IRS Code. Would this penalty force taxpayers to be more careful when they file their tax returns? And why do you think this is necessarily a bad penalty?

Mr. WHITE. My perspective may be somewhat different than those who assist small taxpayers in preparation of their returns; but when we prepare our return, we know that the return will be audited. We are a controlled large-case audit. It is not possible, as Mr. Alexander suggested, in a return such as I am responsible for to have a $10 million item that is not going to receive careful scrutiny in the course of auditing the return. We know every return will be audited, audited thoroughly, and any items of any significance will receive thorough-going review by revenue agents who are pretty competent.

The thing that concerns me is not particularly that we will take a position that we don't tell the Internal Revenue Service about, but that there will be a position implicit in the return about which we know nothing, which becomes a trap for us, and it will become the basis upon which an assessment of a penalty might be made, even though we didn't know that the position was in the return and had no way of finding it other than a vast increase in our staff, beyond anything we could do.

Senator PRYOR. Let's assume there was a negligence infraction, and you or your tax preparer had filled out something on the wrong line or, let's say, it was a day late or whatever. In a corporate outlook, in a corporate insight, how do you decide whether to fight or to litigate that penalty? Do you just pay it and say we don't want to be bothered with the time loss? At what stage do you get to the point where you say, by gosh, we are going to take this thing to court; we will go all the way.

Where does the corporate executive make that decision?

Mr. WHITE. We have one person on my staff who does nothing but handle the Internal Revenue Service audit. She is full time on that job, a CPA, a thoroughly trained accountant who handles our day-to-day interface with the agents.

If the items are items as they often are, where we have made a mistake either in interpreting the law or we have made a mistake in concluding what the facts were when the return was prepared, we wouldn't contest an issue.

On the other hand, if we believe that an issue is one in which our position is a reasonable position, we would take it through all of the processes, through appellate conference, and if necessary, carry it to litigation.

However, I would point out that we have only had to take two issues to litigation in my 15 years of working with the Dow Chemical Company's tax returns. So, most of the items get resolved on an amicable basis with the Revenue Service, without resorting to litigation.

If penalties become involved, however, then to protect the corporation's position, I might find that it was necessary to take the issue to litigation just to get the penalty disspelled to show that we were in good faith compliance with the statute.

Senator PRYOR. Now, you are with Dow Chemical, and you have a full-time person, a CPA, just to deal with this all the time. And you know who to go to to try to get something resolved with the IRS. Where does the average taxpayer go to get resolution of, let's say, a problem. Mr. Rohrs, you represent a lot of small businesses.

Mr. ROHRS. Hopefully, he might come to me or one of my members of the national society. That is the concern that we all have, that too many of the tax-paying public are accepting IRS penalties because they received the notice in the mail; and if the IRS said it, it must be true. Therefore, they are paying it, and they are paying all of the concurrent penalties that are attached to it, in addition to the underpayment of tax and interest that might be there, without giving themselves the opportunity for the proper redress because of fear of raising a stigma over their name being placed on some list that might in the future be brought up again and cause them additional problems.

I think the whole penalty aspect of the Code now extends to the fact that, if you want to talk about fairness, we all have an opportunity to be penalized; and maybe that is the aspect that brings out fairness.

There is too much out there in that regard. For the slightest of infractions there are penalties; and we all live in some sort of a state of concern, if you will—it would perhaps be inappropriate to use the word "fear"—but a concern that we might be doing something wrong. And I think the penalties that are basically being applied today are "catching" the individuals they were not intended to catch in the first place. They are catching the average taxpayer who is making a bona fide effort to report and pay his income tax properly, even seeking outside services. And when the professional community is concerned about their ability to properly apply the tax law, it is a real problem.

The ones we are not catching, we are not going to catch with penalties because it is like every other law out there. A burglar doesn't not break into a home because there is a law against burglary. Isn't that correct? He still burglarizes homes and/or other places. The same thing is true for the tax fraud cheat; he is going to continue to do it, and other methods need to be implemented to secure those people in the penalty process that they need to be caught at, not the average taxpayer who is making a simple mistake—the two cent mistake.

Senator PRYOR. Mr. Silverman.

Mr. SILVERMAN. Mr. Chairman, if you made a $1,000 payment to the IRS and some clerk at the service center misposted that and they didn't credit your account, then you would receive a bill that you owed $1,000, interest and penalties. And if you sent the IRS a copy of that cancelled check, somewhere along the line they would credit your account; and then you would receive a new notice saying that you owed penalties and interest.

Then, you start the process a second time around. It is a very burdensome process for the small taxpayer who is struggling under a blizzard of IRS forms to cope with that. And sometimes, on these minor items—and it is up to everyone's discretion as to what is a minor item—it is just easier to pay the assessment than to hire someone—it is not cost effective—to protest a $60 penalty.

Mr. ROHRS. I have had four instances within the last three months of taxpayers receiving notices on the cross matching program of IRS on 1099s, not an intentional effort on their part to overlook a 1099 that they didn't put on their tax return; but it resulted in some additional penalties out there. And they researched their tax return, called me up—fortunately, since we did the tax return—and said we have received this penalty notice.

We understand it—and he was one of the few who did—and he said we did omit this particular item. Should we just go ahead and pay it?

And I said, well, I don't think so. I think you should allow me to look at it and see what other items are on that penalty notice because perhaps they are sticking you with something in addition to just the underpayment of tax and interest that is not rightfully so with the proper explanation.

They gave me the reasons things have been overlooked. We provided that information; and in every single instance, those penalties were abated. Now, had that person not sought out the additional service, raised the question and/or written them himself, he would have paid an additional windfall to the IRS.

Senator PRYOR. Now, Mr. Hall is a great tax lawyer from Texas. I have known him for a couple of years now, and he talks about 13 different standards of conduct—standards of conduct—subject to penalties.

Now, Mr. Hall, can you explain to us what is a "standard of conduct" and give me an example of some of these? Who decides whether a taxpayer has exemplified the necessary standard of conduct, or has met the test of a standard? Who decides that?

Mr. HALL. Initially, the revenue agent or his superior and then the courts decide it. One example of conduct has to do with waiver of penalties. Some penalties may be waived if there has been due diligence; others may be waived if there has been reasonable cause.

When I gave you the 13 number I was thinking of 13 different ways of describing things like that. You asked about conduct. One thing I wish the committee would consider is some sort of logical progression of penalties in proportion to culpability.

For example if in one place in the Code it could be stated that if you have criminal intent, you go to prison, or you pay a fine; if you have civil fraud, you pay 50 percent on just the fraud item; if you are negligent, 25 percent; if you understate, 10 percent. You pick your percentages; you could start higher or start lower.

And then do away with the valuation penalties which just complicate it, but rely on the understatement. Make the understatement apply to all taxes, not just income taxes; and if possible, have one defined that lists different types of conduct with the standards and the sanction by each.

Senator PRYOR. If the IRS agent decides that taxpayer John Doe did not exercise due diligence and he assesses a penalty because of lack of due diligence, does John Doe, the taxpayer, or the agent have the burden of proof in that instance?

Mr. HALL. Below fraud, the taxpayer has the burden.

Senator PRYOR. So, John Doe would have the burden of proof showing that he used due diligence. Is this correct?

Mr. HALL. Yes, sir.

Senator PRYOR. He never had that chance; he would probably just pay it in order to get the IRS off of his back.

Mr. HALL. Or have reasonable cause for his actions.

Senator PRYOR. Yes.

Mr. HALL. Of course, one of the problems is that penalties in the audit process are thrown out as a threat sometimes.

Senator PRYOR. Right.

Mr. HALL. Against IRS instructions, but they are thrown out—excuse me, they are added in, I should say—thrown out on the table; and that is unhealthy.

Usually, they get resolved. You asked one of the other witnesses when does a corporation fight. In my experience, I see that agents throw out penalties as a bargaining tool, and then corporate executives fight to the hilt if those penalties aren't removed. The average corporate executive I deal with will fight a negligence penalty about as hard as he will fight anything because it impunes his organization.

Senator PRYOR. Speaking about organization, you stated that there is no internal coordination within the present penalty structure, and that one single act of misconduct or negligence can result—I think you said—in the imposition of multiple penalties.

How can this happen, and what can we do about this?

Mr. HALL. It happens if you have negligence and you have an understatement and maybe you have an overvaluation, and not all of these overlap; but several of them can. And the way I think the committee should address it is to come up with some structure, such as I outlined a minute ago, and make it clear that at certain levels penalties apply and only that penalty applies at that level.

Senator PRYOR. I believe Mr. Lerner may share that viewpoint. I believe he stated something in his opening statement to that effect.

Mr. LERNER. I would agree with that. I think you need that kind of rationalization to address this problem of, one, the excessive number of standards for infraction and, two, overlapping aspects of penalties.

But I think, as you approach this area, you are going to uncover a whole host of things along those lines. There are $50 penalties which are for fairly bad acts, and there are $50 penalties which are for fairly minor infractions. It doesn't make any sense to have the same dollar penalty for something that is really a willful failure to furnish statements to an employer regarding tips so that the employee can adequately prepare his or her tax return. That is a $50 penalty; and there is a similar $50 penalty for failure to include an I.D. number on a taxpayer information return, which is not necessarily willful.

So, you have a willful one in one case and an inadvertence in another, both having a $50 penalty. That doesn't make any sense.

Mr. ROHRS. Another good example of that, Senator, in the same area—the 1099s—information returns for nonemployee compensation type of thing. Maybe you have a small taxpayer who comes in for his tax return, and he is a procrastinator like many of us are, and doesn't come in until after March 1 to have his work done.

He does his own record-keeping; and you find out in the process of preparing his Schedule C that he has X thousands of dollars that he has perhaps paid for contract labor, as he calls it. Those require 1099s to be issued; and you are now late in giving it to the individual recipient. That was due January 31. You are late in filing with the IRS; that was due on February 28, and it is a $50 fine for not having filed those.

It is also a $50 fine for filing it late. What do you advise the client to do? Do you say run the gamut, play the "IRS lottery," as Commissioner Gibbs referred to it earlier and take your two percent chance of being audited and caught? It is the same penalty; no incremental advantage at all.

Senator PRYOR. Mr. Lerner.

Mr. LERNER. Yes, I think that is a very good example. One way to address that really would be to have some mechanism whereby you are required to file. There are two aspects to your problem. One describes the other—the magnetic tape for filing it. The magnetic tape for filing it really can be cured by not imposing the magnetic tape filing in the first year when you are not close to the limit until the end of the year, since prior approval must be obtained from the service as to form of magnetic media the taxpayer will use.

Right now, there is sort of a cliff vesting approach to magnetic media filing. If you file more than 250 W-2s or 50 1099s for interest and dividends, or 250 1099s for other payments, you have got to make the magnetic media filing.

People, particularly those who haven't previously been subject to the magnetic media reporting requirements, will meet that limit at some point during the year—maybe on the last day of the year—so that their ability to even gear up to magnetic media filing is not possible within the time frame required.

I just saw recently one hospital assessed a $25,000 plus penalty for just having exceeded its 500 limit on 1099s for non-interest and dividends. They didn't know about it for 1986; and they got a $25,000 penalty for having gone to 507 or so 1099s; and the IRS had all the data on paper. I mean, they have all the 1099s on paper; it was a penalty for just failing to provide the magnetic tape data.

Senator PRYOR. Will that penalty be ultimately abated, or will that taxpayer have to pay that exact amount?

Mr. LERNER. We just got it March 1, and we are addressing it now. I hope it will be abated.

Senator PRYOR. One of our final questions, and I would like to ask this of all the panel: Is our system of taxation losing credibility with the average taxpayer in this country?

Mr. LERNER. If you received that kind of notice and you knew that you did everything that you could, and this is for the year 1986—they have already filed the magnetic tape for 1987—so it isn't anything except going back in time. It isn't causing greater compliance. It really isn't doing that. I think that taxpayer certainly is not too pleased with the system, and I am sure there are others.

Senator PRYOR. Mr. Hall, what about your clients that you deal with? Is credibility, trust—let's see what Mr. Gibbs said we had to have. Respect, confidence, and support.

Do we have as much respect, confidence, and support of our tax system as we did ten years ago?

Mr. HALL. The people I deal with are discouraged and disheartened. True, the rates are down, but that seems to be at the expense of an inordinate number of complexities, including these penalties. I think a lot of them—but I am getting off of what I am authorized to say; this is strictly personal—but I think a lot of them would trade just a few points in rates to get rid of a bunch of these penalties and a bunch of this complexity that has gone in.

Senator PRYOR. Mr. Silverman.

Mr. SILVERMAN. I think the problem with compliance can be traced to the inflation of the last 15 years where plain, ordinary working people were escalated into tax rates that were really intended for the very rich.

I was called in by a major symphony when they were negotiating a contract. In 1963, the base pay was $13,000 a year or $50 a week—something like that—and their tax liability—Social Security tax, State tax, Federal tax—amounted to $2,000 or $3,000. So, the net take-home was $10,000.

In 1986, they asked me to apply the cost of living to see what the consumer price index was to that; that amounted to $28,000, when you grossed up their salary. It now came to $43,000.

This has escalated people into these rates, and you find people coming in with tax schemes and buying tax shelters which at one point you thought were really reserved for the domain of the very rich.

Senator PRYOR. Thank you, Mr. Silverman. Mr. White?

Mr. WHITE. From discussing this whole complexity issue with other professionals who are responsible for large tax returns, it is becoming obvious to me that many of them feel completely defeated in their ability to comply with the Internal Revenue laws.

We are counseling people against that, but I am convinced that many are going to take short cuts that are unwarranted simply because they do not believe they have either the ability or the computer or manpower capacity to comply with the Internal Revenue laws.

Senator PRYOR. Mr. Rohrs.

Mr. ROHRS. I believe that the credibility of the taxing system is severely impaired. I believe that my clients are concerned about the cost effectiveness of administrating those tax laws. They are, as I refer to them—and not disparagingly so—the hamburger slingers and the hair stylists and the small manufacturers and the professional people who are out there doing the things that America is all about.

They are not accountants; that is why they hire us, but they don't have a full-time accounting staff on board, and they have a difficult time.

If Dow Chemical has a difficult time, what does the small individual do? He has himself and perhaps a secretary and an additional person in his office, and he relies upon services such as mine; and we try to do the best that we can.

I think we are also seeing a certain "get even" attitude fostering in some respects out there. They may sit across the table and see an audit go against them for something that they deem to be very minor; and in fact, as we have heard testimony today, the act was very minor, but they still got "dinged" for it. And they got dinged somewhat unjustly.

And they sit there, and they say on the way home from the audit: "I will get them. I will get back at them some way or another." And I won't have any ability to detect that at the time I prepare the tax return perhaps or at the time that I am doing the work for them on an accounting basis.

They will have gotten their ounce of retribution some other place. That is not what we are trying to achieve in the system. That is not what I am trying to achieve as a professional. I don't think that any of the others at this table, or any of the others who have come before us, are trying to achieve that. We are caught in an in-between role.

We are trying to administer at the local level the tax laws of this country and to tell people what they are obligated to pay and why it is just. And at the same time, they are having to pay us to do that because it is too complicated for them to figure out themselves.

I have a phrase that most people liken to, and that is the fact that they really have a problem paying somebody to tell them how much they have to pay.

Senator PRYOR. Yes. I assume Dow Chemical started off as what we call a small business.

Mr. WHITE. Very much so.

Senator PRYOR. But today, I do not, for the life of me, know how a small business can start off in the United States of America any longer. With all the local, the State and Federal governments have put on their backs, I don't know how they can even get off the ground, with weekly and quarterly and yearly requirements just in paperwork. I don't know how a small business even starts.

Mr. ROHRS. Senator, I have said that if my clients knew everything they were supposed to know before they went into business, they wouldn't go into business. Unfortunately, that is not what this country was built on. You know, entrepreneurship and self-achievement is the hallmark of the American way. So, they go out and do it, anyway. So, maybe I am glad that every now and then I get a client who finally comes to an accountant 18 months after he went into business to find out what he should have done from day one.

Senator PRYOR. Mr. White.

Mr. WHITE. We have recently done some economic modeling, and we find the Internal Revenue Code is indeed a severe inhibition for small rapid-growing businesses and it is a matter of concern.

Those people are our customers. Those people are people we would like to do business with, and they are clearly impaired by the Code.

Senator PRYOR. If you have those results and if they could be seen by members of this committee and the staff, we would very much appreciate getting that.

Mr. WHITE. We will make them available.

Senator PRYOR. We would appreciate that, Mr. White.

[The information appears in the appendix.]

Senator PRYOR. Any concluding statements? Mr. Hall. Mr. Silverman. Mr. Lerner.

Mr. SILVERMAN. I would just second the statement on the cost of compliance. It is enormous, and it is a growing industry, I would guess.

Senator PRYOR. Mr. Hall.

Mr. HALL. No, thank you.

Senator PRYOR. Thank you, Mr. Hall. Mr. Lerner.

Mr. LERNER. Just one last point. This is an unusual year, the first year in which we are implementing major changes in the 1986 Act. And I wonder whether, as part of your deliberations, you might also consider whether special provisions are needed to address the likely high error rate that is going to occur certainly in the complex returns in the 1988 filing season and whether that deserves some special consideration from a penalty standpoint, notwithstanding that your study may not involve the completion of legislation until 1989.

Senator PRYOR. Fine. Thank you for that thought, Mr. Lerner. Gentlemen of this final panel, let me thank you on behalf of the committee. We will have the transcript of this testimony available in the next several weeks. You all, of course will be receiving a copy of the transcript of this morning's hearing.

This is the first—as I repeat—of several hearings just on penalties. This is the first hearing the Congress has ever had, I guess, on penalties within the Internal Revenue Service Code.

Let me, if I might, as a personal note thank the members not only of my own staff for helping in this preparation, but also the members of the Senate Finance Committee staff and the Joint Committee on Taxation staff for helping in getting ready for this particular hearing. It takes quite a bit to get ready for a hearing like this. We are very appreciative for their support work and very appreciative for all of the witnesses that we have had this morning.

This meeting stands adjourned. Thank you.

[Whereupon, at 12:24 p.m., the hearing was adjourned.]

APPENDIX

ALPHABETICAL LIST AND MATERIAL SUBMITTED

DESCRIPTION OF TAX PENALTIES

SCHEDULED FOR A PUBLIC HEARING

BEFORE THE

SUBCOMMITTEE ON PRIVATE RETIREMENT PLANS AND OVERSIGHT OF THE INTERNAL REVENUE SERVICE

OF THE

SENATE COMMITTEE ON FINANCE

ON

MARCH 14, 1988

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

INTRODUCTION

The Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service of the Senate Committee on Finance has scheduled a public hearing on the subject of tax penalties on March 14, 1988. This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides an overview of the major penalties currently in the Internal Revenue Code, a discussion of some significant issues relating to the current penalty structure, and a listing of the penalties contained in the Code.

The first part of the pamphlet describes the major tax penalties under present law. The second part discusses background and significant issues concerning tax penalties. The Appendix presents a list of current tax penalties.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Description of Tax Penalties* (JCS-4-88), March 9, 1988.

I. DESCRIPTION OF SIGNIFICANT PENALTIES

A. Overview

Tax penalties are generally designed to preserve the integrity of the tax system, and have been a component of the tax laws since the Revenue Act of 1913. Although the Internal Revenue Code includes a large number of penalties, only a relatively small number of these penalties are of general applicability. This portion of the pamphlet describes the more significant penalties of general applicability. The Appendix contains a listing of the tax penalties (including the penalty excise taxes) in the Code.

B. Negligence Penalty [2]

Under present law, a taxpayer is subject to a penalty if any part of an underpayment of tax is due to negligence or disregard of rules and regulations. The amount of this penalty is the sum of two components. The first component is an amount equal to 5 percent of the total amount of the underpayment of tax by the taxpayer (whether or not the entire underpayment is the result of the taxpayer's negligence). The second component is an amount equal to 50 percent of the interest payable on the portion of the underpayment attributable to negligence.[3]

For purposes of this penalty, negligence includes any failure to make a reasonable attempt to comply with the provisions of the Code, as well as any careless, reckless, or intentional disregard of rules and regulations.

A special negligence penalty may be imposed with respect to information reporting. If an amount is shown on an information return and the payee or other person with respect to whom the return is made fails properly to show such amount on his or her income tax return, then the portion of any underpayment attributable to such failure is treated as subject to the negligence penalty absent clear and convincing evidence to the contrary.

In some instances, a taxpayer's return might lead to the imposition of both a fraud penalty and a negligence penalty. If an underpayment of a tax is partially attributable to negligence and partially attributable to fraud, the negligence penalty (which generally applies to the entire underpayment of the tax) does not apply to the portion of the underpayment with respect to which a fraud penalty is imposed.

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[2] Section 6653(a).

[3] A technical correction has been considered that would repeal the second component, and, in its place, impose interest on the penalty from the last date prescribed for filing the return to which the penalty relates.

C. Civil Fraud Penalty [4]

Tax fraud can render an individual liable for either civil or criminal sanctions, or both. An individual's actions that provide grounds for a civil tax penalty may also constitute grounds for criminal prosecution for willful attempt to evade or defeat tax.[5] Although civil tax fraud is not statutorily defined, it is generally considered to be intentional wrongdoing on the part of an individual, usually involving an element of deception, with the specific purpose of evading a tax due.

The Code provides that if any portion of an underpayment of tax is due to fraud, a civil penalty may be imposed equal to (1) 75 percent of the portion of the underpayment attributable to fraud, plus (2) an amount equal to 50 percent of the interest payable on the portion of the underpayment attributable to fraud.[6] Prior to the Tax Reform Act of 1986, the fraud penalty was 50 percent of the entire amount of the underpayment, if any portion of the underpayment was attributable to fraud. Thus, the 1986 Act reduced the scope of items to which the fraud penalty applied but increased the rate of the penalty.

Once the IRS establishes that any portion of an underpayment is attributable to fraud, the entire underpayment is treated as attributable to fraud, except to the extent that the taxpayer establishes that any portion of the underpayment is not attributable to fraud. Unlike most other civil penalties, the burden of proof is on the Government to establish that a portion of the underpayment is attributable to civil fraud. Once that burden has been met, the burden shifts to the taxpayer (who is presumed to have the best access to the information) to establish the portion of the underpayment that is not attributable to fraud.

D. Substantial Understatement Penalty [7]

If a taxpayer's correct income tax liability for any taxable year exceeds that reported 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 25 percent of the underpayment of tax attributable to the understatement.

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) in non-tax shelter cases, facts relevant to the tax treatment of the item were adequately disclosed on the return (or a statement attached thereto).[8]

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[4] Section 6653(b).

[5] Significant criminal penalties, including the criminal tax evasion penalty, are discussed below.

[6] A technical correction has been considered that would repeal this second component, and, in its place, impose interest on the penalty from the last date prescribed for filing the return to which the penalty relates.

[7] Section 6661.

[8] A special rule governs items "attributable to a tax shelter," meaning a partnership or other entity, plan or arrangement, the principal purpose of which is the avoidance or evasion of Federal income tax. In the case of such a tax shelter item, adequate disclosure on the return will

Continued

Whether the taxpayer's filing position is or was supported by substantial authority depends on the circumstances of the particular case. In order to determine whether the weight of authorities that support the taxpayer's position is substantial when compared with those supporting other positions, it is necessary to weigh statutory provisions, court opinions, Treasury regulations and official administrative pronouncements (such as published revenue rulings and revenue procedures) that involve the same or similar circumstances and are otherwise pertinent (giving each its proper weight), as well as the Congressional intent reflected in committee reports. The "substantial authority" standard is less stringent than a "more likely than not" (i.e., more than 50 percent) standard but more stringent than a "reasonable basis" (i.e., non-negligent) standard.

The IRS has discretion to waive all or part of the substantial understatement penalty if the taxpayer establishes that there was reasonable cause for the understatement (or part thereof) and that the taxpayer acted in good faith. A waiver could be appropriate, for example, if the taxpayer made a good faith mistake in deciding the proper timing of a deduction.

In determining the amount of the penalty to be imposed for a substantial understatement, no account is to be taken of any portion of the substantial understatement attributable to items on which the overvaluation penalty (*see next item*) is imposed.

E. Valuation Penalties [9]

If an individual, personal service corporation, or certain closely held corporations underpays income tax for any taxable year by $1,000 or more as a result of a "valuation overstatement," then a penalty may be imposed. A parallel penalty applies to valuation understatements for purposes of the estate and gift tax.

A "valuation overstatement" exists when the valuation or adjusted basis of any property claimed on the return is 150 percent or more of the correct value or adjusted basis. Thus, the penalty could be imposed as a result of claimed depreciation based on an inflated adjusted basis in property or claimed charitable contributions of allegedly appreciated property. If the valuation claimed is 150 percent or more but not more than 200 percent of the correct valuation, then a penalty may be imposed equal to 10 percent of the underpayment of tax attributable to the overvaluation. If the valuation claimed is more than 200 percent but not more than 250 percent of the correct valuation, then a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the overvaluation. If the valuation claimed is more than 250 percent of the correct valuation, then a penalty may be imposed equal to 30 per-

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not, by itself, reduce the amount of the understatement. Instead, the amount of the understatement is reduced by the portion attributable to a tax shelter item only if (1) the treatment of the item is or was supported by substantial authority, *and* (2) the taxpayer reasonably believed (based upon the taxpayer's analysis, or that of a professional tax advisor, of pertinent authorities) that the tax treatment claimed was more likely than not the proper treatment.

[9] Sections 6659 and 6660.

cent of the underpayment of tax attributable to the overvaluation.[10]

Both the valuation overstatement penalty and the negligence (or fraud) penalty may be applied with respect to the same underpayment. The IRS may waive all or part of the valuation overstatement penalty on a showing by the taxpayer that there was a reasonable basis for the valuation or adjusted basis claimed on the return and that the claim was made in good faith.

F. Penalties for Failure to File and Failure to Pay

Failure to file [11].—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 the return is not filed, up to a maximum of 5 months or 25 percent. The net amount of tax due is the excess of the amount of 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 the tax. The amount of any applicable credit that may be claimed on the return also may be used to reduce the net amount of tax due.

In the case of a failure to file an income tax return within 60 days of the due date, the failure to file penalty may not be less than the lesser of $100 or 100 percent of the amount required to be shown on the return. In addition, if a penalty for failure to file and a penalty for failure to pay tax shown on a return 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.

Failure to pay tax shown on return[12].—A taxpayer who fails to pay the amount of tax shown on a return is subject to a penalty of 0.5 percent of the amount of tax shown on the return for each month the amount remains unpaid, up to a maximum of 25 percent (50 months). For purposes of calculating the amount of the penalty for any month, the amount of unpaid tax liability is reduced by the amount of tax paid on or before the beginning of that month and by the amount of any credit that may be claimed on the return.[13]

Failure to pay tax after notice and demand[14].—A taxpayer who fails to pay an amount of tax required to be shown on a return that is not so shown within 10 days of notice and demand for such tax is subject to a penalty equal to 0.5 percent of the amount of tax stated in the notice and demand for each month the amount remains unpaid, up to a maximum of 25 percent (50 months). The rate of this penalty increases to one percent for each month the

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[10] For purposes of the estate and gift tax, if the valuation claimed for property is 50 percent or more but not more than 66-2/3 percent of the correct valuation, then a penalty may be imposed equal to 10 percent of the underpayment of tax attributable to the valuation understatement. If the valuation claimed is 40 percent or more but less than 50 percent of the correct valuation, then a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the valuation understatement. If the valuation claimed is less than 40 percent of the correct valuation, then a penalty may be imposed equal to 30 percent of the underpayment of tax attributable to the valuation understatement.

[11] Section 6651(a)(1).

[12] Section 6651(a)(2).

[13] If the amount required to be shown as tax on a return is less than the amount actually shown as tax on the return, the penalty is based on the amount required to be shown as tax on the return.

[14] Section 6651(a)(3).

amount is outstanding after the IRS notifies the taxpayer that the IRS is going to levy upon the assets of the taxpayer.[15] The penalty is applied against the tax stated in the notice and demand, less any partial payments made by the taxpayer.

The IRS has discretion to waive the imposition of any failure to file or failure to pay penalty if the taxpayer's failure was due to reasonable cause and not willful neglect.

G. Information Reporting Penalties [16]

Under present law, the Code requires that information returns be filed with the IRS, and a copy be provided to the taxpayer, detailing all wages, most other types of income, and some deductions. These requirements apply to a variety of specific payments, and are described in a number of Code provisions.

The Code also provides civil penalties for each failure either to file an information return with the IRS or to provide a copy to the taxpayer. The general penalty for failure to supply an information return to the IRS is separate from the penalty for failure to provide a copy to the taxpayer. Generally, these penalties are $50 for each failure, with a maximum penalty of $100,000 per calendar year applicable to failures to file information returns with the IRS, and another maximum penalty of $100,000 per calendar year applicable to failures to provide copies of information returns to payees.[17]

If the failure to file information returns with the IRS is due to intentional disregard of the filing requirement, these penalties are imposed without an overall maximum. In addition, the amount of the penalty per return not filed is increased from $50 to $100 (or a higher amount for some types of information returns).[18]

The Code also provides a penalty[19] of either $5 or $50 (depending on the nature of the failure) for each failure to furnish a correct taxpayer identification number (for individuals, the social security number). These taxpayer identification numbers are the principal means by which the IRS matches the information reported by the third party with the taxpayer's tax return.

The Code also includes a penalty for failure to include correct information either on an information return filed with the IRS or on the copy of that information return supplied to the payee. This penalty applies to both an omission of information or an inclusion of incorrect information. The amount of the penalty is $5 for each information return or payee statement, up to a maximum of $20,000 in any calendar year. This maximum does not apply in cases of intentional disregard of the requirement to file accurate information returns. In addition, the amount of the penalty per inaccurate return is increased in cases of intentional disregard.

The penalty for the failure to include correct information does not apply to an information return if a penalty for failure to

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[15] Section 6651(d).
[16] Sections 6721-6724.
[17] These caps do not apply to failures with respect to interest or dividend returns (section 6724(c)(2)).
[18] For example, the penalty for failure to report cash transactions that exceed $10,000 is 10 percent of the amount that should have been reported.
[19] Section 6676.

supply a correct taxpayer identification number has been imposed with respect to that information return.

In general, no penalty is imposed if the failure to file an information return with the IRS, to provide a copy to the payee, or to include correct information on either of those returns is due to reasonable cause and not to willful neglect.[20] Thus, under this standard, if a person required to file fails to do so because of negligence or without reasonable cause, that person would be subject to these penalties.

H. Estimated Tax Penalties

Individual[21].—Individuals must generally make quarterly estimated tax payments that equal at least 25 percent of the lesser of (1) 100 percent of the prior year's tax liability or (2) 90 percent (80 percent for taxable years beginning before January 1, 1988) of the current year's tax liability. For this purpose, amounts withheld from wages are considered to be estimated tax payments.

If an individual fails to make the required estimated tax payments under these rules, a penalty is imposed. 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. 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 for the installment. 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. No penalty is imposed if the amount of tax shown on the return (net of wage withholding) for any taxable year is less than $500.

Corporate[22].—Under present law, a corporation that fails to pay an installment of estimated income tax on or before the due date generally is subject to a penalty, which may not be waived. 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.

For taxable years beginning after December 31, 1987, the underpayment penalty with respect to any installment applies to the difference between payments made by the due date of the installment and the lesser of an installment based on (1) 90 percent of the tax shown on the return,[23] or (2) 100 percent of the tax shown on the preceding year's return. Exception (2) generally is not available to a large corporation, except that a large corporation can use that exception for purposes of making its first estimated payment for any taxable year. Thus, both large and small corporations may base their first estimated tax payment for any taxable year on 100 percent of the tax shown on the preceding year's return. A large

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[20] Higher standards apply with respect to interest or dividends returns (Section 6724(c)).
[21] Section 6654.
[22] Section 6655.
[23] Corporations may compute these installments as if the income already received during the year was placed on an annual basis if doing so reduces the amount otherwise required to be paid.

corporation is defined as a corporation having at least $1 million of taxable income in any of the three prior taxable years. No penalty is imposed if the tax shown on the return for any taxable year is less than $500.

I. Tax Shelter Penalties

Promoting abusive tax shelters [24].—The Code imposes a penalty upon those who promote abusive tax shelters. The penalty applies to persons who organize, assist in the organization of, or participate 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 organization or sale, the person makes or furnishes either (1) a statement which the person knows or has reason to know is false or fraudulent as to any material matter with respect to the availability of any tax benefit alleged to be allowable by reason of holding an interest in the entity or participating in the plan or arrangement, or (2) a "gross valuation overstatement" (i.e., a representation of the value of services or property which exceeds 200 percent of the correct value and which is directly related to the amount of any income tax deduction or credit allowable to any participant) as to a matter material to the entity, plan or arrangement, whether or not the accuracy of the statement of valuation is disclaimed. Reliance by the purchasing taxpayer or actual underreporting of tax need not be shown.

The amount of the penalty equals the greater of $1,000 or 20 percent of the gross income derived or to be derived by that promoter or organizer from such activity. This penalty is in addition to all other penalties provided for by law.

The IRS may waive all or any part of the penalty in the case of a gross valuation overstatement upon a showing that there was a reasonable basis for the valuation and the valuation was made in good faith.

Aiding and abetting the understatement of tax liability [25].—The Code imposes a penalty on any person who aids, assists in, procures, or advises with respect to the preparation or presentation of any portion of a return or other document under the internal revenue laws which the person knows will be used in connection with any material matter arising under the tax laws, and which the person knows will (if used) result in an understatement of the tax liability of another person. This penalty, which is $1,000 for each return or other document ($10,000 in the case of returns and documents relating to the tax of a corporation), can be imposed whether or not the taxpayer knows of the understatement. The penalty can, however, be imposed only once for any taxable period (or taxable event) with respect to documents relating to any one person.

The aiding and abetting penalty applies only if the person is directly involved in aiding or assisting in the preparation or presentation of a false or fraudulent document that will be used under the tax laws, or directly "procures" a subordinate to do any act

[24] Section 6700.
[25] Section 6701.

subject to this provision. The requirement that a person "know"[26] that a document will be used in connection with a material matter arising under the tax laws and the requirement that the person "know" that the document, if used, will result in an understatement of tax, were designed to limit the penalty to cases involving willful attempts to accomplish an understatement of the tax liability of a third party. Thus, for example, a tax advisor would not be subject to this penalty for suggesting an aggressive but supportable filing position to a client even though that position was later rejected by the courts and even though the client was subjected to the substantial understatement penalty. If, however, the tax advisor suggested a position he or she knew could not be supported on any reasonable basis under the law, the penalty could apply.

The Government bears the burden of proof with respect to this penalty. Furthermore, this penalty generally is in addition to all other penalties provided by law except the penalty on income tax return preparers (discussed below). If either the return preparer penalty or the aiding and abetting penalty may apply with respect to any document, the IRS must choose which penalty to impose.

Failure to furnish information regarding tax shelters[27].—The person having principal responsibility for organizing a tax shelter must register that tax shelter with the IRS.[28] For purposes of this requirement, a tax shelter is defined as any investment with respect to which a person could reasonably infer from the representations made that, as of the close of any of the first 5 years, the ratio of deductions and 350 percent of credits to cash and other property invested is greater than 2 to 1. In order for the registration requirement to apply, a tax shelter must also be subject to Federal or State securities law requirements or must meet specified size requirements. The IRS will provide the person registering the investment a tax shelter identification number, which must be provided to each investor. The investor is required to include the number on his or her tax return.

The Code also provides a penalty for failure to register a tax shelter with the IRS or for filing false or incomplete information with respect to such registration. The penalty for failure to register is the greater of 1 percent of the aggregate amount invested in such tax shelter or $500. No penalty is imposed if the failure is due to reasonable cause.

The Code also provides that persons (such as promoters) who are required to furnish to investors an identification number and who fail to do so are subject to a penalty of $100 for each such failure.

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[26] This generally requires actual knowledge. This is a subjective test, which may result in difficulties in applying this penalty. It has been suggested that some of this difficulty could be reduced if the standard were objective. Thus, a person would be subject to penalty if the person reasonably should have known both that the return or other document would be used in connection with any material matter and that it would result in an understatement of tax liability.

[27] Section 6707.

[28] If the person principally responsible for organizing the tax shelter fails to register the shelter as required, then any person who participates in the organization of the shelter must register the shelter. A person who is secondarily liable for registering the shelter must register it not later than the day on which the first offering for sale of any interest in the shelter is made. In the event that persons who are principally and secondarily liable for registering a shelter fail to register the shelter, any person participating in the management or sale of the investment must register the shelter. Registration by the manager or seller does not relieve the organizer or promoter of liability for the penalties for failure to register.

Moreover, any investor who fails to include the number on his or her tax return is subject to a penalty of $250, unless the failure is due to reasonable cause.

Failure to maintain lists of investors in potentially abusive tax shelters [29].—Any person who organizes any potentially abusive tax shelter or who sells any interest in such a shelter must maintain lists of purchasers. A potentially abusive shelter is any tax shelter that is required to be registered with the IRS or that is of a type that has a potential for tax avoidance or evasion and is described in IRS regulations. Failure to maintain the required lists of purchasers subjects the organizer or seller of the tax shelter to a penalty of $50 for each name omitted from a list, up to a maximum of $100,000 in any calendar year. The penalty may not be imposed where the failure is due to reasonable cause and not due to willful neglect.

J. Return Preparer Penalties

Negligent or fraudulent preparation [30].—The Code imposes a penalty of $100 on an income tax return preparer for each return on which an understatement of tax is caused by the return preparer's negligent or intentional disregard of the Federal tax law. If any part of an understatement of tax is due to a return preparer's willful attempt to understate tax, a $500 penalty is imposed upon the return preparer.

For purposes of this penalty, the term "income tax return preparer" means any person who prepares for compensation, or who employs one or more persons to prepare for compensation, all or a substantial portion of an income tax return or claim for refund.[31]

Failure to furnish copy to taxpayer or other information[32].—If an income tax return preparer fails to furnish a completed copy of a return or claim for refund to the taxpayer by the time the return or claim for refund is presented for the taxpayer's signature, the return preparer is subject to a penalty of $25 for each such failure, unless the failure was due to reasonable cause and not willful neglect.

A return preparer is also subject to a $25 penalty if the return preparer fails to furnish on a return his or her identifying number (generally his or her social security number). A $50 penalty is imposed for each failure (up to $25,000 for any return period) by a return preparer to retain for three years after the close of the return period a completed copy of the return or a list of the name and taxpayer identification number of the taxpayer for whom the return was prepared. These penalties do not apply if the failure was due to reasonable cause and not willful neglect.

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[29] Section 6708.

[30] Section 6694.

[31] A person is not an income tax return preparer merely because he or she (1) furnishes typing, reproducing, or other mechanical assistance; (2) prepares a return or claim for refund for his or her employer or for employees of the employer, provided the employment is regular and continuous; (3) prepares a return or claim for refund for any trust or estate of which that person is a fiduciary; or (4) prepares a claim for refund for a taxpayer in response to a notice of deficiency issued to the taxpayer by the IRS or under certain audit procedures.

[32] Section 6695.

In addition, if a return preparer endorses or otherwise negotiates a check issued to the taxpayer with respect to any income tax return which the return preparer has prepared, a $500 penalty is imposed with respect to each such check. This penalty does not apply with respect to the deposit by a bank of the full amount of the check in the taxpayer's account in the bank for the benefit of the taxpayer.

K. Criminal Penalties

Tax evasion [33].—The Code provides that any person who willfully attempts to evade or defeat any tax [34] imposed by the internal revenue laws shall be guilty of a felony and, upon conviction, shall be fined not more than $100,000 ($500,000 in the case of a corporation), or imprisoned not more than 5 years, or both, together with the costs of prosecution. To convict a defendant under this section, the Government must prove [35] beyond a reasonable doubt: (1) an additional tax due and owing; (2) knowledge on the part of the defendant that an additional tax was due; and (3) an affirmative act taken by the defendant to willfully evade, or attempt to evade, the tax. Willfulness in this context means the "voluntary, intentional violation of a known legal duty." [36]

Willful failure to collect or pay over tax [37].—The Code provides that any person required to collect, account for, and pay over to the Government any tax imposed by internal revenue laws (e.g., an employer required to withhold and pay over Federal wage and FICA taxes) who willfully fails to do so shall be guilty of a felony and, upon conviction, shall be fined not more than $10,000, or imprisoned not more than 5 years, or both, together with the costs of prosecution.

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[33] Section 7201.
[34] This includes any income, estate and gift, employment, or excise tax.
[35] The burden of proof is on the Government in all criminal proceedings.
[36] *United States v. Pomponio*, 429 U.S. 10, 13 (1976), *reh. denied*, 429 U.S. 987 (1976). This definition of "willful" is generally applicable to all criminal provisions of the Internal Revenue Code. *See United States v. Bishop*, 412 U.S. 346 (1973).
[37] Section 7202.

Willful failure to file return, supply information, or pay tax [38].—The Code provides that any person required to pay any estimated tax or tax, or required to file a return, keep records, or supply information, who willfully fails to do so shall be guilty of a misdemeanor and, upon conviction, 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, together with the costs of prosecution. A conviction under this provision may be based on a failure to act on the part of the defendant (e.g., a taxpayer's willful failure to file a return), whereas a conviction for tax evasion (discussed above) requires the Government to prove an affirmative act taken by the defendant to willfully evade tax (e.g., creating fraudulent documents).

False returns [39].—The Code provides that any person who willfully submits any false return, statement, or other document that contains a declaration that it is made under penalties of perjury, or any person who willfully aids or assists in the preparation or presentation of such a false return or document, shall be guilty of a felony and, upon conviction, shall be fined not more than $100,000 ($500,000 in the case of a corporation), or imprisoned not more than 3 years, or both, together with the costs of prosecution.

The Internal Revenue Code contains additional criminal penalties that apply to other offenses.[40] In addition, the United States Code contains a number of criminal provisions of general applicability (e.g., conspiracy, false statement, and mail fraud) that may also apply to tax offenses.[41]

[38] Section 7203.
[39] Section 7206.
[40] These are listed in the Appendix.
[41] Because of the general nature of these criminal provisions, they are not listed in the Appendix.

II. BACKGROUND AND ANALYSIS

A. Development of Penalty Structure

As the income tax laws have increased in scope and complexity over the past 75 years, so too have income tax penalties grown in number and complexity. In many ways, the growth of penalties is parallel to and results directly from the growth of the income tax laws. This growth also, of course, parallels the growth and increasing complexity of transactions in the underlying economy. Although the early income tax laws contained relatively few penalties as compared with present law, a number of the important issues arising out of the current civil penalty structure have existed for a number of years. This is perhaps best illustrated by developments involving the negligence and fraud penalties.

The negligence and fraud penalties were originally enacted as part of the Revenue Act of 1918 [42] and were part of both the 1939 Code and the 1954 Code. Although these were probably the most important civil penalties in the Code, several aspects of these penalties led to the development of additional penalties.

One important aspect of both of these penalties that has existed from the date of their original enactment is fault: the intent of the taxpayer is vital to determining whether the penalty applies in a particular circumstance. Indeed, an element of fault seems inherent to concepts of negligence or fraud.

The element of fault also created several difficulties. Disputes concerning these penalties revolved around the knowledge or state of mind of the taxpayer; in many instances, resolving these disputes was difficult. In addition, in some instances the taxpayer had taken a seemingly indefensible return position, but was not held subject to either the negligence or fraud penalties because the requisite element of fault could not be established. These difficulties led to the establishment of no-fault penalties, such as the substantial understatement or valuation overstatement penalties.[43] The latter penalties are imposed on the basis of the return position taken by the taxpayer, which can be established by objective evidence, as opposed to the more subjective element of knowledge or state of mind of the taxpayer.

Another aspect of the negligence and fraud penalties that led to the development of additional penalties is the ability of taxpayers generally to avoid the imposition of the negligence or fraud penal-

[42] Section 250(b) of Public Law No. 254, 65th Congress; February 24, 1919. The fraud penalty predates this Act, but the prior version was substantially different from the 1918 Act provision, which parallels present law.

[43] An element of fault may be relevant with respect to these penalties, in that the IRS has discretion to waive these penalties if the taxpayer establishes that (1) there was a reasonable basis or reasonable cause for the position claimed on the return and (2) the taxpayer acted in good faith.

ties if they reasonably relied on a competent tax advisor. This aspect of these penalties is closely related to the fault element: reasonable reliance on a competent tax advisor may mitigate or eliminate any element of fault on the part of the taxpayer.

The Code also includes penalties on return preparers. These penalties are not, however, coextensive with penalties imposed directly on taxpayers. The standards tend to be applied differently; behavior generally must be more egregious for a penalty to be imposed upon a return preparer. Also, the dollar amount of the penalties on return preparers is significantly lower than the level imposed under the general penalties. Thus, under present law, a return position that could be subject to a substantial penalty if the taxpayer completed his or her own return could escape penalty or be subject to a relatively minimal penalty if the return is completed by a return preparer.

Another factor that led to the development of additional penalties has been the failure by the IRS and the courts to apply the negligence and fraud penalties in some instances where their application would seem fully justified.

In one Tax Court case, for example, the taxpayer had kept detailed mileage records, required by his employer for reimbursement purposes, that indicated that his business use of a vehicle was approximately five percent of total use. On his tax return, the taxpayer claimed 70 percent business use, with no records to justify this claim. The Tax Court properly allowed only five percent business use. The Court did not, however, impose a negligence or fraud penalty.

In another Tax Court case, the taxpayer had kept detailed records so that he could be reimbursed by his employer, but claimed on his tax return approximately 35,000 miles of business use beyond what his records demonstrated, without any justification. No negligence penalty was imposed. In another case, the taxpayer produced a diary purporting to justify the claimed deductions. The Tax Court called the diary a "fabrication" and said that the taxpayer "was not telling the truth." The Court still permitted him a deduction, and did not impose the regular negligence or civil fraud penalty. Another taxpayer apparently claimed a deduction for business mileage that exceeded the total mileage shown on his odometer, but the Tax Court did not impose a negligence or civil fraud penalty.

In another Tax Court case, the taxpayer claimed that 89 percent of his main house was used exclusively for business purposes, and that his children were not permitted to use the living room, the dining room (which they called a conference room), or the family room, which contained a wide-screen television, but were restricted to several bedrooms, bathrooms, and one of the kitchens. (The house contained approximately 9,000 square feet and 40 rooms.) The Tax Court stated that the business usage was "substantially overstated" and imposed the negligence penalty. The fraud penalty was not discussed." [44]

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[44] In addition, these taxpayers owned three cars: a sedan, a station wagon, and a two-seat sports car. They claimed 100 percent business use of the sedan and station wagon, and testified that they plus their two children either used the two-seat sports car or rented a car for all personal driving. The Tax Court stated that this "defies belief"

Other developments in the Code, unrelated to the negligence and fraud penalties, have had an impact on the development of penalties. For example, during the 1980's a number of detailed information reporting requirements have been added to the Code. These information reporting requirements were added to improve compliance and the ability of the IRS to verify compliance with the tax laws. As the information reporting structure became more detailed, so did the parallel penalty structure.

The administration of the tax laws by the executive branch and the courts also has had an impact on the development of penalties. Relatively few prosecutions are undertaken each year for criminal fraud.[45] This increases reliance on the civil fraud penalty. Also, the difficulties experienced by both the IRS and the courts in administering fault-based penalties, such as negligence and fraud, led to the development of no-fault penalties.

Another administrative development that, at least indirectly, has increased the number of, and level of specificity in, penalties has been the increased difficulties experienced by the IRS and Treasury in promulgating guidance on the tax laws. For example, there has been a substantial backlog in issuing regulations during this entire decade. The resulting delay in providing administrative guidance often makes it desirable, when possible, to provide as much guidance as possible in the statute, thereby increasing the detail in penalty provisions (as well as tax provisions generally).

An example that illustrates many of these elements was the growth of abusive tax shelters in the late 1970's and early 1980's. This growth was attributable to a number of factors, such as the willingness of taxpayers to take aggressive return positions, shortcomings in the substantive law, and administrative delay by both the IRS and the courts in resolving shelter disputes. One of the early legislative efforts undertaken to deal with tax shelters was the imposition of penalties on shelter organizers and promoters. Although the imposition of these penalties did not deal with all aspects of the abusive tax shelter problem, it was helpful in both indicating the increasing level of Congressional concern with the problem and providing increased information to the Government on the extent of the problem. Although the importance of these penalties may have been eclipsed by the enactment of the passive loss rules in the Tax Reform Act of 1986, they were an important element in dealing with abusive tax shelters.

B. Theory of Penalties

Overview

Civil and criminal penalties are only one part of a legal system designed to encourage compliance with the tax collection process. Withholding of tax on many types of income, information reporting on many payments and expenditures, audit and collection procedures, taxpayer assistance programs, and patriotic and moral values also provide incentives for timely and accurate computation and payment of tax.

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[45] This may be due to lack of resources, prosecution of other crimes taking a higher priority, and the desire to prosecute only cases with a high likelihood of ultimate conviction.

In addition to having a deterrent effect, penalties can also be viewed as providing a just punishment for socially undesirable behavior, compensation to the Government for the cost of audit and detection, and an additional source of revenue for the Government. This portion of the pamphlet discusses the ways these theories may have shaped the current penalty structure.

A variety of penalties may be imposed under the Code upon taxpayers who understate their tax liability or fail to comply with the tax laws in other respects. In addition, penalties may be imposed upon persons who may not directly owe tax but have other responsibilities under the Code, such as submission of information returns or the accurate preparation of returns. The following discussion of the rationales underlying the penalty system generally applies to both taxpayers and other persons with compliance responsibilities.

Economic Deterrence

One widely held view of the purpose of penalties is that they provide appropriate incentives for taxpayers to comply with the tax laws. In this view, taxpayers rationally weigh the economic costs and benefits of tax compliance. Although social and moral influences also underlie a taxpayer's decision to comply, it may be useful to examine penalties solely within the framework of the economic incentives they generate.

The costs of compliance, from the taxpayer's standpoint, consist of the value of the taxes and other expenses paid as well as the effort required for timely and accurate compliance with the laws. The benefits to the taxpayer from compliance stem from negative consequences avoided. The negative consequences of noncompliance arise from the possibility that the taxpayer will be audited and identified as a noncomplier, the original tax liability plus interest and penalties will have to be paid, and criminal charges may be brought.

The expected benefit to the taxpayer of noncompliance equals the value of failing to pay tax without detection, minus the chance of being caught times the perceived costs, if caught. An increase in the probability of detecting noncompliance or an increase in the level of the potential penalty imposed generally will raise the incentive for compliance.[46] The deterrent effect of penalties is therefore integrally related to both the likelihood of detection and the severity of the penalties.

Under the economic deterrence view, higher penalties may substitute for a higher likelihood of detection. For example, information reporting and withholding on wages make detection of tax evasion on wages relatively easy; the likelihood of detecting the overstatement of business expenses may be much lower. It may still be possible to provide equivalent incentives for taxpayer compliance if the penalty on overstatement of business expenses is correspondingly higher than that for underreporting of wage income. To maximize taxpayers' incentives to comply, the relationship of pen-

[46] There may be situations where an increase in the penalty will have no impact because the incentive to comply is still too small or was already so large that there will be no additional impact on the incentive to comply.

alties and detection suggests that information reporting, audit programs, and penalty structures should be considered simultaneously.

A more complex or uncertain penalty structure may actually increase compliance relative to a structure that is simple and certain, if taxpayers are risk-averse. If a taxpayer correctly perceives the average level of penalties which may be imposed but is uncertain about the exact level of penalty which would be imposed in his or her specific case, the incentive for compliance may be greater than if the penalty level were certain. This is because the risk-averse taxpayer generally will respond more strongly, for example, to a 25-percent chance of being penalized $10,000 than a 50-percent chance of being penalized $5,000.

A more complex and uncertain penalty structure may, however, make it difficult for taxpayers to estimate accurately the average potential penalty. If taxpayers underestimate potential penalties, increasing taxpayer awareness of the costs of noncompliance will increase the deterrent impact of the penalties. Conversely, it may be in the Government's interest for taxpayers' perceptions to overestimate the average size of penalties since this will provide a larger incentive to comply.

Complexity and uncertainty about the application of the tax laws often raise the costs of compliance since the taxpayer may be unable to determine simply and accurately the tax due. Instead, complexity may force the taxpayer to retain more sophisticated advice which still may not be determinative.[47] Many argue that fairness dictates that penalties be less harsh in these situations, but a deterrence view would not necessarily lead to the same conclusion. The incentive to comply may be the same regardless of how complex the law. As long as additional resources and effort expended by the taxpayer will generate more accurate compliance, the incentive to comply will still be effective; it does not depend on the ability of the taxpayer to obtain easily the correct outcome.

Some take the view that the penalty structure should be used to encourage taxpayers to expend a reasonable effort to comply with the tax laws. Others argue that the true function of the penalty structure is simply to advance the end result of timely payment by the taxpayer of the correct amount of tax due. However, basing penalties on the results of the effort, i.e., the amount of tax understatement, while ignoring fault or the reasonableness of the taxpayer's position, may provide to the taxpayer the appropriate incentives to comply. It will usually be administratively easier for the Government to measure the amount of tax understatement than the efforts made by the taxpayer to comply.[48] The penalty structure in the Code embodies a mixture of both principles, since some penalty rates are based to a degree on determinations of the reasonableness of the taxpayer's position and effort applied in complying.

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[47] For example, the taxpayer may be able to request a private letter ruling from the IRS on the tax consequences of a particular transaction.

[48] Peculiarly, penalties based solely on effort would require the IRS to penalize taxpayers who paid approximately the correct tax but reached this result with insufficient care and diligence in order that appropriate effort incentives are provided to all taxpayers.

Social or Moral Deterrence

Another, complementary view of penalties is that they provide social or moral deterrence of inappropriate or socially undesirable behavior. The impact of tax penalties in this regard may be limited, primarily due to the fact that the imposition of penalties is not publicized, unless the penalties are contested in court.[49] The imposition of penalties may have a private moral deterrence value, which would be entirely dependent on the values of the taxpayer who is penalized.

Fairness

A different view of the purpose of penalties suggests they serve a purpose beyond promoting incentives for efficient compliance. Instead, penalties may be enacted because of fairness considerations, as just punishment for transgressions against societal standards. A view of penalties based purely on incentives suggests few reasons for limiting the size of penalties. Fairness considerations may, however, lead to limitations on the size of penalties. Few would consider it equitable to impose the same punishment on a murderer as on a tax cheat. Fairness demands the punishment fit the crime.

Most people believe that penalties should be roughly proportional to the degree of the violation. It may be difficult to follow this principle in actuality, however, because the nature of the violation varies considerably among taxpayers. The measure of the violation is usually based on the amount of tax underpaid, so that the penalty imposed is consequently proportional to the tax underpayment. If, however, the measure of the violation is the number of times an act is done or not done (such as failure to file information returns), the total penalty may well be viewed as disproportionate to the violation committed. Because of this, a cap on the amount of total penalty imposed may be viewed as equitable. In some circumstances, however, repeated violations may be viewed as justifying increased penalties.

The sheer size of a penalty may limit its effectiveness. If a penalty is viewed as too large or inappropriate for the particular violation, based on equity considerations, the IRS and the courts may hesitate to impose it. Once taxpayers recognize that the Government is unwilling to impose certain harsh penalties, a smaller, more enforceable, penalty might provide a greater deterrent effect. For example, certain violations of pension rules may result in the disqualification of the whole pension plan. This penalty is considered so draconian that it is rarely, if ever, used. A penalty more fitting to the particular violation, such as an excise tax on the dollar amount of the transaction that violated the tax rules, may prove more efficacious.

Equity considerations often lead one to consider the taxpayer's intent and efforts in complying instead of focusing solely on the amount of tax underpayment. The deterrence view instead suggests that the subjective intent of the taxpayer may not be particularly relevant for determining the level of penalties. Both views are re-

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[49] By contrast, some other countries provide public lists of tax offenders, presumably with the intent of increasing the social stigma associated with tax violations.

flected in different portions of the penalty structure of the Code. The negligence and fraud penalties, for example, require that fault by the taxpayer be demonstrated, which reflects the equity view of penalties. The substantial understatement penalty, on the other hand, is based on the return position taken by the taxpayer, and may be more reflective of the deterrence view of penalties.

In general, equity considerations limit the size and pattern of available tax penalties and thus may limit their ability to provide appropriate incentives for compliance. Consequently, increased detection efforts may be necessary to provide sufficient compliance incentives. Indeed, some argue that in order for the penalty system to be viewed as equitable, Government enforcement efforts must avoid the appearance of randomness by assuring that the detection of tax law violators is relatively certain.

Penalties as Compensation for Enforcement Costs

Another view of penalties is that they serve as compensation to the Government for the cost of finding and collecting the tax from the noncomplier. This view is related to the concept of a user fee in that the taxpayer is compensating the Government for the cost of its enforcement efforts.

Under the compensation theory, penalties would not be related primarily to the taxpayer's behavior that generated the Government's assessment, but rather to the Government's costs of detecting and collecting the underassessment. This could be achieved by assessing the additional tax and interest due as well as a service charge for the amount of various types of resources which were required to locate and determine the assessment. Doing so could conflict, however, with equity goals, in that charging taxpayers for the Government's costs, which are predominantly determined by the Government and are not necessarily proportional either to the tax due or to its costs with respect to similarly-situated taxpayers, may be viewed as unfair. This view of penalties is present, however, in certain penalty provisions. For example, certain criminal penalties under the Code require a convicted taxpayer to reimburse the Government for the costs of prosecution. In addition, the penalty for failure to pay taxes after notice and demand [50] doubles [51] after the IRS notifies the taxpayer that it will levy on the taxpayer's assets.[52]

[50] Section 6651(a)(3).

[51] Section 6651(d).

[52] This was enacted in the Tax Reform Act of 1986 in place of a user fee proposed by the Administration that would have been dependent on the effort expended by the IRS in attempting to collect the tax. The Treasury Department document entitled "Tax Reform for Fairness, Simplicity and Economic Growth" (November 1984, pp. 406-408) contained a proposal to repeal the penalty for failure to pay taxes and replace it with a cost of collection charge approximately equal to the cost of collecting the delinquent taxes. "The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity" (May 1985) also contained this proposal (pp. 112-113). The underlying rationale was that the cost of collecting delinquent taxes would, in effect, be borne by those who have delayed making payment, rather than by all taxpayers. The proposal also was designed to encourage taxpayers to pay delinquent taxes more promptly. In lieu of adopting this proposal, the Congress maintained the general structure of the prior-law penalty for failure to pay taxes, but increased the amount of the penalty once the IRS generally initiates more expensive collection methods. Thus, the rate of the penalty doubles after the IRS notifies the taxpayer that it will levy on the taxpayer's assets.

Penalties as a Revenue Source

Since most penalties assessed under the Code require the payment of additional money to the Government, penalties can be viewed as an additional revenue source beyond the regular tax imposed. The increase in the number of penalties in the last decade, combined with the continuing pressure for increased tax collections, have caused some to suggest that tax penalties are being used to collect revenue and not simply to promote compliance with the tax laws. Use of penalties in this manner may generate disrespect for the tax system and, ultimately, lead to a decline in the level of voluntary compliance.

It has been suggested by some that the changes made in 1986 to the penalty for substantial understatements of tax and the penalty for failure to deposit withholding taxes were motivated by a desire to raise additional revenue. The Omnibus Budget Reconciliation Act of 1986 increased the amount of these penalties effective for penalties assessed after the date of enactment. Because penalties generally are not assessed until a final determination of tax liability, which usually occurs after completion of the audit process, administrative appeals, and Tax Court review, the increased penalties may be imposed with respect to conduct that occurred prior to enactment. Consequently, it has been argued that the "retroactive" increase in these penalties may be unfair in that it could not deter conduct that occurred prior to the enactment of the penalty. However, some feel that the original penalty structure may have been unduly lenient and the penalties have been adjusted to punish violations more equitably.

Some may view penalties as a generally unseen tax, since penalties are not imposed upon (and are therefore not visible to) most taxpayers. On the one hand, since taxpayers who owe penalties commonly may be perceived as being guilty of misbehavior, there could be significant support for using penalties to raise additional revenue. On the other hand, some might consider the use of penalties, especially those unrelated to fault, for any purpose other than to promote compliance with the tax laws as inappropriate and unfair.

A related argument stresses the flexibility the IRS has in assessing penalties and negotiating settlements. Some argue that the IRS uses the threat of additional penalties as a tool to pressure taxpayers into accepting unfavorable settlements. Taxpayers, though convinced that their potential litigating position is sound, may accept a settlement to avoid the possible imposition of substantial penalties. A different view of the same process may characterize the IRS as fairly applying the tax laws to collect revenue efficiently. Like many parties involved in potential judicial proceedings, the IRS may be willing to bargain away a higher level of penalties in order to most efficiently utilize its resources in the enforcement of revenue laws.

C. Tabulations of IRS Penalty Assessments [53]

The changing level of penalties in the tax collection process is illustrated by data on the number and amount of civil penalties assessed by the IRS during fiscal years 1978 through 1986. Table 1 illustrates that while the number of penalties assessed annually has remained fairly stable since 1981, it has actually declined by over three million from 1984 to 1986. The total dollar amount of penalties assessed, however, has grown from approximately $1.3 billion in 1978 to nearly $7.0 billion in 1986. Similarly, the net dollar amount of penalties assessed (penalties assessed less abatements) has increased from approximately $1 billion in 1978 to $3.5 billion in 1986.

Table 1.—Number and Amount of Civil Penalties Assessed, Fiscal Years 1978-1986

Fiscal year	Number of penalties assessed (millions)	Amount of penalties assessed (billions)	Amount of net penalties [1] (billions)
1978	15.4	$1.3	$1.0
1979	20.8	1.6	1.2
1980	19.6	2.1	1.6
1981	22.1	3.0	2.1
1982	26.3	5.1	3.3
1983	25.2	4.6	2.4
1984	26.1	5.1	3.1
1985	22.0	5.7	3.0
1986	22.9	6.9	3.5

[1] Net penalties are penalties assessed during the fiscal year less penalties abated during the fiscal year.

Source: Various issues of the *Annual Report of the Internal Revenue Service.*

[53] The statistical data on IRS penalty assessments contained in this section is derived from various issues of the *Internal Revenue Service Annual Report*. The IRS only began reporting penalties assessed separately from tax and penalties recommended after examination in the 1978 Annual Report. All references in this section are to fiscal years.

Table 2 provides data on the audit rate and the number of returns examined in the corresponding 1978 through 1986 period. Since 1978, the individual audit rate has declined by nearly a half and the corporate audit rate has fallen by two-thirds. The number of returns examined also has declined by over 40 percent during the same period. Despite the drop in audit rates and the number of returns examined, the number of penalties assessed has increased slightly and the dollar amount of penalties assessed has increased dramatically. This could be attributable to better targeting of enforcement resources, increased noncompliance of taxpayers, increased matching of information returns, the increase in the number of potential penalties, increased penalty rates, or a greater willingness by the IRS to impose penalties.

Table 2.—Individual and Corporate Income Tax Return Audit Rate and Returns Examined, Fiscal Years 1978-1986

Fiscal year	Individual audit rate (percent)	Corporate audit rate (percent)	Total returns examined (millions)
1978	2.16	8.01	2.4
1979	2.11	7.44	2.3
1980	2.02	6.48	2.2
1981	1.77	5.05	2.0
1982	1.55	4.73	1.8
1983	1.50	3.64	1.7
1984	1.27	2.66	1.5
1985	1.31	2.39	1.5
1986	1.10	2.25	1.3

Source: Various issues of the *Annual Report of the Internal Revenue Service.*

The data in Table 3 suggest that civil penalties also have increased in importance as an element of total revenue that is directly derived from enforcement activities. Penalties accounted for only 20 percent of the total additional tax and penalties assessed in 1978 but accounted for over 35 percent of additional tax and penalties assessed in 1986. The data in Table 3 also indicate that as a revenue source net penalties represent a very small portion, less than half of one percent, of total IRS collections. This percentage, though, is almost double that in 1978.[54]

Table 3.—Civil Penalties Assessed as a Percent of Additional Tax and Penalties Assessed and as a Percent of Total IRS Collections, Fiscal Years 1978-1986

Fiscal year	Penalties assessed as percent of additional tax and penalties assessed	Penalties assessed as percent of total IRS collections	Net penalties[1] as percent of total IRS collections
1978	20.65	0.32	0.24
1979	21.71	0.34	0.26
1980	22.32	0.41	0.30
1981	27.98	0.49	0.34
1982	43.05	0.80	0.52
1983	33.35	0.73	0.38
1984	35.20	0.74	0.46
1985	33.09	0.76	0.41
1986	35.94	0.89	0.45

[1] Net penalties are penalties assessed during the fiscal year less penalties abated during the fiscal year.

Source: Various issues of the *Annual Report of the Internal Revenue Service.*

[54] The amount of penalties assessed does not represent the revenue gain to the Government because assessed penalties are often not collected. Because it is likely that the ability to collect penalties from taxpayers is considerably worse than for normal tax collections, the amount of assessed penalties actually collected as a percentage of total IRS collections is likely to be lower than Table 3 indicates. There is no available data indicating the amount of penalties assessed which are actually collected.

Table 4 contains data on the number and amounts of civil penalties assessed by type of return for 1986. Penalties assessed with respect to individual income tax returns (11.6 million penalties assessed) comprised over 50 percent of the total number of penalties assessed. Approximately 9.4 million (or 81 percent) of these penalties on individuals were estimated tax and failure to pay penalties. Nearly nine million employment tax penalties were assessed for the 1986 fiscal year, with the vast majority imposed for delinquency and failure to pay. Only 14 thousand civil fraud penalties, totaling $185 million, were assessed in 1986.

Table 4.—Number and Amount of Civil Penalties Assessed and Net Penalties, Fiscal Year 1986

[All values in millions]

Assessments	Number	Amount	Amount of net penalties[1]
Individual	11.620	$2,482.3	$1,592.4
Delinquency	1.579	552.6	406.0
Estimated tax	2.720	985.6	391.5
Failure to pay	6.714	365.9	310.4
Fraud	0.012	151.3	128.1
Negligence	0.229	245.8	199.2
Other	0.366	181.1	157.2
Corporate	0.954	1,507.1	587.1
Delinquency	0.164	598.5	175.2
Estimated tax	0.336	331.4	151.9
Failure to pay	0.432	383.9	110.6
Fraud	0.001	26.3	22.7
Negligence	0.004	28.9	26.5
Other	0.017	138.1	100.2
Employment	8.918	1,770.1	875.4
Delinquency	2.614	763.1	502.4
Failure to pay	5.182	376.8	190.8
Fraud	0.001	1.9	1.8
Other	1.121	628.4	180.4
Excise	0.921	249.5	70.6
Estate and Gift	0.027	91.2	2.8
All Other	0.369	560.5	169.7
Non-Return	0.106	267.6	217.2
Total, All Civil Penalties	22.914	6,928.3	3,515.2

[1]Net penalties are penalties assessed during the fiscal year less penalties abated during the fiscal year.

Source: *1986 Annual Report of the Internal Revenue Service.*

D. Overlapping Penalties

In General

The civil tax penalty provisions of present law may be criticized for providing multiple penalties that may be imposed with respect to a single act or failure to act. One basis for this criticism is that the total dollar amount of all potentially applicable penalties may bear no relation to the conduct of the person that is subject to the penalties. In fact, the imposition of multiple penalties for civil tax purposes may result in total monetary penalties that greatly exceed the monetary penalties for comparable non-tax Federal offenses. The use of statutory caps for many penalties (see part F, below) may mitigate the harshness of these effects.

An additional criticism is that the extent of the overlap among certain penalty provisions is unclear to taxpayers and the IRS. Thus, if two or more penalties are intended to apply to a single act or failure to act, the uncertainty concerning the possible application of such penalties may reduce their intended effect in deterring objectionable behavior. Furthermore, to the extent that the IRS does not uniformly apply the same penalty or penalties to identical or substantially similar conduct, the penalty provisions can be criticized as unfair. On the other hand, however, some uncertainty is unavoidable if an element of judgment is involved in the imposition of a penalty (such as, for example, where there is a reasonable cause exception to a penalty).

Overlap of Understatement Penalties and Negligence/Fraud Penalties

As previously mentioned in parts I., B. and C. (above), taxpayers are subject to a penalty if any part of an underpayment of tax is due to negligence or fraud. In addition, Congress has recently enacted several penalties that apply to underpayments of tax without regard to whether the conduct of the taxpayer that led to the underpayment was negligent or fraudulent.[55] For example, the substantial understatement penalty generally applies if there is an understatement of tax for any taxable year that exceeds the greater of (1) 10 percent of the tax required to be shown on the return, or (2) $5,000 ($10,000 for most corporations). Similarly, the penalty for income tax valuation overstatements and the penalty for estate or gift tax valuation understatements generally apply to an underpayment of tax that is attributable to a valuation overstatement or valuation understatement that exceeds a specific percentage of the correct valuation.

Some have argued that it is inappropriate to impose the negligence or fraud penalty and an understatement penalty with respect to the same underpayment of tax because the understatement penalties were designed to apply without proving fault on the part of the taxpayer (which is a necessary element in proving negligence or fraud). On the other hand, it may be appropriate to permit the imposition of both penalties with respect to the same

[55] These "no fault" penalties, however, may be waived by the IRS if the taxpayer establishes that (1) there was a reasonable basis or reasonable cause for the position claimed on the return and (2) the taxpayer acted in good faith.

underpayment in appropriate circumstances, because the understatement penalties and the negligence and fraud penalties are targeted at different aspects of the taxpayer's behavior. Thus, imposing both penalties could be necessary in order to provide a sufficient deterrent to different elements of objectionable behavior by the taxpayer.

Overlap of Penalty for Aiding and Abetting Understatement of Tax Liability and Penalty for Promoting Abusive Tax Shelters

The recently enacted penalties for aiding and abetting the understatement of tax liability and for promoting abusive tax shelters also may be imposed with respect to a single act of a person. For example, an attorney who assists in the organization of a tax shelter by preparing an opinion with respect to the availability of tax benefits may be subject to the aiding and abetting penalty and the penalty for promoting abusive tax shelters if the opinion contains a false or fraudulent statement that the attorney knows will result in an understatement of tax. In addition, a person's conduct with respect to a single tax shelter may lead to the imposition of multiple penalties for promoting abusive tax shelters.[56]

The imposition of multiple civil penalties with respect to a single tax shelter may lead to a total amount of penalties that greatly exceeds the gross receipts or net income earned by the person from the shelter. It could be argued, however, that this result is appropriate given the fact that the activities of the person may result in an understatement of tax by a large number of taxpayers. One way to mitigate any perceived unfairness in this provision would be to provide an overall limit on the penalty, based on either gross receipts or net income. It is also possible that the application of the passive loss limitations contained in the Tax Reform Act of 1986 may significantly curtail tax shelter activities, thereby decreasing the incidence of tax shelter penalties.

E. Gaps in Current Penalty Structure

Despite the large number of civil penalty provisions provided under present law, in a number of cases penalties are not imposed with respect to undesirable conduct either because no penalty applies to the conduct or the IRS is reluctant to assert a penalty that may be applicable to the conduct. The IRS may be reluctant to assert an otherwise applicable penalty if the amount of the penalty greatly exceeds the amount of tax that is underpaid as a result of the undesirable conduct.

For example, it is understood that the IRS ordinarily does not assert a penalty for a non-willful failure to file an information return relating to distributions from profit-sharing and retirement plans because the only penalty that applies to such conduct is a $25

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[56] In *Waltman v. U.S.*, 618 F. Supp. 718 (M.D. Fla. 1985), the court held that the term "activity" as used in section 6700 refers to each sale of an interest in a tax shelter, and, consequently, a minimum $1,000 penalty could be imposed with respect to each sale. On the other hand, in *Spriggs v. U.S.*, 87-2 USTC Par. 9392 (E.D. Va. 1987), the court concluded that the term "activity" refers to the overall activity of promoting an abusive tax shelter, and, thus, only a single penalty may be imposed for all sales activities.

penalty for each day that the return is not filed.[57] In contrast, the penalty that generally applies to a non-willful failure to file other types of information returns is $50, regardless of the length of time that the return is not filed.

As an additional example of undesirable conduct where a penalty is not asserted, it is understood that the IRS ordinarily does not assert a penalty for a non-willful failure to file an information return with respect to the payment of fixed or determinable annual or periodical income to a nonresident alien or a foreign corporation. The only applicable penalty is the penalty for failure to file a tax return, which the IRS generally considers inappropriate for a failure to file an information return.[58]

Finally, it has been suggested that the current penalty provisions do not adequately address the failure of S corporations to file timely returns. Under present law, a partnership that fails to file timely a return or files a return that fails to show required information is liable for a penalty for each month (not to exceed five months) that the partnership return is late or incomplete. The amount of the penalty for each month is $50 multiplied by the number of partners in the partnership for the taxable year for which the return is due. There is no similar penalty that applies to S corporations.[59]

F. Caps on Penalties

Several of the existing civil tax penalties that relate to information reporting are capped at a specific dollar amount. For example, the total amount of penalties that may be imposed with respect to any calendar year for the failure to file certain information returns, the failure to furnish certain payee statements, or the failure to include a taxpayer identification number on certain returns or statements generally is limited to $100,000. Similarly, a $20,000 cap generally applies to penalties that may be imposed with respect to any calendar year for the failure to include correct information on certain information returns or payee statements.

The limitations on the total amount of penalties that may be imposed with respect to any calendar year do not apply in the case of returns and statements that relate to the reporting of interest, dividends, or patronage dividends. In addition, the $100,000 cap for the

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[57] Under the authority of section 6047, the IRS requires the filing of information returns on Form W-2P (statement for recipients of annuities, pensions, retired pay or IRA payments) and Form 1099-R (statement for recipients from profit-sharing, retirement plans, individual retirement arrangements, etc.). In addition, under the same authority, the IRS requires a copy of each Form W-2P and each Form 1099-R to be provided to the recipient of the annuity, pension, retired pay, IRA payment or total distribution. The only applicable penalty for the failure to file the information return or payee statement is contained in section 6652(e), which imposes a penalty of $25 for each day a return or statement required under section 6047 is not filed.

[58] Treas. reg. sec. 1.1461-2 requires withholding agents to (1) file an annual information return on Form 1042S with respect to each recipient of a payment of fixed or determinable annual or periodical income, and (2) provide a copy of the Form 1042S to the recipient of the income. This information is used by the IRS to verify that each withholding agent is deducting and withholding the correct amount of tax. In addition, the IRS compiles the information submitted on Form 1042S by country of residence of the recipient and supplies it to each country that has entered into a treaty with the United States that provides for the mutual exchange of information.

[59] The general $50 penalty for the failure to furnish payee statements applies to the failure of an S corporation to furnish a copy of information shown on the return to shareholders of the S corporation.

failure to file certain information returns and the $20,000 cap for the failure to include correct information on certain information returns or payee statements do not apply if the failure is due to intentional disregard of the filing requirement.[60]

It has been suggested that the information reporting penalties should not be limited to a specific dollar amount because a limitation diminishes the effectiveness of the penalty where there has been a failure to properly file a large number of returns or payee statements.[61] By limiting the maximum penalty that may be imposed, the cost of complying with the filing requirements for any year may exceed the amount of the penalty for that year, and, consequently, there may be no incentive to comply with the filing requirement. Because, however, the total failure to file information returns may well be regarded as intentional, resulting in the inapplicability of any cap, this problem may not arise in actuality.

In addition, the limitations may be criticized for treating more favorably those persons that are required to file a large number of returns or payee statements. For example, a business that files 10,000 information returns containing incorrect information for any taxable year would pay an average penalty of $2 per return ($20,000 cap divided by 10,000 returns), while another business that files 50 information returns containing incorrect information for any taxable year would pay the full penalty of $5 per return.[62]

In response to the argument in favor of removing the cap on penalties, it has been suggested that the caps are necessary because otherwise filers could be subject to enormous penalties that are disproportionate both to the filer's conduct and to the penalties for many other Federal offenses. Absent a cap on penalties, the IRS may be reluctant to assert penalties of such magnitude.

If it is determined that caps are necessary, it may be appropriate to extend the applicability of the caps to returns and statements that relate to the reporting of interest, dividends, and patronage dividends (absent willfulness in the failure to file).

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[60] In the case of intentional disregard of the filing requirement, the amount of the penalty is generally increased to $100 per return.

[61] See, for example, *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity* (May 1985), pp. 112-113.

[62] Section 6723.

APPENDIX: LIST OF TAX PENALTIES

This Appendix lists the penalties currently in the Internal Revenue Code. The table is organized by section of the Code ("Sec."). Next is the title of the section; a brief description of the penalty is included parenthetically if the title of the section is not self-explanatory. Finally, there is an indication of whether the penalty predominantly applies to individuals, to corporations, or to both. If the penalty relates to, is, or functions similarly to an excise tax, that is also indicated.

List of Tax Penalties Under the Internal Revenue Code

Code section	Title (Description)	Penalty predominantly applicable to—			
		Individuals	Corporations	Both	Excise
72(m)(5)	Special rules applicable to employee annuities and distributions under employee plans.	X			
72(o)(2)	Special rules for distributions from qualified plans to which employee made deductible contributions.	X			
72(q)(1)	10-percent penalty for premature distributions from annuity contracts.	X			
72(t)	10-percent additional tax on early distributions from qualified retirement plans.	X			
4701	Tax on issuer of registration-required obligation not in registered form.				X
4912	Tax on disqualifying lobbying expenditures of section 501(c)(3) organizations.				X
4941	Taxes on self-dealing				X
4942	Taxes on failure to distribute income				X
4943	Taxes on excess business holdings				X
4944	Taxes on investments which jeopardize charitable purpose				X
4945	Taxes on taxable expenditures				X
4951	Taxes on self-dealing				X
4952	Taxes on taxable expenditures				X
4953	Tax on excess contributions to black lung benefit trusts				X
4955	Tax on political expenditures of sec. 501(c)(3) organizations			X	X
4971	Taxes on failure to meet minimum funding standards				X
4972	Tax on nondeductible contributions to qualified employer plans.				X

4973	Tax on excess contributions to individual retirement accounts, certain 403(b) contracts, and certain individual retirement annuities.		X
4974	Excise tax on certain accumulations in qualified retirement plans.		X
4975	Tax on prohibited transactions (relating to pensions)		X
4976	Taxes with respect to funded welfare benefit plans		X
4977	Tax on certain fringe benefits provided by an employer		X
4978	Tax on certain dispositions by employee stock ownership plans and certain cooperatives.		X
4979	Tax on certain excess contributions (to a pension plan)		X
4979A	Tax on certain prohibited allocations of qualified securities		X
4980	Tax on reversion of qualified plan assets to employer		X
4981	Excise tax on undistributed income of real estate investment trusts.		X
4981A	Tax on excess distributions from qualified retirement plans		X
4982	Excise tax on undistributed income of regulated investment companies.		X
5601	Criminal penalties (relating to alcohol taxes)	X	X
5602	Penalty for tax fraud by distiller	X	X
5603	Penalty relating to records, returns, and reports (relating to alcohol taxes).	X	X
5604	Penalties relating to marks, brands, and containers	X	X
5605	Penalty relating to return of materials used in the manufacture of distilled spirits or from which distilled spirits may be recovered.	X	X
5606	Penalty relating to containers of distilled spirits	X	X
5607	Penalty and forfeiture for unlawful use, recovery, or concealment of denatured distilled spirits, or articles.	X	X

List of Tax Penalties Under the Internal Revenue Code—Continued

Code section	Title (Description)	Penalty predominantly applicable to—			
		Individuals	Corporations	Both	Excise
5608	Penalty and forfeiture for fraudulent claims for export drawback or unlawful relanding.			X	X
5609	Destruction of unregistered stills, distilling apparatus, equipment, and materials.			X	X
5610	Disposal of forfeited equipment and material for distilling			X	X
5612	Forfeiture of tax paid distilled spirits remaining on bonded premises.			X	X
5613	Forfeiture of distilled spirits not closed, marked, or branded as required by law.			X	X
5661	Penalty and forfeiture for violation of laws and regulations relating to wine.			X	X
5662	Penalty for alteration of wine labels			X	X
5671	Penalty and forfeiture for evasion of beer tax and fraudulent noncompliance with requirements.			X	X
5672	Penalty for failure of brewer to comply with requirements and to keep records and file returns.			X	X
5673	Forfeiture for flagrant and willful removal of beer without tax payment.			X	X
5674	Penalty for unlawful production or removal of beer			X	X
5675	Penalty for intentional removal or defacement of brewer's marks and brands.			X	X
5681	Penalty relating to signs (relating to liquors)			X	X
5682	Penalty for breaking locks or gaining access (relating to liquors).			X	X

5683	Penalty and forfeiture for removal of liquors under improper brands.			X	X
5684	Penalties relating to the payment and collection of liquor taxes.			X	X
5685	Penalty and forfeiture relating to possession of devices for emitting gas, smoke, etc., explosives and firearms, when violating liquor laws.			X	X
5686	Penalty for having, possessing, or using liquor or property intended to be used in violating provisions of this chapter.			X	X
5687	Penalty for offenses not specifically covered (relating of liquors).			X	X
5691	Penalties for nonpayment of special taxes relating to liquors			X	X
5761	Civil penalties (relating to cigars, cigarettes and cigarette papers and fibers).			X	X
5762	Criminal penalties (relating to cigars, cigarettes and cigarette papers, and fibers).			X	X
5763	Forfeitures (relating to cigars, cigarettes and cigarette papers, and fibers).			X	X
5871	Penalties (relating to machine guns, destructive devices, and certain other firearms).			X	X
5872	Forfeitures (relating to machine guns, destructive devices, and certain other firearms).			X	X
6038(b)	Information with respect to certain foreign corporations (penalty for failure to furnish).			X	
6038(c)	Penalty for reducing foreign tax credit			X	
6038A(d)	Information with respect to certain foreign corporations (penalty for failure to furnish).			X	
6038B(b)	Notice of certain transfers to foreign persons			X	
6039E(c)	Information concerning resident status	X			
6332	Surrender of property subject to levy			X	
6621(c)	(Higher rate of) interest on substantial underpayments attributable to tax-motivated transactions.			X	

List of Tax Penalties Under the Internal Revenue Code—Continued

Code section	Title (Description)	Penalty predominantly applicable to— Individuals	Corporations	Both	Excise
6651	Failure to file tax return or to pay tax			X	
6652	Failure to file certain information returns, registration statements, etc..			X	
6653	Additions to tax for negligence and fraud			X	
6654	Failure by individual to pay estimated income tax	X			
6655	Failure by corporation to pay estimated income tax		X		
6656	Failure to make deposit of taxes or overstatement of deposits..			X	
6657	Bad checks			X	
6659	Addition to tax in the case of valuation overstatements for purposes of the income tax.	X			
6659A	Addition to tax in case of overstatements of pension liabilities.			X	
6660	Addition to tax in the case of valuation understatement for purposes of estate or gift taxes.	X			
6661	Substantial understatement of liability			X	
6672	Failure to collect and pay over tax, or attempt to evade or defeat tax.			X	
6673	Damages assessable for instituting proceedings before the Tax Court primarily for delay, etc..			X	
6674	Fraudulent statement or failure to furnish statement to employee.			X	
6675	Excessive claims with respect to the use of certain gasoline			X	X
6676	Failure to supply identifying numbers			X	
6677	Failure to file information returns with respect to certain foreign trusts.			X	

6679	Failure to file returns, etc., with respect to foreign corporations or foreign partnerships.			X	
6682	False information with respect to withholding	X			
6683	Failure of foreign corporation to file return of personal holding company tax.		X		
6684	Assessable penalties with respect to liability for tax under Chapter 42 (relating to private foundations).	X			
6685	Assessable penalties with respect to private foundation annual returns.	X			
6686	Failure to file returns or supply information by DISC or FSC		X		
6687	Failure to supply information with respect to place of residence.	X			
6688	Assessable penalties with respect to information required to be furnished under sec. 7654 (relating to coordination with income taxes of possessions).	X			
6689	Failure to file notice of redetermination of foreign tax			X	
6690	Fraudulent statement or failure to furnish statement to plan participant.		X		
6692	Failure to file actuarial report			X	
6693	Failure to provide reports on individual retirement accounts or annuities overstatement of designated nondeductible contributions.			X	
6694	Understatement of taxpayer's liability by income tax return preparer.			X	
6695	Other assessable penalties with respect to the preparation of income tax returns for other persons.			X	
6697	Assessable penalties with respect to liability for tax of regulated investment entities.		X		
6698	Failure to file partnership return	X			
6700	Promoting abusive tax shelters, etc.			X	

List of Tax Penalties Under the Internal Revenue Code—Continued

Code section	Title (Description)	Penalty predominantly applicable to—			
		Individuals	Corporations	Both	Excise
6701	Penalties for aiding and abetting understatment of tax liability.			X	
6702	Frivolous income tax return			X	
6704	Failure to keep records necessary to meet reporting requirements under sec. 6047(d) (relating to pensions).			X	
6705	Failure by broker to provide notice to payors			X	
6706	Original issue discount information requirements		X		
6707	Failure to furnish information regarding tax shelters			X	
6708	Failure to maintain list of investors in potentially abusive tax shelters.			X	
6709	Penalties with respect to mortgage credit certificates			X	
6710	Failure to disclose that contributions are nondeductible		X		
6711	Failure by tax-exempt organization to disclose that certain information or service available from Federal Government.		X		
6721	Failure to file certain information returns			X	
6722	Failure to furnish certain payee statements			X	
6723	Failure to include correct information (on information returns).			X	
7201	Attempt to evade or defeat tax			X	
7202	Willful failure to collect or pay over tax			X	
7203	Willful failure to file return, supply information, or pay tax			X	
7204	Fraudulent statement or failure to make statement to employees.			X	
7205	Fraudulent withholding exemption certificate or failure to supply information.	X			
7206	Fraud and false statements			X	

7207	Fraudulent returns, statements, or other documents	....	....	X	....
7208	Offenses relating to stamps	....	....	X	....
7209	Unauthorized use or sale of stamps	....	....	X	....
7210	Failure to obey summons	X	....	....	....
7211	False statements to purchasers or lessees relating to tax	....	....	X	....
7212	Attempts to interfere with administration of internal revenue laws.	X	....	....	....
7213	Unauthorized disclosure of information	X	....	....	....
7214	Offenses by officers and employees of the United States	X	....	....	....
7215	Offenses with respect to collected taxes	....	....	X	....
7216	Disclosure or use of information by preparers of returns	X	....	....	....
7231	Failure to obtain license for collection of foreign items	....	....	X	....
7232	Failure to register or false statement by manufacturer or producer of gasoline or lubricating oil.	....	....	X	X
7240	Officials investing or speculating in sugar	....	....	X	X
7241	Willful failure to furnish certain information regarding windfall profit tax on domestic crude oil..	....	....	X	X
7261	Representation that retailers' excise tax is excluded from price of article.	....	....	X	X
7262	Violation of occupational tax laws relating to wagering—failure to pay special tax.	....	....	X	X
7268	Possession with intent to sell in fraud of law or to evade tax	....	....	X	X
7269	Failure to produce records	....	....	X	....
7270	Insurance policies (relating to intent to evade the excise tax on foreign insurers).	....	....	....	X
7271	Penalties for offenses relating to stamps	....	....	X	....
7272	Penalty for failure to register (relating to alcohol and tobacco taxes).	....	....	X	....
7273	Penalties for offenses relating to (occupational stamp) taxes	....	....	X	....
7275	Penalty for offenses relating to certain airline tickets and advertising.	....	....	X	....

List of Tax Penalties Under the Internal Revenue Code—Continued

Code section	Title (Description)	Penalty predominantly applicable to—			
		Individuals	Corporations	Both	Excise
7304	Penalty for fraudulently claiming drawback	....	....	X	X
7341	Penalty for sales to evade tax	....	....	X	....
7342	Penalty for refusal to permit entry or examination	....	....	X	....

PRIVATE SECTOR PENALTY TASK FORCE

CO-CHAIRMEN

N. Jerold Cohen, Esquire
Southerland, Asbill and Brennan
3100 First Atlanta Tower
Atlanta, GA 30309
(404) 658-8837

Kenneth W. Gideon, Esquire
Fried, Frank, Garris, Shriver, and Jacobson
Suite 800
1001 Pennsylvania Avenue, N.W.
Washington, D.C. 20004-2005
(202) 639-7005

MEMBERS

Mr. Jonathon Allen
Representing the American Banking Association
Senior Vice President and Director of Taxes
First Wachovia Corp.
P.O. Box 3099
Winston-Salem, N.C. 27150
(919) 770-5556

Ms. Patricia Burton
Representing the National Association of Enrolled Agents
34 Inchcliffe Dr.
Gales Ferry, Connecticut 06335
(203) 464-6222

Tom Courtway, Esquire
Wright, Lindsey & Jennings
2200 Worthen Bank Building
Little Rock, Arkansas 72201
(501) 371-0808

Marvin J. Garbis, Esquire
Melnicove, Kaufman, Weiner, Smouse &

Garbis, P.A.
Sixth Floor
36 South Charles Street
Baltimore, Maryland 21201-3060

Mr. Benson Goldstein
Representing the National Society of
Public Accountants
1010 North Fairfax Street
Alexandria VA 22314
(703) 549-6400

Micheal J. Graetz, Esquire
Justus S. Hotchkiss
Professor of Law
Yale Law School
127 Wall Street
New Haven, Connecticut 06520
(203) 432-4828

Jerome Kurtz, Esquire
Paul, Weiss, Rifkind, Wharton
& Garrison
1615 L Street, N.W.
Washington, D.C. 20036
(202) 223-7300

Herbert J. Lerner, Esquire
Chairman of AICPA Tax Division
Executive Committee
Ernst & Whinney
1225 Connecticut Avenue, N.W.
Washington, D.C. 20036
(202) 862-6258

The Honorable Henson Moore
Representing the U.S. Chamber of Commerce
Southerland, Asbill & Brennan
1667 K Street, N.W. Suite 800
Washington, D.C. 20006
(202) 887-3576

Mr. Ed Pendergast

Page 3

Representing the National Federation
of Independent Businesses
Chairman
Kennedy and Lehan, P.C.
1 Monarch Drive
Quincy, Massachusetts 02171
(617) 472-0700

Mr. Leonard Podolin
Arthur Anderson Company
69 West Washington Street
Chicago, Ill 60602
(312) 580-0069

Gerald G. Portney, Esquire
Peat Marwick
1990 K Street, N.W.
Washington, D.C. 20006
(202) 835-1846

Mr. Charles W. Rau
Representing the Tax Executive
Institute, Inc.
Vice President-Tax,
MCI Communications Corporation
Tax Department 0013/001 (Room 401),
1133 19th Street, N.W.
Washington, D.C. 20036
(202) 887-3249

John Riordan, Esquire
Vice President and Counsel
The New England
501 Boyston Street
Boston, Mass. 02117
(617) 578-2523

Michael I. Saltzman, Esquire
Representing the American Bar
Association
Saltzman & Holloran
Suite 1210
One Rockefeller Plaza
New York, NY 10020

Page 4

Jeffery S. Trinca, Esquire
Representing Senator David Pryor
Russell 264
Washington, D.C. 20510
(202) 224-2353

Glenn White, Esquire
Chairman of NAM Compliance, Audit, and
Penalties Task Force
Director of Taxation
Dow Chemical Company
Willard H. Dow Center
Midland, MI 486774
(517) 636-4339

Dale W. Wickham, Esquire
Wickham & Geske
Suite 600
2300 N Street, N.W.
Washington, D.C. 20037
(202) 663-9060

STATEMENT OF
O. DONALDSON CHAPOTON

Mr. Chairman and Members of the Subcommittee:

I appreciate this opportunity to appear before you today to present the views of the Treasury Department concerning efforts by your Subcommittee, the Internal Revenue Service and others to review our existing civil tax penalties with the aim of improving their operation. We welcome this attention to one of the most important aspects of our system of tax administration. To the extent that means can be discovered to eliminate unnecessary complexity and improve the fairness and effectiveness of our civil tax penalties, all taxpayers and the tax system will benefit.

NEED FOR COMPREHENSIVE REVIEW

The Treasury Department supports a thorough review of the existing tax penalty structure. Congress has just completed a fundamental reform of the substantive tax rules to promote fairness, simplicity and economic growth; a comprehensive assessment of the role of existing tax penalties is a natural second step in the effort to improve our tax laws. There has been no recent attempt to examine the fundamental assumptions underlying the various tax penalties and to determine whether each penalty is accomplishing its intended goals. The tax penalty structure has grown piecemeal over time, often incident to substantive changes and without full consideration of the interrelationship between different penalties. Moreover, many of the recent substantive reforms, particularly those intended to discourage tax shelter activities, may permit revisions to the penalty rules.

In addition, there are other indications that a reassessment of the structure and administration of our civil tax penalties is necessary. The Treasury Department has received frequent taxpayer complaints about the fairness of tax penalties. Often, in speaking before taxpayer groups, I am asked what we intend to do about the problems with our penalties. We also understand from our counterparts at the Internal Revenue Service that those who administer our penalties have encountered some difficulties.

At this point in the process, we can only provide a framework for analyzing the proper role of tax penalties and point to certain of the specific issues that we believe should be addressed. We will cooperate fully with this Subcommittee in its review of the tax penalty system and look forward to working with the Congress in developing any necessary reforms.

ROLE OF PENALTIES IN TAX SYSTEM

To understand the function of civil tax penalties in our tax system, it is first necessary to have an overall sense of how our tax collection system works. There are essentially three ways in which taxes are collected: voluntary payment of taxes by the taxpayers themselves; withholding by third parties of tax owed by taxpayers; and collection of taxes by the Service where they are not voluntarily paid by taxpayers or withheld by third parties.

Promotion of Voluntary Compliance

By far the most important function of civil tax penalties is to promote voluntary compliance. The majority of taxpayers recognize the importance of paying taxes, and voluntarily accept their responsibility to do so. There remains, however, a significant group of taxpayers who would carelessly or recklessly disregard the rules or knowingly understate or avoid altogether their obligation to pay tax. Tax penalties serve to deter such noncompliance. Moreover, the penalties imposed on noncompliance reinforce the honest taxpayer's ordinary instinct to comply, by providing assurance that noncompliance is not tolerated and thus that tax burdens are fairly distributed.

Fair Application to All Taxpayers

Although the tax penalty system's primary function is to act as a deterrent to noncompliance, it must also operate fairly with respect to the majority of taxpayers who comply with the tax laws. Our system should not penalize those who have not behaved wrongfully, nor overpenalize those whose noncompliance is inadvertent or relatively minor in nature. In addition, the penalty system should be designed so as to minimize administrative difficulties for such taxpayers. At some point, compliance itself would be jeopardized by a poorly devised penalty system that alienated otherwise law-abiding taxpayers. Thus, as we re-examine the penalty structure, we must pay careful attention to the perceived fairness of the civil tax penalties, particularly given that for some taxpayers the process of adapting to recent substantive changes in the tax law has made voluntary compliance more difficult.

CIVIL PENALTIES APPLICABLE TO TAXPAYERS

The civil penalty system is designed to promote two basic types of behavior by taxpayers: first, the timely reporting and payment of tax; and second, the accurate reporting of taxable income. The problems associated with these two types of compliance vary significantly in their complexity.

Timely Reporting and Payment of Tax

The essential first step in collecting revenues is to obtain the taxpayer's statement of the amount due and the payment of that amount. There currently are penalties for failure to file a return and for failure to pay the amount properly owing. Neither penalty applies in the case of a failure due to reasonable cause.

The failure to file penalty runs at 5 percent per month of the tax owing after subtraction of payments made on or before the due date of the return and of credits, up to a maximum of 25 percent. The separate failure to pay penalty is generally equal to 1/2 percent per month of the amount of tax owing for a month, determined by subtracting any payments made on or before the beginning of such month and credits. The 1/2 percent rate increases to 1 percent per month with respect to certain accounts in the collection stage, but the maximum penalty that may be imposed is 25 percent of the amount unpaid. With respect to amounts that the taxpayer shows on the return but fails to pay, the penalty runs from the date that payment is due. With respect to amounts for which a notice and demand is made, the penalty runs from the tenth day following notice and demand.

The penalty for failure to pay estimated taxes in large part serves as a means of taking into account the time value of money. To the extent it plays this role, it should not be analyzed in the same manner as other penalties.

Even though we believe a careful reassessment of the penalties associated with reporting and payment is appropriate, we anticipate that the issues encountered with respect to such penalties will prove relatively straightforward. It will generally be relatively easy to determine when the taxpayer has failed to report and pay taxes in a timely manner. The question simply is whether timely reporting and payment is encouraged by our penalty structure within a framework of fundamental fairness.

Accurate Reporting of Tax Liability

In contrast to the penalties relating to timely reporting and payment, the problems posed by the penalties relating to the accurate reporting of tax liability by the taxpayer are significantly more difficult. Two different basic approaches to such penalties have been adopted, one primarily relating to the behavior and state of mind of the taxpayer, and the other relating to the strength of the taxpayer's legal position. In both cases difficult questions of line drawing have inevitably been confronted.

Negligence and fraud penalties. Historically, tax penalty standards focused on the taxpayer's behavior and state of mind, with the civil negligence and fraud penalties, bolstered by criminal fraud penalties as necessary, the mainstay of tax law enforcement efforts. Until recent years these were the only generally applicable penalties designed to ensure that taxpayers accurately reported the amount of tax owing.

The negligence penalty applies if a taxpayer fails to make a reasonable attempt to comply with the tax laws or carelessly, recklessly, or intentionally disregards the applicable rules. Today, the negligence penalty stands at 5 percent of the entire underpayment of tax, plus 50 percent of the interest payable on the portion of the underpayment attributable to negligence. Negligence is presumed to be present with respect to an item, absent clear and convincing evidence to the contrary, if the taxpayer fails to properly report an amount shown on an information return prepared by a third party. However, the negligence penalty extends by reason of such negligence to only that portion of the understatement attributable to the misreported item.

The civil fraud penalty generally is imposed only when the taxpayer's behavior extends substantially beyond a failure to take reasonable care in the preparation of the required return and involves an intentional or reckless underpayment of taxes owed. This penalty is currently equal to 75 percent of the portion of the underpayment attributable to fraud, plus 50 percent of the interest payable on this portion of the underpayment.

Substantial understatement penalty. Over time, it became apparent that penalties triggered only by negligent or fraudulent behavior could not adequately assure that taxpayers reported their income accurately. The relative complexity of the system's substantive rules inevitably created large gray areas consisting of arguably correct positions with varying degrees of support. Sophisticated taxpayers were able to take very aggressive positions in areas of legal or factual uncertainty, with no risk of penalty unless the position reported was without a reasonable basis. This standard placed relatively little tension on a taxpayer's decision to take an aggressive position, since the taxpayer's aggressiveness could often avoid penalty in the event of audit, and would be rewarded if the taxpayer were among the great majority of taxpayers not audited.

As a result of the perceived imbalance resulting from the historical approach, new penalties were adopted in the 1980's to impose a cost on those audited and found to have taken aggressive positions on their return that did not have substantial legal support. Perhaps the most significant such penalty was adopted in the Tax Equity and Fiscal Responsibility Act of 1982, the penalty imposed on the portion of an underpayment attributable to a "substantial understatement" of tax liability. This penalty was 10 percent initially and is now 25 percent. For purposes of determining whether the gap between the liability the taxpayer reports and the correct liability is a substantial understatement, the portion of the understatement of tax attributable to positions taken on the tax return that are supported by substantial authority (which is more than a "reasonable basis" but not necessarily "more likely than not") or that are adequately disclosed on the return are disregarded unless the positions relate to certain tax shelter items discussed below. Under this penalty, then, unless the taxpayer discloses the matter on his return or has considerable support for his position, a penalty can be imposed irrespective of negligence or fraudulent intent or recklessness. Of course, the IRS may waive part or all of the penalty upon a showing of good faith and a reasonable basis for the position.

Tax shelter penalties. Concerns over the adequacy of the historical penalty standards were especially pronounced with respect to transactions expressly designed to exploit the disparities between tax and economic measurements of income or loss. The growth in such transactions and the taxpayer aggressiveness associated with them gave rise to a perceived need to strengthen the penalties applicable to "tax shelters."

As a consequence of this perception, several penalties have been adopted in recent years dealing primarily with taxpayers' participation in tax shelters and similar transactions, including a special part of the substantial understatement penalty. With respect to certain tax shelter items reported by a taxpayer with the principal purpose of avoiding or evading tax, the existence of a substantial understatement is calculated by disregarding only those positions taken on the return that the taxpayer reasonably believed were more likely than not to prevail and that were also supported by substantial authority.

In addition, the substantial undervaluation penalty was enacted in the Economic Recovery Tax Act of 1981 to apply to individuals and certain corporations underpaying income tax by $1,000 or more due to use of an inflated value or tax basis for property equal to 150 percent or more of the correct value. This penalty is 10 percent of the underpayment of tax attributable to an overvaluation of at least 150 percent but not more than 200 percent, 20 percent of the underpayment attributable to an overvaluation of more than 200 percent but not more than 250 percent, and 30 percent of the underpayment attributable to an overvaluation of more than 250 percent. A similar penalty is imposed for undervaluation for purposes of the estate tax. If the taxpayer shows that there was a reasonable basis for the position taken on the return and good faith, the IRS may waive part or all of these penalties.

Finally, an additional new civil tax penalty applies to underpayment attributable to "tax motivated transactions" after the Tax Reform Act of 1984. If such underpayment exceeds $1,000, the interest rate applicable to it is 120 percent of the underpayment rate.

PENALTIES APPLICABLE TO NONTAXPAYERS

Although we are focusing today primarily on the civil penalties applicable to taxpayers, it should not be forgotten that many of the civil tax penalties apply to persons with obligations unrelated to their own tax liability. In fact, many of the complaints which we hear about the penalty system relate primarily to these penalties.

Accurate withholding and deposit of trust taxes

Because withholding is critical to the collection of large amounts of revenue without the need for significant governmental enforcement efforts, a penalty applies to any amount that is not deposited on a timely basis by the person responsible for withholding. The penalty (which also applies to certain payroll taxes other than those withheld) is 10 percent of the amount that is not deposited on time. In addition, any person required to withhold an amount that willfully fails to withhold and pay over such amount is liable for it in full.

Information reporting

Information reporting with respect to the income and deduction items of other taxpayers also has played an increasingly important role in recent efforts to improve compliance. To ensure that the obligations to report accurately and on a timely basis are taken seriously, there are penalties for failure to file an information return, failure to provide a copy of such return to the taxpayer, and failure to provide correct information on a properly filed return.

Penalties applicable to parties who may affect another taxpayer's reported tax liability

A number of penalties buttress those imposed on the taxpayer to achieve accurate reporting. Return preparers are penalized for negligent or intentional understatement of a taxpayer's liability. In addition, there is a civil penalty for aiding and abetting a taxpayer's understatement of tax.

Moreover, among the newer penalties are several intended to limit the activities taken by those who would profit from the marketing of tax benefits. There are penalties for promoting an abusive tax shelter, failing to register an investment deemed to be a tax shelter, and failing to maintain an investor list with respect to a tax shelter.

ASSESSMENT OF THE CURRENT SYSTEM

Having identified in general terms the role for penalties and the most significant existing civil tax penalties, it is appropriate to turn to an assessment of the current civil penalty system. Although it would be premature to suggest conclusions, we are aware of a number of concerns that should be addressed during the course of your review.

Structure of Penalties

Review of the civil penalty system should begin with its increasingly complex legal structure. Such complexity is itself a matter of concern, since penalties will not be effective unless understandable by taxpayers, other private parties, and the IRS personnel responsible for asserting them.

The interrelationship of the various penalties must also be examined, with a view to eliminating gaps in coverage or penalties that inappropriately overlap. There are, for example, several different penalties potentially applicable to a taxpayer from participation in a single tax shelter transaction. In addition, it may prove desirable to fold certain specific penalties into a more generic penalty devised to encompass a number of situations.

Each penalty should also be evaluated to determine whether the severity of the penalty is appropriate in light of the conduct sought to be encouraged. The application of multiple penalties may be unduly severe in some cases. Similarly, it may be advisable to consider whether first-time offenders should be treated more leniently than those repeating the behavior targeted by the penalty.

Administration of Penalties

Review of the civil penalty system must also focus on the manner in which penalties are being administered. Independent of the legal structure of the penalty system, uniform application of each penalty to similarly situated taxpayers is of obvious and critical importance. It should also be determined whether specific penalties are either asserted too frequently or ignored to the detriment of the system. In this connection, review should focus on the manner in which penalties are generated and the administrative procedures necessary to monitor the effectiveness of penalties on an ongoing basis.

Three specific issues relating to penalty administration appear to merit particular attention. First is whether the computerized assertion of certain penalties results in an unfair burden on persons against whom no penalty is ultimately assessed. Second is whether the assertion of overlapping penalties and large penalties has, in practice, distorted the administrative procedures designed to resolve disputes between taxpayers and the IRS because such penalties inevitably become part of the tax revenue at stake in such disputes. Finally, there is a question whether the "no-fault" substantial understatement penalty in practice penalizes taxpayers who have made inadvertent errors.

Penalties as One of Several Compliance Tools

In reviewing the civil penalty system, it should be kept in mind that penalties are one of a number of administrative tools that promote compliance. For example, the audit process has long played a role in ensuring that taxpayers' reported positions reflect the correct application of the tax laws. In addition, taxpayer assistance programs can promote accuracy and reinforce positive efforts by taxpayers to abide by the laws. Such programs are particularly necessary in times when substantive changes force taxpayers to reassess their conduct for the future. In the same vein, computerized reminders, form improvements and other efforts to make the rules known and understandable encourage taxpayer cooperation. Improvements to the administration of the information reporting program could also play an important role in the future.

Finally, there are fundamental compliance initiatives that could represent alternative solutions to some of the compliance problems that penalties attempt to address. Withholding at the source of payment remains the most cost-effective way of ensuring that taxpayers pay amounts due. In addition, rate reductions and substantive changes that broaden the tax base can be expected to reduce incentives and opportunities for misreporting the amount of taxes owing.

CONCLUSION

In the coming months we will work with the Subcommittee, the IRS and others seeking to find answers to the questions raised by our existing civil penalty system. I look forward to working with you as our mutual efforts progress.

IRS PENALTY TASK FORCE
(AS OF 4/7/88)

Name	Position
Richard C. Stark, Chairman	Assistant to the Commissioner
Roger Plato, Executive Secretary	Assistant to the Senior Deputy Commissioner
Don Rocen	Assistant to the Commissioner
Gayle G. Morin	Director, Legislative Affairs Division
Damon O. Holmes	Taxpayer Ombudsman
Martin Kaye	Acting Director, Appeals Division
James J. Keightley	Associate Chief Counsel (Litigation)
Daniel Wiles	Branch Chief, Tax Litigation Division
Paul M. Harrington	Deputy Assistant Commissioner (Collection)
Gary O. Booth	District Director, Austin
Gerald Mihlbachler (Jerry)	District Director, Denver
Merlin W. Heye (Merle)	District Director, Fort Lauderdale
Stuart Sirkin	Special Assistant for Employee Plans
Milton Cerney	Branch Chief, Exempt Organization Technical Division
Robert T. Johnson (Bob)	Deputy Assistant Commissioner (Examination)
Vernon Richard Engen (Dick)	Chief, District Programs Section, Examination
Irene Sherk	Assistant Director, Research Division
Jack L. Miller	Assistant Director, Returns Processing and Accounting Division
Patricia McClanahan	Office of the Tax Legislative Counsel, Treasury

PREPARED STATEMENT OF JAMES W. CHILDS

Mr. Chairman, Senators, Commissioner Gibbs, members of the press and guests:

I am Professor James W. Childs of The University of Akron School of Law and Director of The Center for Taxation Studies, Tax Clinic Program. Our Clinic represents low income taxpayers in audits, collection proceedings, and litigation before The United States Tax Court. It is composed of 19 law students and graduate business students, 15 of whom are with me today, and two of whom will present the testimony. In addition, the Tax Clinic prepares between 200 and 400 low income taxpayer's tax returns annually. The Tax Clinic assists in the training of 100 retired tax return preparer volunteers, and provides computer support for over 30 low income tax preparation sites. I wish to now yield to:

There are over 150 different penalties in the Internal Revenue Code (see cites on pages 1-12 in the written testimony). These penalties can range from fines to imprisonment, or both. These penalties are assessed, collected, and paid in the same manner as are tax deficiencies and interest. Interest begins running from the date of demand until the tax, accrued interest, and penalties are fully paid.

Interest is not viewed as a penalty, but as compensation for the government's being deprived of the use of the money. Some penalties are interest sensitive, and the daily accrual of interest on these penalties indicates a revenue yield policy. See pages 14 and 15 for examples of how this combination of interest and penalties can drastically increase the amount owed by the taxpayer, even multiplying the amount of the deficiency by as much as 530% over a ten year period.

Penalties on top of penalties indicate a revenue yield policy. These penalties are supposedly assessed to reimburse the government for the expense of investigation and litigation. A lack of Congressional guidance tends to result in IRS agents applying <u>all</u> penalties to taxpayers without qualified representation. The average low income taxpayer does not have the necessary funds to acquire this service(see pages 15-17).

A major problem is that a lack of reading skills prevents many taxpayers from complying with the tax laws. The reading level of most IRS publications is extremely high in relation to most of the written material that low income taxpayers would normally come into contact with. As measured by the Fry Readability Formula, a Form 1040EZ instruction booklet requires an 8.45 grade reading level. The reading level required for a Statutory Notice of Deficiency is 8.7. It should be noted that the March 3, 1988 Wall Street Journal required only a 7.1 grade reading level(see pages 19-21).

The Internal Revenue Service should write instructions for forms 1040, 1040A, and 1040EZ at between the second and fourth grade level. The University of Akron Center for Taxation Studies would be pleased to offer to provide technically correct instructions for such forms, written at a reading and understanding level of grades two through four, within a time frame established by the Internal Revenue Service, and we could do so even if you were to pass legislation in November, which is unlikely this year .

According to the U.S. Department of Education, the following percent of the population possesses a 8.45 grade reading level: Blacks, 19.8%; Hispanics 37%; Persons with less than a high school education, 11%; and high school graduates, 50.2%. This study indicates that the majority of low income taxpayers will find it difficult, if not impossible, to comprehend and, thus, to comply with the federal income tax laws (see pages 19-21).

Mr. Chairman, I now yield to:

We suggest two alternatives to help remedy these problems. At a minimum, representation should be provided to the taxpayer before penalties or interest are assessed. One possibility is to adopt the ombudsman concept. Another is the to establish Tax Clinics, like ours, nationwide. These clinics would be licensed and supervised by the Director of Practice of the IRS to assist taxpayers. A third is using retired professionals in a senior citizen's clinic structure, also licensed by the Director of Practice. A fourth possibility is a combination of all three. If the taxpayer cannot afford representation, and pro bono representation is not available, the penalty system should be altered with respect to low income taxpayers. This could apply to taxpayers with a gross income of $25,000 or less per year, before FICA taxes (see pages 22-26).

We have encountered several cases in which taxpayers have missed the 90 day period to protest the assessment, and since they could not afford to pay the tax, they could not litigate the matter in court. Without litigation to obtain abatement, interest and penalties continue to accrue, sometimes to levels far beyond what the low income taxpayer will ever be able to pay (see pages 18-19).

If the taxpayer can demonstrate the inability to pay the penalties and interest, the penalties and interest should be automatically abated at the audit level. Part of the justification for this proposal is the fact that a substantial number of these low income taxpayers cannot at this time, and probably never will, be able to pay. Therefore, these amounts being carried on the books of the government are illusory(see pages 25-26).

We contend that in order to assess penalties and interest, the IRS should be required to notify every taxpayer who can be held responsible for the tax and the deficiency. This could be accomplished by sending all notices by certified mail(see page 26).

The low personal exemptions in the Code enable the IRS to impose levies on a substantial portion of the taxpayer's weekly wages. This IRS policy precludes collection as well as increasing federal social service expenditures. Since the IRS will not levy against unemployment compensation or welfare benefits, this provides an economic incentive for low income taxpayers to opt out of the job market and onto the public dole. The current exemption amounts bear no relationship to what the taxpayer needs for basic necessities. By increasing the exemption amount, the government will not only encourage a return to employment, but will also make at least a portion of the deficiency collectible, generating future tax revenue (see pages 26-28).

Unrepresented low income taxpayers often do not fully understand their rights under the existing statutory notice of deficiency. In the case of a divorce, for example, the IRS might send the notice to the taxpayer's spouse. When a joint tax return is involved, the IRS is permitted to send a single joint notice of deficiency to the last known address. This is true unless either spouse has notified the District Director that separate residences have been established. Even then, the IRS may still send a single joint notice, and one of the taxpayers will not be notified. Thus, after 90 days, the taxpayers loses the right to litigate in court, unless full payment has been made beforehand. This can be construed as denial of due process of law, which guarantees the right of access to the courts, regardless of economic status. Often, even the $60.00 filing fee intimidates the low income taxpayer, who considers it equivalent to a small fortune(see pages 26-33).

Certain assessments may be made without the taxpayer's receiving any notice of deficiency. Thus, no assessment made under these circumstances may be litigated in Tax Court, since a notice of deficiency is a jurisdictional prerequisite. Interestingly, the Code specifically states that the notice of assessment in these situations is not a notice of deficiency(see pages 34).

The revenue yield from penalties results in a regressive economic impact on the low income taxpayer. Often, just to pay the tax, installment payments must be arranged. However, without qualified representation, the low income taxpayer may not even be aware of this option(see pages 35-36).

When the penalty system was originally enacted, it was created to enforce the collection of taxes. However, since

1981, legislative history indicates a trend toward using penalties as a revenue raiser. Abuses by high income taxpayers have brought about a number of new penalties. Unfortunately, the low income taxpayer has been caught in this net. Stacking of penalties generally works as a deterrent to abuses by high income taxpayers, but since the low income taxpayer usually lacks the necessary skills to understand the tax system, he is often penalized merely for failure to comprehend (seepages 37-38).

POSSIBLE SOLUTIONS

Interest sensitive penalties should have a floor placed beneath them. In that way, the low income taxpayer with a minimal standard of living would be exempt. This would reduce the administration cost of collection and minimize regressiveness. At the same time as raising revenue, they would deter flagrant abuse of the tax laws by high income taxpayers, as well as introducing some progressivity into the system (see pages 38-39).

Abatement of the second or higher non-interest penalties should be an audit level function in the case of the low income taxpayer. These floor levels should be set by Congress and indexed. Stacked penalties should be automatically abated if, after the levy, the taxpayer does not have sufficient income to pay the primary deficiency (see page 39).

The mandatory services of a qualified representative should be provided at the time of audit or at the very least before wage levies are imposed. Higher amounts of the taxpayer's income should be exempt from the wage levy, as well as being indexed for inflation. The option of obtaining bankruptcy relief for all taxes, interest, and penalties should be available to the low income taxpayer (see pages 39-41).

Mr. Chairman, this concludes our prepared remarks and we offer into the record the written testimony attached hereto. We would be happy to try and answer any questions you or any of the other Senators may have at this time.

On behalf of Professor Childs, Professor Creme, Director of The Center of Taxation Studies, all of the Tax Clinic students, and The University of Akron, we thank you for the opportunity to appear and be heard.

I. PENALTIES AS REVENUE. LOW INCOME TAXPAYER IMPACT.

A. Current tax policy is not clearly set forth.

There are over 150 different penalties presently in the Internal Revenue Code.

1. GENERAL PENALTIES

1. {6651(a)(1) Failure to file a return: 5% per month up to 25% of tax due.

2. {6651(a)(2) Failure to pay tax due on return in {6651(a): 0.5% per month up to 25% of the tax due.

3. {6651(a)(3) Failure to pay amount in {6651(a)(2) within 10 days of notice of deficiency: 0.5% per month up to 25% of the tax due.

4. {6651(a) Also states that failure to pay amount in {6651(a)(2) within 60 days of the notice of deficiency is at least the lessor of $100 or 100% of the tax due.

5. {6652(a)(1)(A)(i) Failure to file a statement regarding amount of payment required by {6041: $50.

6. {6652(a)(1)(A)(ii) Failure to file statement relating to fishing boat operators: $50.

7. {6652(a)(1)(A)(iii) Failure to file a statement relating to income tax withheld: $50.

8. {6652(a)(1)(B)(i) Failure to make a return required of direct sellers: $50.

9. {6652(a)(1)(B)(ii) Failure to make return required of brokers: $50.

10. {6652(a)(1)(B)(iii) Failure to make a return relating to reporting payment of wages in the form of group life insurance: $50.

11. {6652(a)(1)(B)(iv) Failure to make a return relating to reporting of tips: $50.

12. {6652(a)(1)(B)(v) Failure to make a return relating to mortgage interest received: $50.

13. {6652(a)(1)(B)(vi) Failure to make return relating to cash received: $50.

14. {6652(a)(1)(B)(vii) Failure to make a return relating to abandonment of security: $50.

15. {6652(a)(1)(B)(viii) Failure to make a return relating to exchanges of partnership interests: $50.

16. {6652(a)(1)(B)(ix) Failure to make a return relating to donated property: $50.

17. {6652(a)(2)(A)(i) Failure to file statement related to payment of dividends: $50.

18. {6652(a)(2)(A)(ii) Failure to file statement relating to payment of patronage dividends: $50.

19. {6652(a)(2)(A)(iii) Failure to file statement relating to payment of interest: $50.

20. through 34. {6652(a)(3)(A) Separate penalty of 10%, $100, or 5% of gross proceeds for intentional disregard of filing requirements relating to 5 through 19.

35. {6652(b)(1) Failure to file statement relating to payment of dividends aggregating less than $10: $1.

36. {6652(b)(2) Failure to file statement relating to payment of patronage dividends aggregating less than $10: $1.

37. {6652(c) Failure to report tips: 50% of {3101 tax.

38. {6652(d)(1) Failure to file return by exempt organization: $10 per day.

39. {6652(d)(2) Failure of manager of exempt organization to file return: $10 per day.

40. {6652(d)(3) Failure to meet requirements with respect to public inspection of exempt organization's annual return: $10 per day.

41. {6652(e)(1) Failure to register pension plan: $1 per participant per day.

42. {6652(e)(2) Failure to file change of status by pension plan: $1 per day.

43. {6652(f) Failure to file information required in regard to deferred compensation: $25 per day.

44. {6652(g)(1)(A) Failure to file return required by {6039C: $25 per day.

45. {6652(g)(1)(B) Failure to furnish statement required by {6039C(b)(3): $25.

46. {6652(h) Failure to provide required information in connection with deductible employee contributions: $25 per day.

47. {6652(i) Failure to give notice to recipients of certain pensions: $10.

48. {6652(j) Failure to give written explanation to recipients of certain qualified rollover distributions: $10.

49. {6653(a)(1)(A) For negligence add 5% of underpayment.

50. {6653(a)(1)(B) and 50% of interest under {6601.

51. {6653(b)(1)(A) For fraud add 75% of underpayment.

52. {6653(b)(1)(B) and 50% of interest under {6601.

53. {6653(e) Failure to pay stamp tax: 50% of total underpayment.

54. {6654 Failure to pay estimated income tax: {6621 rate X underpayment X period of underpayment.

55. {6655 Failure of corporation to pay estimated income tax· same as {6654.

56. {6656(a) Underpayment of deposit of tax: 5% of underpayment.

57. {6656(b) Overstatement of claim of deposit of tax: 25% of claim.

58. {6657 Bad check: 1% of face value unless under $500, then lesser of $5 or amount of check.

59. {6659(a)(1) Overstatement of valuation by an individual: see {6659(b).

60. {6659(a)(2) Overstatement of valuation by a closely held or personal service corporation: see {6659(b).

61. {6659(f) Overstatement of value of charitable deduction: 30%.

62. {6660(a) Understatement of valuation for Estate/Gift Tax purposes: see {6660(b).

63. {6661(a) Substantial understatement of income tax liability: 10% of underpayment.

2. SUBCHAPTER B: ASSESSABLE PENALTIES

64. {6672(a) Failure to collect tax: 100% of tax.

65. {6672(a) Failure to truthfully account for tax: 100% of tax.

66. {6672(a) Failure to pay over tax: 100% of tax.

67. {6672(a) Attempt to evade or defeat tax: 100% of tax.

68. {6673 Bringing suit in Tax Court to delay assessment of tax: up to $5000.

69. {6673 Frivolous or groundless suit in Tax Court: up to $5000.

70. {6674 Failure to furnish statement to an employee: $50.

71. {6674 Fraudulent statement to an employee: $500.

72. {6675 Excessive claims with respect to certain fuels: greater of twice the excessive amount, or $10.

73. {6676(a)(1) Failure to put TIN on return: $5.

74. {6676(a)(2) Failure to furnish TIN to another person: $50.

75. {6676(a)(3) Failure to provide another person's TIN in a statement regarding such person: $50.

76. {6676(b)(1) Failure to provide the TIN of a payee of interest or dividends: $50.

77. {6676(b)(1) Including incorrect TIN of a payee of interest or dividends: $50.

78. {6676(c)(1) Failure to provide TIN to another person in regard to {215: $50.

79. {6676(c)(2) Failure to provide another person's TIN on return in regard to {215: $50.

80. {6677(a) Failure to file information with respect to a foreign trust: 5% of amount transferred to trust.

81. {6678(a)(1) Failure to furnish statement under {6041: $50.

82. {6678(a)(1) Failure to furnish statement regarding remuneration for services: $50.

83. {6678(a)(1) Failure to furnish statement regarding direct sales: $50.

84. {6678(a)(1) Failure to furnish statement regarding payment of dividends: $50.

85. {6678(a)(1) Failure to provide statement regarding payment of patronage dividends: $50.

86. {6678(a)(1) Failure to provide statement regarding brokers: $50.

87. {6678(a)(1) Failure to provide statement regarding payment of interest: $50.

88. {6678(a)(1) Failure to provide statement regarding payment of wages in the form of group life insurance: $50.

89. {6678(a)(2) Failure to provide statement regarding corporations: $50.

90. {6678(a)(3)(A) Failure to file a statement regarding windfall profits tax: $50.

91. {6678(a)(3)(B) Failure to file a statement regarding fishing boat operators: $50.

92. {6678(a)(3)(C) Failure to file a statement regarding crude oil: $50.

93. {6678(a)(3)(D) Failure to file a statement regarding income tax withheld: $50.

94. {6678(a)(3)(E) Failure to file a statement regarding employee's tips: $50.

95. {6678(b) Failure to file interest or dividend statement: $50.

96. {6678(c) Failure to notify partnership of exchange of partnership interest: $50.

97. {6679(a) Failure to file return with respect to foreign corporation: $1000.

98. {6679(a) Failure to file return with respect to foreign partnership: $1000.

99. {6682(a)(1) Furnishing false withholding information: $500.

100. {6684(a)(1) Becoming liable for Chapter 42 tax relating to a private foundation due to failure to act: a penalty equal to 100% of the tax.

101. {6685 Failure to comply with {7207 regarding private foundation's annual return: $1000.

102. {6686 Failure to file a return by a DISC or FSC: $100.

103. {6686 Failure to supply information by a DISC or FSC: $100.

104. {6687(a) Failure to supply place of residence regarding self-employment taxes: $5.

105. {6688 Failure to provide information in regard to {7654: $100.

106. {6689(a) Failure to file notice of redetermination of foreign tax: 5% per month up to 25%.

107. {6690 Fraudulent statement to plan participant: $50.

108. {6690 Failure to provide statement to plan participant: $50.

109. {6693 Failure to provide report on IRA: $50.

110. {6693 Failure to provide report on annuity: $50.

111. {6694(a) Negligent understatement of taxpayer liability by tax return preparer (TRP): $100.

112. {6694(b) Willful understatement of taxpayer liability by TRP: $500.

113. {6695(a) Failure to provide copy of return to taxpayer by TRP: $25.

114. {6695(b)(1) Failure to inform taxpayer of {274 requirements by TRP: $25.

115. {6695(b)(2) Failure of TRP to sign return: $25.

116. {6695(c) Failure of TRP to provide TIN: $25.

117. {6695(d) Failure to retain copy of return by TRP: $50.

118. {6695(e) Failure to file correct information return: $100.

119. {6695(f) Negotiation of refund check by TRP: $500.

120. {6697 Liability for tax of qualified investment entities: Penalty equals 100% of tax.

121. {6698(a)(1) Failure to file partnership return: $50 per month per partner.

122. {6698(a)(2) Failure to file a partnership return showing information required by {6031: $50 per month per partner.

123. {6698A Failure to provide information regarding carryover basis property: $100.

124. {6698A(b) Failure to provide information regarding carryover basis property to beneficiary: $50.

125. {6699(a)(1) Failure to satisfy requirements of {409 regarding qualified investments: Amount equal to failure.

126. {6699(a)(2) Failure to make contribution under {48(n): Amount equal to failure.

127. {6699(a)(3) Failure to satisfy any requirement of {409 regarding credit claimed under {44D: Amount equal to failure.

128. {6699(a)(4) Failure to make any contribution under {44G(c)(1)(B): Amount equal to failure.

129. {6700(a)(1)(A)(i) Organizing a partnership which promotes an abusive tax shelter: $1000 or 20% of the gross income derived.

130. {6700(a)(1)(A)(ii) Organizing any investment plan to promote an abusive tax shelter: $1000 or 20%.

131. {6700(a)(1)(A)(iii) Organizing any other plan or arrangement to promote an abusive tax shelter: $1000 or 20%.

132. {6700(a)(1)(B) Participating in the sale of any interest in a plan referred to in {6700(a)(1)(A): $1000 or 20%.

133. through 136. If in {6700(a) there is a gross overstatement as to any matter, the penalty is $1000 or 20% of the gross income derived.

137. {6701(a) Aiding and abetting understatement of tax liability: $1000.

138. {6701(a) Aiding and abetting understatement of tax liability by a corporation: $10,000.

139. {6702(a)(1)(A) Filing a return with insufficient information due to a frivolous position: $500.

140. {6702(a)(1)(B) Filing an incorrect return due to a frivolous position: $500.

141. {6702(a)(1)(A) Filing a return with insufficient information to delay tax: $500.

142. {6702(a)(1)(B) Filing an incorrect return to delay tax: $500.

143. {6704(a) Failure to keep records required under {6047(e): $50.

144. {6705 Failure of broker to provide notice to payors: $500.

145. {6706(a) Failure to show information required on debt instrument: $50.

146. {6706(b) Failure to furnish information required under {1275(c)(2): 11% of aggregate price of such issue.

147. {6707(a)(1)(A) Failure to register tax shelter: $500.

148. {6707(a)(1)(B) Registering false information in regard to a tax shelter: $500.

149. {6707(b)(1) Failure to furnish identification of tax shelter: $50.

150. {6707(b)(2) Failure to include identification number of tax shelter on return: $50.

151. {6708 Failure to maintain list of investors in potentially abusive tax shelters: $50.

152. {6708[9](a) Material misstatement about mortgage certificate due to negligence: $1000.

153. {6708[9](b) If #152 is due to fraud: $10,000.

154. {6708[9](c) Failure to file report regarding mortgage credit certificate: $200.

3. SUBCHAPTER A - CRIMES

There are 20 code sections (7201 through 7241) which cover criminal penalties, including fines and prison sentences.

4. SUBCHAPTER B - OTHER OFFENSES

There are nine code sections (7261 through 7275) which cover other penalties. These penalties are usually fines.

Some penalties are interest sensitive.

Section 6651 failure to file, or Section 6651(a)(2) failure to pay tax, Section 6653(a) negligence penalty and Section 6653(b) for fraud are assessed, collected and paid as if they were a part of the tax or deficiency. If it is not paid in full within ten days of notice and demand from the district director, interest is charged upon the unpaid amount at an annual rate as prescribed under Internal Revenue Code Section 6651, from the date of notice and demand until the amount is paid.

According to Rev. Proc. 63-5 (1963-1 C.B.) "...deficiency or (485) will not stop the running of interest, whenever an offer of payment is made prior to the determination, the examining officer will inform the taxpayer that it is preferable to make payment when the amount of deficiency or additional tax is determined."

According to House of Representatives; Rept. 100-391; 100th Congress; 1st Session; H.R. 3545 "Interest on the negligence and fraud penalties generally begins on the date these penalties are assessed..."

One can infer that interest sensitive penalties indicate a Congressional policy of revenue yield from penalties.

"Interest payments are viewed not as a penalty but simply as compensation for the United States having been deprived of the funds in question for the period until they are actually paid to the IRS and available as general revenue." United States v. Augspurger, 508 F.Supp. 327 (1981).

Daily accrual of interest on tax deficiencies and penalties, including interest sensitive penalties, further indicate a policy of revenue yield from penalties.

Example 1. If a taxpayer owing $500.00 was penalized under code section 6651 for failure to pay, he would owe penalties of 25% under section 6651(a)(1), 25% under section 6651(a)(2), 25% under section 6651(a)(3) and $100.00 under section 6651. This would total $975.00 and, at this point, interest would begin to accrue. Assuming an interest rate of 10%:

YEAR ONE	$1,077.53
YEAR FIVE	$1,607.39
YEAR TEN	$2,649.96

It can be seen that in ten years the original deficiency of $500.00 has increased 530% due to the combined effect of interest and penalties.

If a taxpayer is subject to a single penalty at either the 25% or 50% rate, the interest generated at the current rate as prescribed by IRS code would produce the following results.

Example 2. $1000.00 assessment at 25% penalty

YEAR ONE	$1,250.00
YEAR FIVE	$2,013.14
YEAR TEN	$3,242.18

Example 3. $1000.00 assessment at 50% penalty

YEAR ONE	$1,500.00
YEAR FIVE	$2,415.77
YEAR TEN	$3,890.61

As illustrated by the above two examples of a singular penalty, the amount due has increased over 320% as a result of the tacking of interest.

Penalties on penalties and tax deficiency indicate a policy of revenue yield from penalties.

"...In United States v. Thompson, 279 F.2d. 165, 168-169 (10th Cir. 1960) quoting Helvering v. Mitchel, 303 U.S. 391, 401 (1938), we observed that given the policy underlying civil fraud penalty provision of (6653) that "the purpose of the additional assessment of 50 percent of the amount of the tax deficiency is to reimburse the government for the heavy expense of investigation and the loss resulting from the taxpayer's fraud."

Internal Revenue Code Section 6622 requires all interest payable under the Internal Revenue laws to be compounded on a daily basis, while the bond market normally calculates yields to a maturity by compounding on a semi-annual basis.

Lack of clear Congressional guidance as to policy results in auditing agents applying all available penalties in almost all audits where the taxpayer is not assisted by a qualified representative; most low income taxpayers do not have a qualified representative at the audit level.

Practically speaking, many people who make less than $25,000, our suggested standard for a "low income taxpayer", could not afford representation in any form. We suggest, in the alternative, that taxpayers of this classification either be provided with pro bono representation when they have a deficiency assessed, or that they receive different treatment with respect to the penalties and interest attached to their assessment.

We were interested in seeing how many cases were won by the IRS and how many by the taxpayer at the Tax Court level. The only available information on this subject was a table in the 1986 IRS Annual Report which listed 1979 and 1980 results for cases with opinions rendered in different courts. It is our contention that many of the cases lost by taxpayers are argued pro se. Those that are represented by legal counsel win most of the time. The government supposedly won 52.2% of the tax cases in 1980. We believe that with representation low income taxpayers would not only be able to avoid the accumulation of interest and penalties, but to avoid the tax itself. Researchers were unable to find either more current or more representative reports. For instance, only cases for which opinions were rendered were found in the report.

ALTERNATIVE ONE:

We would suggest that at a minimum, representation should be provided to taxpayers before penalties and interest are added.

There are only a handful of pro bono IRS approved tax clinics available in the nation to assist low income taxpayers at the audit level. These clinics are granted permission to practice by the Director of Practice, currently Mr. Leslie Shapiro, and are designed to assist taxpayers in complying with the Internal Revenue Code. Our Clinic also has a contract with the U.S. Tax Court, and we litigate cases pro bono.

While we are not asking for federal funding for our Clinic, the fact remains that the taxpayers of the State of Ohio have a substantial investment in the Clinic to assist the federal government in the fair application of the federal revenue laws and to train future practitioners. Some of our graduates actively seek employment with the I.R.S.. Congress may want to consider that federal funding of clinics such as ours in the over 200 law schools and graduate business colleges to be an economical alternative to other proposals to provide pro bono taxpayer representation and to further provide an educated pool of talent to be employed by the I.R.S.

Most low income taxpayers cannot afford quality representation and are forced to rely on public service announcements and uninformed sources. Some of these services are provided by the IRS. However, these services are very limited in what they offer.

Many low income tax payers are not aware of the significance of the 90 day notice, or even what to do when they receive one. This information is not provided to them in any form, from any source. Despite their lack of knowledge, interest and penalties are assessed against them in a manner which often precludes them from getting fair treatment under the system.

Lack of reading skills prevent low income taxpayers from complying with the tax laws.

It was suggested to our clinic that information alone, if distributed to taxpayers, should suffice to make low income taxpayers aware of their rights and responsibilities. We believe that this would be insufficient and misleading as to its intended purpose, for the following reasons:

The reading levels for the following publications , as measured by the Fry Readability Formula, a commonly used guide to evaluate public school texts, were found to be the following:

A Statutory Notice of Deficiency required a reading level of grade 8.70; a Form 1040 EZ instruction book required a reading level of grade 8.45; a form 1040 instruction book required a reading level of grade 7.85; a New York Times, March 2, 1988, required a reading level of grade 7.65; and the Wall Street Journal, March 3, 1988, required a reading level of grade 7.10. A Statutory notice of deficiency required a reading grade level 1.6 years higher than that of the Wall Street Journal.

According to the U.S. Department of Education, the following percent of the population would possess the skill necessary to understand the type of information contained in the 1040 or 1040 EZ instructions:

Of those persons of black racial origin, only 19.8% would possess the skills necessary to understand the instructions. Only 37.0% of those persons of hispanic racial origin would possess such skills. Of the general population only 11.0% of the persons with less than a high school education could understand the instructions. Also only 22.0% of persons with some high school education could understand the instructions, and a mere 50.2% of High School graduates having less than two years of post secondary education could understand the instructions. Of persons with a two year degree or more than two years of postsecondary education, 82.8% can understand the instructions.

These studies indicate that four out of five Blacks or persons without a completed high school education, two out of three Hispanics, and nine out of ten persons with

<u>less than a high school education, cannot comprehend the instructions for a Form 1040, or a 1040 EZ, and a Notice of Deficiency is even more difficult.</u>

The major problem in the readability of these documents is the complexity of their sentence structure. The average sentence length of these publications exceeds twenty-five words. To add to the complexity, one-third of the words in these publications are multi-syllabled words. This problem can and should be corrected.

This analysis is based on applying the Fry Tables to studies by Kirsch and Jungeblut, Literacy: Profiles of America's Young Adults, U.S. Department of Education Research and Improvement, final contractor order from Educational Testing Service, September 1986.

If the taxpayer cannot read the instructions, how can the government expect compliance? We have no reason to believe that information distributed to the taxpayers about their rights and responsibilities with respect to unpaid taxes would be written at a greater level of understandability. Taxpayers in general, and especially low income taxpayers, would never be able to read and comprehend such information. It is imperative that they be assisted if the penalty system is not improved.

Another suggestion is that low income taxpayers should be told to call someone at the IRS level to obtain information about their rights and responsibilities with respect to deficiencies. For instance, most taxpayers are not aware that they only have 90 days to object to an assessment before their relief is barred without litigation. Most low income taxpayers will probably have the penalties automatically assessed because of their lack of information.

We also do not believe that a phone line will be beneficial. Studies have shown an error rate for the call in question and answer system set up by the IRS ranging from 25%, as reported by Commissioner Gibbs, to 39% as reported by The General Accounting Office. Either way, the information does not seem to be reliable. It is imperative that low income taxpayers be informed, not misinformed.

For the reasons stated above we firmly believe that a requirement of representation should be used in conjunction with the penalty system.

ALTERNATIVE TWO:

If taxpayers who are not able to provide their own representation are not to be provided with representation, we believe that the penalty system should be altered with respect to them.

We are not advocating the complete prohibition of interest and penalties based on a gross income level of less than $25,000, even though this looks to be a very feasible possibility, but are instead suggesting the implementation of a system which would permit low income taxpayers to at least be presented with a forum before the interest and penalties become so outrageous that they will never have "their day in court."

We acknowledge that to effectively administer the tax laws it is necessary to limit the ability of a taxpayer to abuse judicial economy and prevent wasting the court's time. However, many low income tax payers are in a position as to not even be able to pay the tax itself let alone all of the attached interest and penalties.

B. Regressive Economic Impact

In our Tax Clinic, we have encountered several cases where taxpayers, for differing reasons, had missed the 90 day period to protest the assessment, yet could not afford to pay the tax in order to litigate the matter.

One such case involved an innocent spouse who had filed a joint return with her husband at his insistence after a separation, but before a divorce. Once divorced, he received the notice of deficiency yet failed to contact her and give her notice. By the time we had been approached to represent her, a tax of approximately $1000, which she could never have paid in the first place, had been increased by interest and penalties to over $2000, which she STILL has not been able to pay. Because the Tax Court has no jurisdiction to hear this case, we as a Clinic are not able to defend her in this matter. The interest and penalties are still accruing, far beyond what she will ever be able to pay.

This particular taxpayer has a number of potentially valid defenses to the liability on the tax yet she is prevented from having herself cleared of such liability because of the jurisdictional requirement. To add insult to injury, she is being charged interest and penalties on a daily basis. We believe that there are several ways that taxpayers in this situation, the number of whom are far greater than one would imagine, could be afforded relief.

A taxpayer who is to receive these suggested allowances should be able to demonstrate an inability to pay the deficiency, a prima facie meritorious defense to the deficiency, and present a case of ineffective notice. The allowances could be, but are not limited to, the ability of U.S. Tax Court to grant extensions of time past the 90 day imposed threshold, the staying of the accumulation of interest and penalties until one has received sufficient notice, or even the ability of the Tax Court to obtain jurisdiction upon payment of a portion of the tax itself rather than all of the tax, penalties and interest.

The extension on time which, we suggest, would be analogous to that permitted by the Federal Rules of Civil Procedure as found in rule 6(b). The Tax Court, if directed, could choose to accept petitions on deficiencies after the 90 day period has expired. This would not affect the ability of the Government to use the penalty system as a revenue raiser. If the taxpayer does not have a meritorious defense, or cannot prove their innocence, the Government will then be able to assess interest and penalties.

By refusing taxpayers with meritorious claims the ability to prove their innocence, the Government is merely padding the books as to outstanding "revenues" available for collection. In most cases, based on information received from private tax practitioners, when a person is able to get to court, many if not most, of the penalties themselves are abated. Therefore, it is our contention that the low income tax payers, who cannot get into court or do not know about the system of abatement are accumulating large debts attributable to interest and penalties, which will prevent them from ever being relieved of this liability.

As a practical matter, these "revenues" will never be collected. But they will be a burden and embarrassment to otherwise lawful citizens. In all of our extensive research we were unable to find any statistics to show exactly how much of the outstanding federal debt attributable to uncollected taxes are the responsibility of low income taxpayers. We wanted this information to see how heavily the penalty system affected this class of taxpayers.

With respect to our second suggestion, the staying of the accumulation of interest and penalties until the taxpayer in question has received sufficient notice, is partly self explanatory. We contend that in order to assess penalties and interest charges, the IRS should be required to prove that the taxpayer did, in fact, receive notice. This could be accomplished simply by requiring that the notice of deficiency be delivered by certified mail. Until the IRS can make a showing that the taxpayer received and understood the significance of the deficiency, we believe that no penalties should be assessed.

Extremely low personal exemptions in the Code result in a low income taxpayer being able to retain out of earnings after I.R.S. levy on wages, a weekly sum less than the taxpayer could receive in levy exempt unemployment payments. I.R.C. section 6334 provides that various types of property shall be exempt from levy.

Internal Revenue Code Section 6334(a)(4) provides that unemployment compensation payments are exempt from levy. Section 6334(d) provides that there shall be exempt from levy $75 per week of wages, salary or other income exempt from levy plus $25 for the spouse and each individual for which the taxpayer has provided over half the support. For example, a single individual with no dependents might choose to "lose" his job if he would receive more than $75 dollars per week in unemployment compensation.

Also, Policy Statement P-5-32 of the Internal Revenue Manual provides that, although not exempt, welfare payments will not be levied against. Therefore, the same situation exists in regards to welfare payments as for unemployment compensation. A taxpayer may very well be faced with the choice of working and keeping only $75 per week or going on public assistance to receive a "pay raise".

The scenarios described cannot be beneficial to the government or the taxpayer and we support increasing the exempt amount in 6334(d)(1) to an amount that would not encourage this practice.

Existing penalty and interest structure added to the deficiency, invariably exacerbate the plight of the low income taxpayer. A wage levy of all amounts in excess of exemptions often never reduces the primary tax deficiency, since the interest and penalties accrue greater than the maximum levy.

For example, the tax clinic has what it feels is a meritorious defense to a deficiency assessed for social security taxes. The taxpayer in question was a State of Ohio employee, and therefore should never have been subject to federal social security taxes. Notwithstanding this fact, the taxpayer received a direct assessment and was not afforded an opportunity to litigate his claim in Tax Court. When we first encountered this case the taxpayer was making $18,000 per year and could not be levied against in an amount sufficient to reduce his outstanding liability.

Such amounts carried on the books of the I.R.S. as collectible are illusory and, in reality, are uncollectible.

Due to the three year rule the low income taxpayer can find no relief in bankruptcy. 11 U.S.C.A. sec. 507. See 11 U.S.C.A. sec.523.

Voluntary compliance with the tax laws is negatively impacted by the regressive economic effect of the existing perception on the part of the low income taxpayer of a revenue yield policy: it is seen as unfair; it is seen as a form of legal blackmail; and it encourages an underground economy at the lower end of the economic spectrum.

C. Existing policy with its regressive impact on low income taxpayers amounts to de facto confiscation, with few effective due process of law remedies available.

Unrepresented low income taxpayers do not fully understand their rights under the existing statutory notice of deficiency. In divorce situations, one party often does not even receive the notice, and loses the 90 day window to litigate such provisions as innocent spouse, in Tax Court without full payment.

The Fifth Amendment of the Constitution of the United States provides, *inter alia*, that no person shall "...be deprived of life, liberty, or property without due process of law...". The Supreme Court has interpreted "due process of law" to include a right of access to the courts: "...[although] many controversies have raged about the cryptic and abstract words of the Due Process Clause, there can be no doubt that at a minimum they require that deprivation of life, liberty, or property by adjudication be **preceded** by notice and opportunity for hearing appropriate to the nature of the case." (*Mullane v. Central Hanover Trust Co.*, 339 U.S. 306, at 313 (1950); emphasis supplied); "It is to courts, or other quasi-judicial official bodies, that we ultimately look for the implementation of a regularized, orderly process of dispute settlement. Within this framework, those who wrote our original Constitution, in the Fifth Amendment, and later those who drafted the Fourteenth amendment, recognized the centrality of the concept of due process in the operation of this system. Without this guarantee that one may may not be deprived of rights, neither liberty nor property, without due process of law, the State's monopoly over techniques for binding conflict resolution could hardly be said to be acceptable under our scheme of things." (Boddie v. Connecticut, 401 U.S. 371, at 374 (1970)); and, most significantly, "Just as a generally valid notice procedure may fail to satisfy due process because of the circumstances of the defendant, so too a cost requirement, valid on its face, may offend due process because it operates to foreclose a particular party's opportunity to be heard. The State's obligations under the Fourteenth Amendment are not simply generalized ones; rather, the State owes to each individual that process which, in light of the values of a free society, can be characterized as due."

We have included these references to point out the fact that the courts have interpreted due process of law to include access to the courts regardless of economic circumstances. The payment of the assessment and filing fees, while it would present no major problem for most of us, may be an insurmountable barrier to the low income taxpayer, who often finds it difficult merely to provide himself and his family with the bare necessities of life. The low income taxpayer is, in effect, denied any judicial remedy, just as surely as though the doors to the courthouse were locked in front of him.

A $60.00 filing fee intimidates some low income taxpayers, who consider such an amount a fortune, and who are not capable of appreciating what lies in store for them. This type of litigation is by no means frivolous, nor should this right be treated as a luxury, since the low income taxpayer has a much greater proportional interest at stake than the middle or high income taxpayer; for the low income person, the question is often not whether he will eat steak or hamburger, but whether he will eat.

It is worth noting at this point that there is a certain deference associated with what has been called the "tax label;" that is, when a statute is labeled a "tax" statute, it is scrutinized differently than any other type of legislation (see Sundberg, Jacob W. F., The Tax Label, privately published). That is the case here, since the principle of due process of law seems to operate in a vacuum in tax cases, with the justification being couched in such terms as "tax autonomy" and "tax sovereignty," and the use of such phrases as "legislative grace" in describing the "privilege" to litigate these matters. Certainly, the founders never intended to create exceptions to fundamental civil rights, such as due process, simply because one of the parties represents the administrative apparatus of the State.

The failure of a statutory notice of deficiency being received by one of the spouses is common in a divorce situation.

Under IRC Section 6212(b)(2), when a joint income tax return is involved, the Internal Revenue Service is permitted to send a single joint notice of deficiency to the taxpayers at their last known address. This is true unless either spouse has notified the I.R.S. that separate residences have been established. Under Internal Revenue Code Regulation 301.6212-1(b)(2), this notice must be sent to the district director for the district in which the return has been filed. Therefore, even though the taxpayers may be divorced and have actually established separate residences and filed subsequent income tax returns using their new addresses, the I.R.S. may still send a single joint notice of deficiency. Thus, one of the two persons involved will not receive a notice of deficiency. Edward J. Camous, 67 TC 721.

Most low income taxpayers are not sophisticated enough to know that they are required to notify the IRS of their new address upon being divorced. Even fewer taxpayers would know or have the means to find out that the notice is to be sent to the district director.

The I.R.S.'s failure to ascertain the latest address of the separate taxpayers, and to send separate notices to them, could be construed as a denial of due process, since adequate notice to defend will not reach at least one party. The I.R.S. should at least be required to consult their central computer to see if there is a more recent address for each of the taxpayers involved. In cases where the I.R.S. may not be aware of a divorce situation, this computer check could also establish the current marital status of the taxpayers (per the filing status on subsequent returns filed) While this may not solve all the problems involved in this area, it could eliminate some the bitterness towards the IRS in this situation.

Certain assessments can be made under the Internal Revenue Code without the taxpayer receiving a notice of deficiency. The most commonly seen illustration of this is probably Internal Revenue Code Section 6213(b)(1) which allows the I.R.S. to assess taxes in cases dealing with "mathematical or clerical errors". Any assessments made in these circumstances cannot be litigated in Tax Court, since a notice of deficiency is a jurisdictional prerequisite, and Section 6213(b)(1) specifically states that the notice of such an assessment shall not be considered a notice of deficiency. While the notice of such an assessment is required to explain the alleged error, it is not required to include an explanation of the taxpayers appeal rights. IRC Section 6213(b)(2) allows for the automatic abatement of these assessments, if the taxpayer files a request for abatement with the Secretary within 60 days of notice of such assessments. While in most cases these mathematical and clerical errors will indeed be errors (as defined in the Internal Revenue Code), in a few cases they are correct.

II. Penalties as a deterrent to non-compliance.

A. The prevailing view since the inception of the Internal Revenue Code.

Historically, there were no interest sensitive penalties, which resulted in a less regressive economic impact on low income taxpayers. Low income taxpayers traditionally purchase a larger percentage of goods and services on credit, paying interest. Interest sensitive penalties add to an already heavy interest burden. Penalties as a percentage of deficiency have a theoretical non-regressive, non-progressive economic impact. This theory is not borne out for the low income taxpayer, where the deficiency itself may represent a higher percentage of net spendable income after basic necessities than to a higher income taxpayer. A larger percentage of higher income taxpayers have the services of qualified representatives at audit and appeals, who succeed in obtaining remission of penalties. Disparity of representation creates a reduced but still regressive economic impact to such penalties.

REVENUE YIELD POLICY FROM PENALTIES:

The revenue yield from penalties as presently enacted results in a regressive economic impact on the low income taxpayer. As stated before, for a great number of low income taxpayers the tax deficiency itself is an insurmountable burden. The University of Akron Tax Litigation Clinic sees this situation in almost all of its cases. Many times, just to pay the tax, installment payments have to be arranged. However, these taxpayers are at an advantage. They have had some sort of representation who has informed them of the availability of the installment system. Unrepresented taxpayers will probably not know of this arrangement.

We cannot hope to represent them fairly and equitably if the dictates of the Code are not followed. Since we have gone from the deterrent effect as intended by Congress when the penalties were enacted, to a revenue raising purpose, it is time to revamp the consequences to taxpayers who are no longer fairly represented. Regardless of the intention of Congress, or the Courts, in writing and interpreting the penalty system of the Internal Revenue Code, what is most important is how the Code is interpreted by the I.R.S., both for and against the taxpayer.

What is the reason for the implementation of the penalty system? Was it designed to have a deterrent effect, or was it designed to raise revenue? The answer to this question is of vital importance, especially to the low income taxpayer.

When the penalty system was originally enacted, it was to enforce the collection of duties and taxes. Dorsheimer v. U.S. 74 U.S. 166 (1868). Currently, there are differing views for its use depending on who is speaking.

The Internal Revenue Manual states that fair and equitable treatment of taxpayers requires the I.R.S. to administer civil penalties in a manner which fosters voluntary compliance and confidence in the tax system. The I.R.S. will strive to meet this expectation in the interest of fairness, equality and effective tax administration.

More recent discussions belie the original intent of the penalty system, with so much emphasis placed on the amount of revenue which is raised or to be raised as a result of the penalty system. Review of Taxation of Individuals, No. 1, 47 (1987) said that the penalty area is a growth industry for the IRS. Penalties contributed more than $3 billion in 1985, while contributing untold dollars to the system, by encouraging increased voluntary compliance by fear.

The legislative history of years 1981 through 1987 indicate a trend towards the idea of using penalties as a revenue raiser.

While little considered by the courts, there is a de facto lack of equal protection. Congress has also not adequately recognized, nor has it addressed, this problem in considering penalties. The low income taxpayer has about as much knowledge of how to obtain abatement of a penalty through problems resolution as he/she does of getting to the moon. Abuses by high income taxpayers have brought about a plethora of new penalties. Unfortunately, the low income taxpayer has been caught in this net. The number of penalties should be a deterrent, not a means for increasing revenue. Stacking of penalties generally works as a deterrent for high income taxpayers, and, in this context, stacking of penalties is a progressive economic concept. However, penalty stacking is also economically regressive at the lower end of the economic spectrum. Penalty stacking for all tax noncompliance violates the concept that stacking is meant to deter specific tax conduct.

III. Possible solutions.

A. Interest sensitive penalties.

These penalties should have a floor placed under them.

A taxpayer with a minimal standard of living taxable income should be exempt. There is economic savings in administration cost of collection due to the fact that at this level the penalties are, in fact, uncollectible. It minimizes regressiveness. As revenue raisers they will deter flagrant misconduct by high income tax abusers. It instills a degree of progressivism to the tax system. Progressivism is then the price the abuser pays.

B. Penalty stacking.

Abatement of the second or higher non-interest sensitive penalty should be made an audit function for a low income taxpayer; i.e., below a certain economic floor. The low income floor should be set by Congress and indexed.

Stacked penalties should be automatically abated if a taxpayer, after levy, does not have sufficient income to be paying on the primary deficiency.

<u>C. Other needed remedies for the low income taxpayer.</u>

The mandatory services of a qualified representative or ombudsman before a wage levy should be required.

The services of a qualified representative will increase the opportunities available to the low income taxpayer to pursue the abatement of certain penalties and interest assessed by the IRS. A qualified representative could also provide a first tier screening process as to the validity of the taxpayers' defense.

Indexed and higher amounts should be exempt from wage levy.

Present law states, in Section 6334(d)(1), that the following amount is exempt from wage levy: "...in the case of an individual who is paid or receives all of his wages, salary, and other income on a weekly basis, the amount of the wages, salary, and other income payable to or received by him during any week which is exempt from levy under subsection (a)(9) shall be $75.00 plus $25.00 for each individual who is specified in a written statement..."

It appears, in todays environment, that it would be extremely difficult for a family of four to exist on a mandatory stipend of $150.00 per week. This removes, or reduces, an individual's incentive to work and would tend to encourage unemployment coupled with increased reliance upon government assistance. This has what we consider to be three major drawbacks: 1. Inability to collect the original deficiency; 2. Reduced future tax revenues since earned income is now non-existent; and, 3. Increased public expenditures due to reliance on public assistance programs.

The ability to obtain bankruptcy relief for all taxes, interest, and penalties for the low income taxpayer.

Currently, the IRS code does not permit relief even when a taxpayer is in bankruptcy. It is our feeling that this is unfair treatment for the economically disadvantaged.

Statement of

Lawrence B. Gibbs
Commissioner of Internal Revenue

MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE:

I AM PLEASED TO BE HERE TODAY TO DISCUSS AN IMPORTANT AND SENSITIVE ASPECT OF FEDERAL TAX LAW -- CIVIL SANCTIONS IN THE INTERNAL REVENUE CODE. WITH ME TODAY ARE CHARLES BRENNAN, DEPUTY COMMISSIONER (OPERATIONS), AND RICHARD STARK, ASSISTANT TO THE COMMISSIONER. MR. STARK NOW CHAIRS OUR TASK FORCE WHICH IS REVIEWING CIVIL SANCTIONS. WE WILL BE PLEASED TO RESPOND TO THE SUBCOMMITTEE'S QUESTIONS FOLLOWING MY TESTIMONY. AMONG THE AREAS I'LL BE COVERING ARE:

-- THE RELATIONSHIP BETWEEN TAXPAYERS AND THE TAX SYSTEM,

-- OUR CONCERNS ABOUT THE CURRENT PENALTY STRUCTURE IN THE INTERNAL REVENUE CODE,

-- THE ROLE WE FEEL PENALTIES SHOULD PLAY IN MAKING OUR TAX SYSTEM WORK, AND

-- A MAJOR STUDY IRS HAS UNDERTAKEN TO REVIEW CURRENT PENALTIES.

IN THE NEW ENVIRONMENT ARISING FROM THE TAX REFORM ACT OF 1986, I BELIEVE THE ROLE OF PENALTIES IN THE TAX SYSTEM SHOULD BE REVIEWED. ADDITIONALLY, THE TOUGHER PENALTIES ENACTED IN 1981, 1982, AND 1984 HAVE NOW BEEN IN EXISTENCE LONG ENOUGH TO EVALUATE THEIR IMPACT ON TAX ADMINISTRATION. THUS, THE TIME IS RIGHT FOR A SYSTEMATIC LOOK AT OUR CIVIL PENALTY SYSTEM. WE HOPE THAT SIGNIFICANT IMPROVEMENTS WILL RESULT, AND FOR SEVERAL MONTHS NOW WE HAVE BEEN DOING OUR PART BY UNDERTAKING A COMPREHENSIVE STUDY OF THE PENALTY SYSTEM.

THE CHANGING TAX ENVIRONMENT

OUR CONCERN WITH THE APPROPRIATENESS AND ADMINISTRABILITY OF PENALTIES ISN'T NEW. IN THE IRS ANNUAL REPORT OF 1865,

COMMISSIONER ROLLINS CAUTIONED THAT PENALTIES WERE BECOMING AS NUMEROUS AS TYPES OF RETURNS, DIFFERING "LARGELY IN AMOUNT FOR THE SAME GRADE OF OFFENSE, WHILE THE MANNER OF THEIR RECOVERY IS AS VARIOUS ALMOST AS THE FORMS OF PROCEEDINGS KNOWN TO THE COURTS." AS I LOOK AT THE PENALTY SYSTEM TODAY, I THINK COMMISSIONER ROLLINS' COMMENTS ARE STILL PERTINENT.

OUR TAX SYSTEM, THE BASIS OF WHICH IS VOLUNTARY COMPLIANCE, RAISES ALMOST $900 BILLION A YEAR, AND THAT IS INCREASING EVERY YEAR. THAT FACT MAKES OUR TAX SYSTEM THE ENVY OF THE WORLD. HOWEVER, OUR TAX SYSTEM HAS BORNE INCREASING BURDENS OVER THE PAST TWO DECADES.

CONGRESS HAS MADE MAJOR CHANGES TO OUR TAX LAWS IN 1969, 1974, 1976, 1978, 1981, 1982, 1984, 1986, AND AS RECENTLY AS LAST DECEMBER. CONSTANT CHANGES IN THE TAX LAW CAUSE CONFUSION; CONFUSION CREATES DISTRUST; AND ULTIMATELY, DISTRUST LEADS TO DISRESPECT OF OUR TAX LAW. IT IS ALSO MY OBSERVATION THAT DISRESPECT INCREASES AS PEOPLE FEEL THAT SIMILARLY SITUATED TAXPAYERS ARE NOT PAYING THE SAME AMOUNT OF TAX.

OVER THE LAST TWO DECADES, WE HAVE SEEN TAX BENEFITS BECOME TAX LOOPHOLES AND TAX LOOPHOLES BECOME TAX SHELTERS AND SUBSEQUENTLY ABUSIVE TAX SHELTERS. WITH THE ADVENT OF TAX PROTESTERS, WE HAVE SEEN TAX GIMMICKS IN THE FORM OF MAIL ORDER MINISTRIES, FAMILY ESTATE TRUSTS, AND A VARIETY OF CONSTITUTIONAL ISSUES REGARDING WHETHER PEOPLE HAVE TO PAY TAXES IN THIS COUNTRY AT ALL.

INITIALLY, OUR GOVERNMENT'S REACTION TO THIS STATE OF AFFAIRS, IN THE LATE 1970S AND EVEN INTO THE 1980S, WAS TO COMBAT INCREASING NONCOMPLIANCE WITH ADDITIONAL PENALTIES, TO FIND WAYS TO MAKE IT LESS ECONOMIC TO PLAY THE AUDIT LOTTERY, AND TO INCREASE THE IRS COMPLIANCE TOOLS FOR DEALING WITH TAXPAYER NONCOMPLIANCE. THUS, ESPECIALLY IN THE PAST 12 YEARS, WE HAVE SEEN A PROLIFIC GROWTH IN THE NUMBER AND STRENGTH OF PENALTIES. FROM APPROXIMATELY 60 DIFFERENT PENALTIES AND SANCTION PROVISIONS IN THE EARLY 1970S, THE CODE HAS GROWN TO INCLUDE APPROXIMATELY 150 SUCH SANCTIONS TODAY.

THE ADDITION OF PENALTIES WAS DONE ON AN AD HOC BASIS TO ADDRESS SPECIFIC PROBLEMS THAT AROSE SUCH AS ABUSIVE TAX SHELTERS. IN ADDITION TO ENACTING TOUGH PENALTIES, CONGRESS CLEARLY MANDATED THAT IRS AGGRESSIVELY ASSERT THESE NEW PENALTIES. FOR EXAMPLE, IN THE CONFERENCE COMMITTEE REPORT ON THE DEFICIT REDUCTION ACT OF 1984, IRS WAS TOLD TO, "ASSERT WITHOUT HESITANCY IN APPROPRIATE CIRCUMSTANCES, THE PENALTIES THAT THE CONGRESS HAS PROVIDED. IN PARTICULAR, THE NEGLIGENCE AND FRAUD PENALTIES ARE NOT CURRENTLY BEING APPLIED IN A LARGE NUMBER OF CASES WHERE THEIR APPLICATION IS FULLY JUSTIFIED."

IN FISCAL YEAR 1987, IRS ASSESSED JUST UNDER 27 MILLION PENALTIES INVOLVING OVER $14 BILLION. IN ADDITION, IRS ABATED APPROXIMATELY 4 MILLION PENALTIES TOTALLING IN EXCESS OF $4 BILLION. AS YOU CAN SEE, PENALTIES ARE FELT IN A SIGNIFICANT NUMBER OF POCKETBOOKS. THE PRESENCE OF PENALTIES, AS WELL AS THEIR USE, THEREFORE STRONGLY AFFECTS THE ATMOSPHERE IN WHICH OUR TAX SYSTEM OPERATES.

FORTUNATELY, I DETECT SOME CHANGES IN ATTITUDES TOWARD OUR TAX SYSTEM BEGINNING WITH THE TAX REFORM ACT OF 1986. WITH RESPECT TO TAX SHELTERS AND TAX-ADVANTAGED TRANSACTIONS, THE TAX REFORM ACT IS AN EXTRAORDINARY PIECE OF LEGISLATION. WHAT THE IRS HAS STRUGGLED FOR YEARS TO DO IN THE TAX SHELTER AREA, EVEN WITH THE STRENGTHENED PENALTIES, HAS BEEN LARGELY ACHIEVED IN THE 1986 ACT THROUGH CHANGES IN THE UNDERLYING SUBSTANTIVE LAW.

REDUCTIONS IN MARGINAL TAX RATES MEAN THAT UNCLE SAM IS SHARING LESS OF THE INVESTMENT RISK IN TAX-ADVANTAGED INVESTMENTS--A MAXIMUM OF 28% RATHER THAN 50%. THE ENACTMENT OF THE PASSIVE LOSS RULES MEANS THAT CLASSIC TAX SHELTER LOSSES WILL NO LONGER REDUCE EARNED INCOME--BREAKING THE TRADITIONAL LINK BETWEEN THE WAY MANY PEOPLE EARN THEIR INCOME AND THE WAY THEY SHELTER IT FROM TAX. FINALLY, A MORE INCLUSIVE ALTERNATIVE MINIMUM TAX MAKES IT MUCH MORE DIFFICULT FOR AFFLUENT INDIVIDUALS AND CORPORATIONS TO REDUCE THEIR TAX LIABILITIES BELOW 20%.

THESE FUNDAMENTAL CHANGES IN THE SUBSTANTIVE LAW JUSTIFY A NEW LOOK AT THE PENALTY SYSTEM EVEN THOUGH MANY OF THE PENALTIES ENACTED OVER THE PAST 12 YEARS MAY STILL BE NEEDED. PROMOTER PENALTIES, FOR EXAMPLE, GIVE THE IRS NEEDED TOOLS TO IMPOSE SANCTIONS ON THOSE WHO SELL FRAUDULENT INVESTMENTS TO UNSUSPECTING TAXPAYERS. THE PENALTIES THAT CAN BE USED TO ADDRESS SUCH ISSUES AS OVERVALUATION PROVIDE A WAY TO POLICE THE USE OF APPRAISALS FOR TAX PURPOSES. AND THE SUBSTANTIAL UNDERSTATEMENT PENALTY DOES MUCH TO RAISE THE STANDARD OF RETURN PREPARATION. HOWEVER, IT IS CLEAR THAT THESE AND OTHER PENALTIES WERE ENACTED AND HAVE BEEN UTILIZED BY IRS IN A CONTEXT THAT HAS BEEN SIGNIFICANTLY ALTERED BY THE TAX REFORM ACT.

THIS CHANGE IN THE ENVIRONMENT ALONE MERITS A NEW LOOK AT THE SYSTEM OF PENALTIES TO SEE WHETHER THEY MEET THE NEW NEEDS CREATED BY TAX REFORM. ADDITIONALLY, WE NOW HAVE SEVERAL YEARS EXPERIENCE WITH THE TOUGHER PENALTIES ENACTED IN 1981, 1982, AND 1984. IT IS TIME TO TAKE A LOOK AT THE RESULTS AND EVALUATE THEM.

ONE THING THAT MY IRS COLLEAGUES AND I WOULD LIKE TO SEE HAPPEN IS A FUNDAMENTAL IMPROVEMENT IN THE RELATIONSHIP BETWEEN IRS AND ITS CUSTOMERS--THE TAXPAYERS AND TAX PRACTITIONERS OF THIS COUNTRY. YOU HAVE HEARD ME SAY, MR. CHAIRMAN, THAT THE TAX MAN WILL NEVER BE LOVED. BUT WE DO ASPIRE TO A RELATIONSHIP WITH OUR CUSTOMERS THAT IS ONE OF MUTUAL RESPECT, CONFIDENCE AND UNDERSTANDING. AN EXAMINATION OF THE PENALTY STRUCTURE AND ITS APPLICATION IS GOING TO BE AN IMPORTANT NEXT STEP TOWARD THIS GOAL.

CONCERNS ABOUT CIVIL SANCTIONS IN THE CODE

ALTHOUGH THE ENACTMENT OF THE MANY PENALTY PROVISIONS DURING THE PAST 12 YEARS RESPONDED TO REAL COMPLIANCE PROBLEMS, THE PENALTIES THEMSELVES WERE ADDED IN AN AD HOC MANNER. A

COMPLIANCE PROBLEM WAS IDENTIFIED, AND THEN A PENALTY WAS CONSTRUCTED TO ADDRESS THAT PROBLEM, OR AN EXISTING PENALTY WAS TIGHTENED UP OR MADE MORE SEVERE. THE SPECIFIC PROBLEMS THAT THESE ADDITIONAL PENALTIES WERE TARGETED TO ADDRESS WERE VIEWED AS SO SERIOUS THAT MORE GENERAL CONCERNS ABOUT THE DIRECTION OF THE CIVIL SANCTION SYSTEM AS A WHOLE OR THE DESIRABILITY OF THE EMPHASIS ON PENALTIES WERE NOT CRITICALLY ASSESSED. BUT THESE TOUGHER PENALTIES BROUGHT WITH THEM THEIR OWN ISSUES AND PROBLEMS.

--PENALTIES THAT ARE VIEWED AS TOO TOUGH MAY CAUSE TAXPAYERS TO QUESTION THE FAIRNESS OF OUR TAX SYSTEM BECAUSE THE PUNISHMENT IS OUT OF PROPORTION TO THE SERIOUSNESS OF THE PENALIZED ACT.

--PENALTIES THAT ARE TOO COMPLICATED MAY BE DIFFICULT TO APPLY WITH CONSISTENCY AND MAY BE TOO HARD FOR TAXPAYERS TO UNDERSTAND, AGAIN CREATING SKEPTICISM OF THE SYSTEM'S FAIRNESS.

--PENALTIES THAT VARY BASED ON FACTORS OTHER THAN THE SERIOUSNESS OF THE CONDUCT THAT IS PENALIZED CAUSE SIMILAR BEHAVIOR TO BE PENALIZED RANDOMLY, AGAIN RAISING QUESTIONS AS TO THE SYSTEM'S FAIRNESS AND RATIONALITY.

TAXPAYERS' ATTITUDES ARE EXTREMELY IMPORTANT IN A VOLUNTARY COMPLIANCE SYSTEM. A PENALTY SYSTEM THAT OPERATES BASED ON THE WRONG PRINCIPLES MAY PROVIDE APPROPRIATE SANCTIONS FOR SOME TYPES OF BEHAVIOR AND YET HAVE AN OVERALL NEGATIVE IMPACT ON TAXPAYER BEHAVIOR BECAUSE IT IS NOT PERCEIVED AS FAIR.

MUCH OF THE INTEREST IN PENALTIES THIS YEAR REFLECTS A VERY DESIRABLE CRITICAL LOOK INTO THE ROLE OF PENALTIES IN OUR TAX SYSTEM. THIS CONCERN IN AND OF ITSELF IS VERY HEALTHY, FOR IT TURNS AWAY FROM THE <u>AD HOC</u> APPROACH OF PRIOR YEARS.

APPROACHING THE CIVIL SANCTIONS OF THE CODE AS A COHERENT WHOLE WITH ITS OWN SET OF ASSUMPTIONS AND OBJECTIVES WILL PROVIDE A HEALTHY AND INFORMED PERSPECTIVE THAT WILL PERMIT IMPROVEMENTS TO BE MADE.

THERE ARE A NUMBER OF ISSUES THAT NEED TO BE EXPLORED. FIRST AND FOREMOST, WE NEED TO DEVELOP A WIDELY ACCEPTED SET OF ASSUMPTIONS ABOUT WHAT A CIVIL PENALTY CAN AND SHOULD BE USED FOR. WHAT IS AN APPROPRIATE PURPOSE FOR A PENALTY? IS IT TO ASSURE THE COMPLIANT TAXPAYER THAT NONCOMPLIANCE IS NOT ADVISABLE? IS IT TO PUNISH THE NONCOMPLIER? SHOULD CIVIL SANCTIONS BE USED TO RAISE REVENUES? THESE ISSUES NEED TO BE RAISE, DISCUSSED, AND, IF POSSIBLE, RESOLVED.

ONCE THE PURPOSE OR PURPOSES OF CIVIL SANCTIONS ARE ADDRESSED, WE ARE STILL LEFT WITH MANY QUESTIONS TO ANSWER. WHAT ARE THE CHARACTERISTICS OF A PENALTY THAT DOES A GOOD JOB OF FULFILLING ITS PURPOSE? SHOULD PENALTIES BE SIMPLE, OR IS COMPLEXITY EITHER PERMISSIBLE OR UNAVOIDABLE? HOW IMPORTANT IS FAIRNESS, PARTICULARLY IF IT CONFLICTS WITH SIMPLICITY? IN APPROPRIATE CASES SHOULD FIRST-TIME VIOLATORS BE LET OFF WITH A WARNING? WHAT IS THE APPROPRIATE SEVERITY OF A PENALTY? AS THE PENALTY INCREASES IN SEVERITY, IT MAY MORE EFFECTIVELY PREVENT OBJECTIONABLE CONDUCT, BUT AT SOME POINT WE ALL MAY AGREE THAT THE ANGER, FRUSTRATION, OR FEAR THAT IS CREATED MEANS THAT A LOWER LEVEL OF SEVERITY IS APPROPRIATE.

HOW MUCH LEEWAY SHOULD THE IRS HAVE TO ABATE OR FORGIVE THE PENALTY? IS IT BETTER FOR THE PENALTY TO BE ASSERTED IN ALL CASES THAT MEET SPECIFIC CRITERIA, OR SHOULD THE IRS HAVE DISCRETION NOT TO ASSERT PENALTIES? IF SO, HOW BROAD SHOULD THIS DISCRETION BE?

ARE THERE THINGS IRS CAN DO TO REACH SOME BEHAVIOR THAT IS NOW PENALIZED IN OTHER WAYS? SHOULD THERE BE MORE EDUCATIONAL PROGRAMS ON THE SUBSTANTIVE TAX LAW? NEW OR CHANGED PUBLICATIONS OR FORMS? ADDITIONAL TRAINING FOR OUR PERSONNEL? MORE LEGAL GUIDANCE? DIFFERENT ASSERTION AND ABATEMENT PROCEDURES?

ALL OF THESE QUESTIONS NEED ANSWERS, AND THE ANSWERS NEED TO BE DISCUSSED AND UNDERSTOOD FROM THE PERSPECTIVE OF ALL CONCERNED, WHICH IN MY VIEW INCLUDES PRACTITIONERS, TAXPAYERS, LAWMAKERS, AND ADMINISTRATORS. THE ISSUES ARE NOT SIMPLE AND THE TRADEOFFS THAT ARE NEEDED ARE NOT OBVIOUS. BUT IT IS CLEAR THAT MUCH CAN BE AND IS BEING DONE.

THE IRS PENALTY STUDY

MR. CHAIRMAN, THESE CONCERNS PROMPTED ME LAST YEAR TO INITIATE A MAJOR REVIEW OF CIVIL SANCTIONS IN THE INTERNAL REVENUE CODE. THIS REVIEW WILL FOCUS ON THE IMPORTANCE OF PENALTIES, PROBLEMS IN THEIR APPLICATION, AND RECOMMENDATIONS FOR IMPROVEMENT.

WE EXPECT THE STUDY, AFTER DISCUSSIONS WITH INTERESTED PARTIES BOTH INSIDE AND OUTSIDE THE GOVERNMENT, TO DEVELOP A PHILOSOPHY OF CIVIL PENALTIES AGAINST WHICH THE EXISTING PENALTY STRUCTURE CAN BE EVALUATED. THE WORK OF THE GROUP IS UNDERWAY, BUT IT IS NOT COMPLETED. GENERALLY, HOWEVER, WE BELIEVE THE FUNDAMENTAL ROLE OF THE CIVIL PENALTY SYSTEM IS TO HELP IRS DO ITS JOB OF COLLECTING THE PROPER AMOUNT OF TAX REVENUE, AT THE LEAST COST TO THE PUBLIC, AND IN A MANNER THAT WARRANTS THE HIGHEST DEGREE OF PUBLIC CONFIDENCE IN OUR INTEGRITY, EFFICIENCY AND FAIRNESS. TO THE EXTENT THAT CIVIL SANCTIONS DO NOT CONTRIBUTE TO THIS PURPOSE, WE BELIEVE THAT SERIOUS QUESTIONS SHOULD BE ASKED CONCERNING THEM.

AS OUR PHILOSOPHY OF PENALTIES IS DEVELOPED, WE WILL BE EVALUATING THE EXISTING PENALTY STRUCTURE TO SEE WHETHER THERE ARE PROBLEMS--EITHER STATUTORY OR ADMINISTRATIVE--IN THE WAY THE PENALTIES RELATE TO THIS PHILOSOPHY. AS PROBLEMS ARE IDENTIFIED, WE WILL DEVELOP RECOMMENDATIONS TO REMEDY THEM. THESE RECOMMENDATIONS WILL BE FORWARDED TO THE TREASURY DEPARTMENT AND RAISED WITHIN OUR ORGANIZATION, AS APPROPRIATE.

THE STUDY WILL ALSO ARTICULATE WAYS TO IMPROVE THE ADMINISTRATION OF THE PENALTY SYSTEM THROUGH TRAINING OF IRS EMPLOYEES, INTERNAL PROCEDURES, TAXPAYER UNDERSTANDING, AND LEGISLATIVE PROPOSALS. FINALLY, ONE OF THE STUDY'S OBJECTIVES IS TO ESTABLISH BETTER MONITORING CAPABILITIES REGARDING PENALTY ASSERTION, ABATEMENT, EFFECTIVENESS, AND TRENDS.

AS THE STUDY PROGRESSES, THE EXECUTIVE GROUP LED BY MR. STARK WILL BE CONSULTING WITH EXPERTS OUTSIDE IRS. THESE GROUPS INCLUDE CONGRESSIONAL STAFF, THE GENERAL ACCOUNTING OFFICE, OUR TREASURY COUNTERPARTS, AND REPRESENTATIVES OF NUMEROUS OTHER GROUPS SUCH AS THE AMERICAN BAR ASSOCIATION, THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, THE TAX EXECUTIVES INSTITUTE, NATIONAL SOCIETY OF PUBLIC ACCOUNTANTS, THE NATIONAL ASSOCIATION OF ENROLLED AGENTS, AND OTHER PROFESSIONAL ORGANIZATIONS.

WE HAVE DRAWN ON THE EXPERTISE WITHIN IRS, BOTH HERE IN WASHINGTON AND IN OUR MANY FIELD OFFICES. A STAFF WORKING WITH THE EXECUTIVE GROUP IS CATALOGING OTHER STUDIES AND REPORTS, ARTICLES AND STATISTICS, BUILDING A REFERENCE FILE ON EACH PENALTY, AND EVALUATING THAT MATERIAL. IN ADDITION, WE PLAN TO CONTRACT WITH A RESEARCH FIRM TO CONDUCT A SERIES OF FOCUS GROUP INTERVIEWS WITH REPRESENTATIVES FROM ALL SEGMENTS CONCERNED WITH TAX ADMINISTRATION, INCLUDING PRACTITIONERS, TO PROVIDE INFORMATION THAT SUPPLEMENTS INSIGHTS GAINED FROM OTHER SOURCES.

THE TASK FORCE HAS BEEN MEETING SINCE LAST NOVEMBER. WE HAVE PLACED OUR STUDY ON AS FAST A TRACK AS POSSIBLE WITHOUT SACRIFICING DEPTH AND QUALITY OF ANALYSIS. I EXPECT THEIR FINDINGS AND RECOMMENDATIONS BY THE END OF THIS FISCAL YEAR.

CONCLUSION

MR. CHAIRMAN, THERE IS CLEARLY ENOUGH BLAME TO GO AROUND WITH RESPECT TO OUR CURRENT CIVIL PENALTIES STRUCTURE. IN

RECENT YEARS, SOME TAXPAYERS AND PRACTITIONERS HAVE INITIATED A MUCH MORE AGGRESSIVE RELATIONSHIP WITH OUR TAX SYSTEM THROUGH ABUSIVE TAX SHELTERS AND TAX AVOIDANCE GIMMICKS. CONGRESS RESPONDED BY DRAMATICALLY INCREASING THE NUMBER OF CIVIL PENALTIES ON AN AD HOC BASIS AND HAS INSTRUCTED US TO AGGRESSIVELY ASSESS THEM. FINALLY, THE IRS HAS NOT ALWAYS ADMINISTERED CIVIL PENALTIES IN A MANNER WHICH IS CLEARLY UNDERSTOOD BY TAXPAYERS AND WHICH IS PERCEIVED AS PROPORTIONAL TO THE SERIOUSNESS OF THE MISCONDUCT.

IT IS OUR HOPE, HOWEVER, THAT THROUGH THE EFFORT WE BEGAN LAST YEAR AND THROUGH CONGRESSIONAL EFFORTS, WE CAN BEGIN TO DEVELOP A FRAMEWORK OF GENERAL PRINCIPLES OR STANDARDS FOR EACH GROUP OF PENALTIES IN THE CODE. WITH THE ASSISTANCE OF PRACTITIONER GROUPS, THE ACADEMIC COMMUNITY, AND LET US NOT FORGET TAXPAYERS THEMSELVES, OUR EFFORTS HOLD GREAT PROMISE.

MY COLLEAGUES AND I WILL BE HAPPY TO RESPOND TO QUESTIONS YOU AND THE MEMBERS OF YOUR SUBCOMMITTEE MAY HAVE TODAY.

CHARLES W. HALL
CHAIR, SECTION OF TAXATION
AMERICAN BAR ASSOCIATION

Mr. Chairman and Members of the Subcommittee:

Introduction

I am Charles W. Hall, Houston, Texas, Chair of the Section of Taxation of the American Bar Association. These views are presented on behalf of the Section of Taxation. They have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, accordingly, should not be construed as representing the position of the Association.

For some months our Committees on Civil and Criminal Penalties and Administrative Practice have been making a study of the civil penalty structure. The most recent draft of a report those Committees are preparing to the Section as a whole is nearly 200 pages long and addresses in some fashion each of the 150 or so civil penalties now in existence. We will be pleased to furnish this Subcommittee and its staff with that detailed report upon its completion and approval. Today, however, I intend to address only a few key points we believe may help guide this Subcommittee's review of the civil penalty structure.

Rationale for Penalties

We have identified four overlapping rationales supporting a civil penalty for taxpayer misconduct:

1. To enhance voluntary disclosure of relevant tax information thereby discouraging tax evasion. Helvering v. Mitchell, 303 U.S. 391 (1938).

2. To indemnify the government against the loss it suffers as a result of having to investigate and discover the taxpayer's failure voluntarily to disclose the relevant tax information. Helvering v. Mitchell, supra.

3. To deter noncompliance by increasing its costs. See Administrative Report to Adminis~~trative Co~~nference, "Administrative Procedures of the Internal Revenue Service" October 1975, p. 625.

4. To deter noncompliance bv putting into the minds of taxpayers generally the knowledge that other taxpayers are complying with the law or are being punished when they do not. Kelley and Oldman, Readings on Income Tax Administration, p. 486.

Each of these points relates to the overall objective of encouraging voluntary compliance with the tax laws. This is consistent with the recent report of the ABA Commission on Taxpayer Compliance, which took the position that civil penalties are an appropriate part of the effort to achieve voluntary compliance, although that effort must include a large number of other elements as well.

Principles for Evaluating Penalties

The underlying objective of the penalty system provides a basis for developing principles by which it can be evaluated and improved. For example, if penalties are to be effective in the role of enhancing voluntary compliance they must be understood by the average taxpayer whose behavior is to be influenced. As a result, effective penalties should be those which are relatively simple to understand, and which are perceived as logical and fair in relation to the particular misconduct penalized. Penalties that may be applied to conduct that is reasonable or appropriate will be seen as illogical and unfair, and those penalties are unlikely to enhance voluntary compliance. Even more clearly, penalties for conduct not proscribed when the conduct was completed cannot enhance voluntary compliance. Finally, because civil penalties ideally promote 100 percent voluntary compliance, the revenue effect of penalties should come from increased tax collections, not increased penalties.

Increased revenues from penalties probably indicates the existence of other problems in the voluntary compliance system and would not be good news.

Need for Reexamination of Penalty Structure

As an overall comment, we agree with the Treasury's 1984 statement to the President that:

> The penalty provisions under existing law are overly complex and often result in inconsistent treatment of similar violations. Penalties have been added piecemeal to the Code as new filing and reporting requirements have been legislated. The inconsistencies in the present penalty structure undermine horizontal equity among taxpayers and make the penalty provisions difficult to understand and administer. "Tax Reform for Fairness, Simplicity and Economic Growth" (General Explanation of Treasury Dept. Proposals), Vol. 2: p. 406 (1984).

The following observations on the current penalty structure suggest the need for a reexamination of that structure at an early date:

1. The current structure is needlessly complex. We have counted 13 different standards for conduct subject to penalty. It should be possible to do with several fewer standards and to develop some greater precision of expression about exactly the conduct to be penalized.

2. The structure is not internally coordinated. For a single act of misconduct, more than one penalty can apply resulting in an aggregate penalty that is considerably larger than any of the single penalties. It should be possible to develop some greater precision of expression about exactly what the penalty is to be for any particular misconduct.

3. Taxpayers and tax practitioners are openly questioning whether the current penalty structure is always fair, which is to say appropriate, in light of the type or degree of misconduct penalized. It should be possible to achieve a better consensus about what is fair if progress can be made on reducing the complexity and better coordination of the penalties.

Although we have not reached any final recommendations at this point and we intend to work with this Subcommittee and the Task Force on Tax Penalties that has been created to assist in reexamining the civil penalty structure, we have identified several issues that should be addressed. These are grouped below according to the category of penalty involved, i.e., penalties on taxpayers, penalties relating to information returns, and penalties on bad conduct by others.

Taxpayer Penalties

These penalties are imposed directly on the taxpayer by reason of his or her understatement or delinquent payment of tax. In particular our observations focus on the following four taxpayer penalties.

1. Negligence penalty (§ 6653). Currently the penalty applies to any actual negligence and to presumed negligence from omitting interest or dividends shown on a form 1099. The penalty is measured, however, by the total tax deficiency for the year and not the amount of the deficiency due to the negligence. Although the Technical Corrections Act may soon limit the penalty on form 1099 items to the omitted interest and dividends, a similar limitation may be appropriate in other negligence situations. It is also the case that negligence and substantial understatement penalties may be imposed for the same misconduct. Cumulation of the penalties seems questionable policy, as will be discussed further in connection with the substantial understatement penalty.

2. Valuation penalties (§§ 6659, 6659A and 6660). Primarily a response to aggressive tax shelter valuation, this penalty presumes negligence if the taxpayer's return misses the correct valuation by too great a margin. Additional thought should be devoted to coordinating this penalty with the fraud and the negligence penalties. It is not apparent why this penalty should cumulate with the negligence or fraud penalties.

3. Substantial Understatement Penalty (§ 6661). The substantial understatement penalty is a modified no fault penalty imposed if current tax liability is understated on the return by a substantial amount. There are exceptions to this penalty if taxpayers meet certain statutory criteria and the Internal Revenue Service is given authority to waive the penalty in other circumstances. We suggest reexamination of the proper place in the penalty structure for this penalty. It should be possible to achieve a more logical and precise set of standards for misconduct that is not fraudulent than is currently achieved by the uncoordinated application of the negligence, valuation, and substantial understatement penalties. It might be possible, for example, to merge each of these penalties into a single penalty with any appropriate presumptions being specified. The percentage rate of the penalty might then be varied with the amount and type of the understatement. For example, understatements attributed to negligence might produce a penalty of 25 percent, whereas substantial understatements not attributable to negligence would produce a penalty of 10 percent. Finally, thought should be given to applying any resulting uniform penalty to all taxes under the Code (estate and gift and pension liability taxes are not covered by the current substantial understatement rules).

Information Return Penalties

Document matching by the Internal Revenue Service is crucial to ensuring compliance with the tax laws, and it cannot occur unless the providers of tax relevant data correctly and timely file information returns. Perhaps for this reason, approximately one-third of the penalties in the Internal Revenue Code apply to failure to correctly and timely file information reports.

Traditional information reporting requirements on payors of wages, interest, and dividends and on partnerships have been augmented in recent years by information reporting requirements on brokers and barter exchanges, businesses making payments for services received (otherwise not subject to wage withholding), direct sellers of consumer goods, banks with respect to currency transactions of more than $10,000, employers with respect to tips received by their employees, recipients or mortgage interest, secured lenders of money with respect to any foreclosure or acquisition of property in satisfaction of a debt secured by that property, transferor partners with respect to a sale or exchange of a partnership interest involving unrealized receivables or appreciated inventory, and payors of royalties. In general, such third party reporting requirements are accompanied by requirements that a statement or copy of the information return be furnished to the taxpayer involved.

In addition, many recently added information reporting requirements are imposed upon individuals with knowledge of circumstances that could assist in selection of returns for audit though not related to a particular transaction between a taxpayer and a third party. Among such provisions are information reporting requirements with respect to foreign personal holding companies, foreign corporations controlled by foreign persons, U.S. persons resident abroad, amounts paid by U.S. partnerships to foreign partners, and the requirement that taxpayer identification numbers ("TINs") of dependents be included in tax returns.

With the changes made in the 1986 Act, Congress has generally endorsed the principle of making the penalties on information return filers uniform and simpler. In some instances, however, consistency still has not been achieved, and these cases should be reexamined (see, for example the $200 penalty for failure to file a report with respect to a mortgage credit certificate. § 6709(c)). More important, Congress should reexamine the standards for abatement of the penalties. At present, the abatement standards are not uniformly stated. Generally, penalties are abated if the failure to comply with the reporting requirements are due to reasonable cause and not willful neglect. Interest and dividend reports, however, have a different standard, which is "due diligence." It may be that the same standard will ultimately be held to result from these different formulations, but it would be more appropriate for Congress to make this decision.

We are concerned that unintentionally erroneous reports by payors and others may not be corrected at all or as promptly as needed by the Internal Revenue Service. We suggest that the system problems involved in correcting notices for both filers and the Service be carefully explored. Based on that information, a penalty system could be designed to provide incentives for corrected filings where appropriate.

Bad Conduct Penalties

These penalties generally apply to third party conduct which instigates or cooperates in the preparation of improper returns by taxpayers. These include penalties on tax return preparers, promoters of abusive tax shelters, and tax protestors. Most of these penalties are specific reactions to widespread abuses in the tax system experienced in the 1970's and early 1980's.

The civil penalties in this class include penalties designed to apply to tax return preparers and advisors (§§ 6694, 6695, and 6696); promoters of abusive tax shelters (§ 6700); aiders and abettors of tax understatements (§ 6701); and taxpayers who file frivolous returns or Tax Court proceedings (§ 6673). Each of these penalties has been enacted since 1976 to combat a specific compliance problem too difficult to address within the then-existing penalty structure.

These provisions are relatively new, and little authority interpreting them exists. In fact, Regulations have not been issued in some instances. We are aware that concerns have been raised about the influence which the Internal Revenue Service might exert over tax practitioners through threatening imposition of these penalties and the related threat of disciplinary action by the Service or professional groups. We would expect the Subcommittee may want to satisfy itself that the provisions are producing the intended results in individual cases. As individual tax practitioners, we are clearly in the class of persons whose conduct is influenced by these penalties, and we can provide that point of view. Further, we have a few technical suggestions that can be made at the appropriate time.

Interest

Although the interest paid on a tax deficiency is not technically a penalty, we suggest the Subcommittee may want to reexamine the interrelationship of tax deficiencies, penalties, and the interest thereon as it reexamines the civil penalty structure. Particularly since interest paid on a tax deficiency is nondeductible for many taxpayers while interest received on a tax refund is included in gross income, the question of fairness to taxpayers is raised.

Conclusion

We commend the Subcommittee for its attention to a reexamination of the Code's civil penalty structure. Voluntary compliance is at the heart of our tax system's success, and civil penalties have a role to play in achieving voluntary compliance. We stand ready to assist you in achieving a civil penalty system that is understandable, logical, and appropriate to encourage voluntary compliance and respect for our tax system.

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STATEMENT OF HERBERT J. LERNER

CHAIRMAN OF THE

FEDERAL TAXATION EXECUTIVE COMMITTEE

OF THE

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

MARCH 14, 1988

Mr. Chairman and Members of the Subcommittee, my name is Herbert J. Lerner. I am Chairman of the Tax Division Executive Committee of the American Institute of Certified Public Accountants (AICPA). The AICPA is the national, professional organization of CPAs with more than 264,000 members in public practice, industry, government and education. A large proportion of our members are engaged in tax practice and represent millions of individuals and businesses on tax matters. The AICPA is thus concerned with tax policy and tax administration matters, and we appreciate the opportunity to provide this early input as your subcommittee commences its review of the civil penalties contained in the Internal Revenue Code.

We certainly share your desire to simplify and rationalize the civil tax penalty structure. The AICPA Tax Division has recently formed a Penalty Task Force to address this subject. The task force will develop detailed comments and recommendations to our Executive Committee. We will thereafter be prepared to present our detailed views to your subcommittee.

My comments this morning will be in two parts. First, I will identify four specific areas that we urge your subcommittee to examine as part of its review. After that, I will describe briefly the focus and activities of our task force.

The threshold area that needs to be addressed very early is the appropriate role of tax penalties within the tax system. While there is general agreement that the principal objective of civil tax penalties should be to promote compliance on the part of taxpayers, there is widespread disagreement that even a minor objective should be to raise revenue or to reimburse the IRS for the administrative costs of enforcement and collection. There is considerable concern that Congress seems to be increasingly viewing tax penalties as a source of revenue.

The second area is one that has received very little attention to date, but that we think is worthy of consideration and could provide an avenue to significant simplification of the penalty structure. We suggest that you consider the relative impact of examinations, as compared to penalties, in encouraging taxpayer compliance. For many taxpayers, the desire to avoid examination is probably a stronger motivating influence for tax compliance than is the complex, little understood penalty structure that is presently in place. As the IRS develops more sophisticated techniques for selecting returns for examination and more efficient techniques for conducting examinations (including expanded document matching programs), you may conclude that some penalties are no longer necessary to promote compliance and others could be simplified and perhaps made less severe.

The third area is one that seems critical to any penalty study. This is the severity of each penalty provision relative to the seriousness of the infraction. Special attention needs to be paid to the present situation where multiple penalties can be applied to a single infraction. Perhaps inadvertent or careless errors or first-time offenses, for example, in the information reporting area, should be dealt with less severely than other situations. Also involved in this issue is the fact that the stigma attached to being penalized--

particularly for tax professionals--may outweigh the monetary cost associated with the penalty. When one considers that the mere assertion of a penalty can call into issue the practitioner's future right to practice before the Treasury and the IRS, it is essential that the severity of the penalty be carefully matched with the seriousness of the infraction.

The fourth area arises from the sheer magnitude of the tax system. Millions of individuals and entities worldwide are potential subjects to be penalized by the IRS, which has tens of thousands of employees. In such an environment, it is essential that penalties be structured in such a way that they can be administered equitably and even-handedly throughout the system in all geographic areas and in all economic strata.

The AICPA Penalty Task Force is made up of individuals from national, regional, and local firms with representation from various parts of the country. They are designing a practitioner survey that will reflect the opinions and experiences of our 20,000 Tax Division members. The survey will focus on the administrability of the penalty system from the point of view of the tax practitioner. The Task Force report will cover preparer penalties and those taxpayer penalties that our survey indicates are most burdensome or are most difficult to administer fairly and uniformly. We expect to complete this project by September 30, 1988.

In conclusion, I simply point out that we detect a widespread expectation that with Congress, the IRS, and many private groups and individuals addressing this issue, the end results should be a meaningful improvement in an area of great concern.

The AICPA will cooperate and assist in this effort in every way possible.

STATEMENT
on
TAX PENALTY REFORM
before the
SUBCOMMITTEE ON PRIVATE RETIREMENT PLANS AND
OVERSIGHT OF THE INTERNAL REVENUE SERVICE
of the
SENATE COMMITTEE ON FINANCE
for the
U.S. CHAMBER OF COMMERCE
by
W. Henson Moore
March 14, 1988

Mr. Chairman and members of the Subcommittee, I thank you for the opportunity to present testimony on the tax penalty system. I am Henson Moore, member of the Taxation Committee of the U.S. Chamber of Commerce and a partner at the law firm of Sutherland, Asbill, and Brennan. On behalf of the U.S. Chamber, the world's largest federation of businesses, associations, and state and local chambers of commerce, I commend you and the members of your Subcommittee for holding hearings on this important and timely subject. I am glad to be a member of your Private Sector Task Force on penalties and look forward to working with your staff and the distinguished members of the group.

I am very pleased that penalty reform has become a top priority of the tax writing committees this year. I compliment you, Mr. Chairman, for your leadership on such important issues as the Taxpayers' Bill of Rights Act and penalty reform. Comprehensive reform of the penalty system is long overdue. In the opinion of our members, the complexity, overlap, and unfairness of many of the approximately 150 penalties now in effect have eroded taxpayers' trust in our voluntary tax system and, as a result, have jeopardized the Internal Revenue Service's (IRS) ability to perform its collection function.

Congress is not without fault in this area. There have been five major tax bills in this decade alone--the Economic Recovery Tax Act of 1981, the Tax Equity and Fiscal Responsibility Act of 1982, the Tax Reform Act of 1984, the Tax Reform Act of 1986, and the Revenue Act of 1987. These bills enacted new penalties and raised the amounts of penalties, without completely examining how the changes would interact with the existing penalty structure.

My tenure on the House Committee on Ways and Means has taught me that Congress is under tremendous pressure to develop new and creative ways to raise money. Unfortunately, as demonstrated by the proliferation of penalties in recent years, increasing penalties has become a rather easy way of meeting the ever-increasing demand for federal revenue.

A reexamination of the role that penalties should play is essential. The U.S. Chamber understands that tax penalties are an appropriate vehicle to deter certain types of behavior and to ensure compliance with the tax laws. Penalties also allow the government to recover a certain amount of the administrative costs it incurs from those who are in noncompliance. However, penalties that are perceived to be arbitrary, excessive, or unfair have a detrimental impact on voluntary tax compliance by promoting disrespect for the tax collection process.

However well-intentioned, 150 distinct penalties unnecessarily complicate the system. The system is nearly impossible for taxpayers and practitioners to understand and the IRS to administer. The overlap of the penalties also fosters uncertainty and can result in the imposition of unreasonably high penalties for relatively minor offenses. This is often because of the lack of coordination between the substantial understatement penalty and the negligence and fraud penalties.

The IRS's inability to administer effectively and uniformly the existing penalties is an obvious consequence of the system. The IRS Commissioner's 1986 Annual Report (Table 14) indicates that in 1985, 21.4 million computer-generated penalties for delinquency, estimated tax, failure to pay, and failure to deposit were assessed totaling $5.2 billion. Of this figure, $2.5 billion, or 48 percent, was ultimately abated. The same report indicates that in 1986, 22 million computer-generated penalties were assessed totaling $5.6 billion. Of this figure, $3.0 billion, or an astounding 53 percent, was eventually abated.

PRINCIPAL COMPUTER-GENERATED PENALTIES

	1985	1986
Total number of penalties assessed	21.4M	22.0M
Total assessments	$5.2B	$5.6B
Total abatements	$2.5B	$3.0B
Total abated	48%	53%

One may speculate that these figures indicate that the IRS is being overly zealous or heavy-handed in its collection efforts and inappropriately imposing penalties, perhaps using penalties as a negotiating tool. During the hearings on the Taxpayers' Bill of Rights Act, we heard evidence that this may indeed be the case. Such practices could largely be prohibited by the enactment of the Taxpayers' Bill of Rights Act and by appropriate penalty reforms.

The figures also indicate the magnitude of the IRS's inability to apply penalties where they are appropriate. The vast number of penalties, their complexity, and their overlap have also made it extremely difficult, if not impossible, for the IRS to issue timely regulations and other written guidance about how specific penalties will be applied. This lack of guidance inevitably has left taxpayers confused and the IRS's administration of the penalties disorderly and inefficient.

The Tax Administration Subcommittee of the Chamber's Taxation Committee is working to identify penalties that are particularly burdensome to taxpayers. A preliminary review has shown that serious problems exist with the negligence penalties, the failure to file penalties, the payroll deposit penalties, and the substantial underpayment penalties.

Presently, if any portion of an underpayment is due to negligence, the five percent negligence penalty under Internal Revenue Code (IRC) Section 6653(a) is applied to the entire underpayment. Thus, if a taxpayer negligently underpays only one dollar and the underpayment in question was one million dollars, the negligence penalty would be applied to the one million dollars. This is a manifestly unjust result. The magnitude of the penalty often will bear only a tenuous relationship with the magnitude of the infraction.

The need for statutory reform of the negligence penalty is particularly acute in light of the recent Asphalt Products Co. case. In that 1986 case, the Sixth Circuit Court of Appeals upheld the taxpayer's claim that the negligence penalty should not apply to the entire understatement where the penalty would have been five or six times the income negligently reported, on the grounds that such a result was "absurd." The Supreme Court, under the law as then written, reversed the Sixth Circuit. Clearly, this is an issue for statutory correction. The negligence penalty should be reformed so that the penalty only applies to the amount that was negligently understated.

Several dozen penalties relate to failure to file information reports. Examples of penalties relating to transaction-based reports include the $50 per failure penalty relating to 1099 forms, the $500 per failure by brokers to provide notice to payors concerning interest, the $100 penalty for failure of a Domestic International Sales Corporation or Foreign Sales Corporation to supply information and the $50 penalty for failure to provide a report regarding an individual retirement account. Examples of penalties relating to disclosure information reports include the $50 penalty for failure to furnish a statement of registration to a pension plan participant and the $50 penalty for failure of an issuer to show on the debt instrument original issue discount information.

This panoply of penalties, imposed at different amounts, for different infractions, and with different caps, is quite confusing and, at times, can lead to results that are difficult to rationalize. For example, the penalty for failing to disclose a $100 transaction on a 1099 is the same as for failing to disclose a $1,000,000 transaction. Moreover, the penalty for not filing the report is the same as for filing it late. This provides incentive for a taxpayer not to comply if he or she has missed the filing deadline by even a day or two. It seems more logical for the penalty to increase as the period of noncompliance grows. For example, the non-filing penalty could be $50 while the late filing penalty could be $5 per month or a fraction thereof that the report was late up to a maximum of $25. Thus, the system would always contain an incentive to comply.

It seems possible to achieve true simplification in this area by integrating all transaction-based, information return related penalties into a single penalty that increases as a function of the degree of lateness and the size of transaction in question, with appropriate maximums and minimums. Similarly, it appears that most disclosure information reports penalties could be integrated into a single penalty of a certain standard amount per failure. There may also be ways of consolidating certain information reports that businesses are now required to file and, thus, decrease chances of errors and the imposition of unreasonable penalties.

Two other penalties give our members the most problems. Those relating to federal payroll tax deposits are of particular importance to our small business membership. The kind of frustration that they feel is exemplified by the IRS notice attached to our testimony. A two-cent underpayment led to a four hundred dollar penalty--clearly an unreasonable result.

The other major problem, of concern to the entire business community, is the substantial understatement penalty under IRC Section 6661. The Tax Reform Act of 1986 increased this penalty from 10 percent to 20 percent, prospectively only. The 1986 Budget Reconciliation Act increased the penalty another five percent to 25 percent and made it retroactive to open-year transactions for which such penalty had not yet been asserted. This raises serious issues as to when the penalty stops being a penalty and becomes, instead, a revenue raiser. If one of the functions of a penalty is to sanction undesirable behavior, it is impossible to justify a 150 percent retroactive increase for a "penalty" applying to behavior that took place three years earlier. Such a practice leads to inequitable consequences and arguably is unconstitutional as a violation of due process.

This penalty should be reexamined-- given the fact that a portion of the increase was not in a tax bill but was a last-minute addition to a budget reconciliation bill that needed some additional millions of dollars to meet its revenue targets. Even if the substantial understatement penalty is not held to be unconstitutional, it represents a questionable approach by Congress to the making of tax policy.

Finally, the operation of the substantial understatement penalty is unclear to many businesses and practitioners. For example, to the extent that a taxpayer had "substantial authority" to justify his or her position, the amount of the understatement to which the penalty applies is accordingly reduced. In determining whether substantial authority exists, taxpayers must look to a gamut of authority, including provisions in the statute, Congressional intent, court opinions, regulations, and other IRS written guidance. Given the uncertainty over what constitutes "substantial authority," as well as the meaning of many provisions of the Tax Reform Act, there is a critical need to reexamine this penalty.

Because of the extraordinary complexity of the existing penalty system, the Private Sector Penalty Task Force, the IRS, and interested business groups and associations are faced with a difficult and challenging task--reevaluating the policies underlying the different penalties, cataloguing existing penalties to understand how they interrelate and which penalties overlap, reassessing the criteria and standards for penalty assessments and abatements, and eventually consolidating and simplifying the penalty system into a comprehensive package.

Vast improvements of the penalty system can and must be made to ensure the success of our tax collection system. Penalties should be proportional to the magnitude of the infraction or the level or frequency of noncompliance. Penalties should be administered in a uniform fashion. And the entire penalty system should be made more comprehensible to taxpayers and tax practitioners by eliminating overlapping penalties. As a member of the Private Sector PenaltyTask Force, I look forward to discussing these ideas and the many other constructive recommendations heard today.

On behalf of the Chamber, Mr. Chairman, I thank you for the opportunity to testify before your Subcommittee. Your commitment to developing and implementing a lasting penalty reform proposal will enable the tax administration system to operate as smoothly and effectively as possible in future years.

I would be glad to answer any questions.

STATEMENT OF DONALD C. ALEXANDER BEFORE THE SUBCOMMITTEE ON PRIVATE RETIREMENT PLANS AND OVERSIGHT OF THE INTERNAL REVENUE SERVICE, COMMITTEE ON FINANCE, UNITED STATES SENATE

My name is Donald C. Alexander, and I am a partner in the law firm of Cadwalader, Wickersham & Taft. I am appearing, solely in my personal capacity, at the request of the Committee.

This Subcommittee's interest in our present complex system of tax penalties is healthy and good, and I note that the Ways and Means Committee is taking a similar interest. There is little room for dispute that a searching examination of our present structure is overdue, that duplications and ambiguities should be reduced, and that the various penalties should be integrated. However, this task should be approached deliberately and cautiously. With its faults, the present structure is far superior to that which existed when I joined the Internal Revenue Service over a decade ago. A sound and effective system of penalties is necessary to preserve the integrity of the tax system.[1] The deterrent effect of penalties--a genuine downside risk associated with noncompliance--is vital to assure the many who do comply that those who would avoid their responsibilities will not gain by such attempts.[2]

In the early 1970s, we had a much simpler penalty system. Its problem was its inadequacy, not its complexity. There were penalties for negligence and fraud, both of which focused upon the intent of the taxpayer.[3] The negligence penalty was a toothless tiger, in part due to the showing required to establish its applicability and in part due to its small size (5 percent of the deficiency). In 1981, the negligence penalty was expanded to include 50 percent of the interest on the portion of the underpayment attributable to negligence, and in 1986 the definitional rules of the negligence penalty were materially changed to include "any failure to make a reasonable attempt to comply" with the Internal Revenue Code and any "careless, reckless, or intentional disregard" of rules or regulations. While these changes add somewhat to the deterrent effect of the negligence penalty, they do so at the expense of creating ambiguities and the possibility of uneven administration.

To impose the civil fraud penalty (formerly 50 percent of the entire underpayment, but now 75 percent of the portion of the underpayment due to fraud plus 50 percent of the interest on such portion), the IRS is required to prove by clear and convincing evidence that the taxpayer committed deliberate or intentional wrongdoing. As one might expect, this penalty has been sparingly used.

The penalties described above fall only on the taxpayer, not on those who market shabby tax merchandise (abusive tax shelters) or those who give bad assistance (return preparers). Yet, clearly, the marketers and the preparers need to maintain high standards if our system is to work properly. The Internal Revenue Code has not repealed Gresham's Law. Penalties were enacted in 1978 and are still needed, and should be strengthened, to keep tax return preparers in line. In addition, penalties were enacted in 1982 (and 1984) and are still needed to curb abusive tax shelters.[4] While the 1986 Act (together with certain predecessors) reduced the market for abusive shelters, they have not disappeared. Even if they had, they would be resurrected by an increase in marginal rates and a concomitant restoration of various incentives.

Finally, a substantial downside risk must be present to deter truly aggressive tax planning, even where there is sufficient justification to prevent application of penalties turning upon intent. Accordingly, a "no-fault" penalty was added to cope with material understatements of tax which were not justified by substantial authority or which, with lesser support, were not disclosed to the Internal Revenue Service.[5] This penalty, which counters to some extent the "needle in the haystack" gambit used by aggressive tax avoiders, has aroused much hostility, as will likely be evident from the hearings which this Subcommittee is conducting. While both taxpayers and the IRS alike would benefit from reasonable, uniform, and clear rules interpreting this penalty, it is a useful and a necessary ingredient to effective administration of our complicated tax laws.

As I have stated above, tax penalties are necessary to make our system work. However, I do not mean to suggest that penalties should be viewed as a source of revenue. If the system worked perfectly and there were full compliance, penalties would produce zero. Of course, the system does not work perfectly, compliance is not perfect, and it will not be perfect in the future. But assigning revenue numbers to penalties carries the scent of a quota system. If Congress declares that X dollars will be collected by a particular penalty and if the IRS, responsible to and dependent upon Congress for its budget, collects only one-half X dollars, has IRS proved to be an inefficient or ineffective organization? While I am fully sympathetic with the demands of the budget process, I hope that penalties will be viewed in the future as a means to make our system work better by deterring bad tax behavior, thereby increasing the effectiveness and fairness of the system.

In short, our complex and overlapping system of tax penalties needs review and improvement. However, the integrity of our tax system calls for the retention of a comprehensive structure of penalties which impose an effective deterrent upon those who would turn their backs upon their responsibilities as taxpayers.

[1] *See* Joint Committee on Taxation, *Description of Tax Penalties* 3 (Comm. Print 1988). Since I understand that this hearing focuses on civil, rather than criminal, penalties, my statement is addressed to such penalties.

[2] My personal view is that the punishment aspect of penalties is of lesser significance than deterrence.

[3] Buttressing these two penalties were penalties for late filing and late payment, and various other penalties for underestimation of tax, failure to file information returns, etc. These penalties (or similar provisions) are necessary, but need not be discussed here.

[4] Self-regulation or licensing by state or other authorities is not effective.

[5] More stringent requirements apply to tax shelters.

Statement

of

Thomas M. Nee
Vice President-Taxes
American Home Products Corporation
New York, New York

on behalf of

TAX EXECUTIVES INSTITUTE, INC.

on

the Civil Penalty Provisions
of the
Internal Revenue Code

before

the Subcommittee on Private Retirement Plans and
Oversight of the Internal Revenue Service

United States Senate

March 14, 1988

Mr. Chairman and Members of the Committee: I am Thomas M. Nee, Vice President - Taxes for American Home Products Corporation in New York. I am here today in my capacity as President of Tax Executives Institute to present the Institute's views in connection with the Subcommittee's study of the Internal Revenue Code's civil penalty provisions.

I am accompanied today by Charles W. Rau, Vice President-Taxes for MCI Communications Corporation, who is chairman of the Institute's Task Force on Penalties, and by the Institute's Tax Counsel, Timothy McCormally. Together we shall endeavor to respond to any questions the Committee might have.

The Institute appreciates the opportunity to testify today and looks forward to working with the Subcommittee, both directly and through the Chairman's task force, in bringing order to the Code's complex penalty provisions.

TEI's Perspective

Mr. Chairman, TEI comes to this hearing from a vantage point different from those of most other witnesses appearing before the Subcommittee. We represent the corporate tax community and are only tangentially involved with individual tax rules and penalties. The Institute's 4,000 members are employed by the 2,000 largest corporations in North America and are charged with the day-to-day management of their companies' tax departments. Most of our members are certified public accountants or attorneys, and many are both. As a professional organization, we are firmly committed to maintaining a tax system that works--one that is both administrable and can be complied with.

The Philosophical Basis for Civil Tax Penalties

Mr. Chairman, in announcing this hearing you stated that, after years of "patch-work legislation," it was time "for Congress to review the penalty provisions of the Internal Revenue Code in their entirety and work toward creating a rational and simplified penalty system." TEI wholeheartedly agrees.

To achieve that goal, there must first be the development of a consensus on what the proper role of penalties should be in the tax system. Stated differently, the philosophical, or (if you will) moral, basis for the imposition of penalties must be identified.

Tax Executives Institute submits that the following principle should govern: **Civil tax penalties should be exacted only for deviation from a standard of conduct that is timely established and promulgated, either by Congress or the Treasury Department and Internal Revenue Service.** Although the foregoing principle may seem self-evident, we suggest there is considerable merit in analyzing its different components.

First, we submit that, before a penalty is asserted, there must be a clearly identified standard of conduct. That is to say, the substantive tax rules must be known and understood by both taxpayers and the IRS. Such rules should be determined in light of the relative administrative cost and burdens that taxpayers will be required to bear.

Second, the governing standard of conduct must be precisely identified in advance of the time for which deviations from the standard will give rise to the penalty. Penalties should not operate in an ex post facto manner. They should only be asserted where taxpayers could have been aware of what the operable substantive rules are, and only after taxpayers are given a reasonable amount of time to review the rules and to gather and analyze the information necessary to comply. If the standard of conduct is amorphous or ever-changing, no penalty should be imposed.

Third, if a penalty is to be asserted, there must be a deviation from the standard of conduct. If the prescribed standard of conduct is unknown or does not lend itself to clarity, then no penalty should be imposed. Consequently, penalties should not be imposed where the taxpayer commits no culpable act or where the taxpayer's act is not capable of being described as culpable until after it is committed.

In summary, penalties should be imposed only for deviations from a discernible and precise standard of conduct that is clearly identified in advance.

Overview of Current System

TEI believes that if the Internal Revenue Code's current penalty provisions were judged against the foregoing principle, they would be found wanting in several respects. First and foremost, we believe that the rapidity and magnitude of substantive law change in recent years has rendered it very difficult, if not impossible, to discern a clear standard of conduct with respect to some areas of the Internal Revenue Code. The lack of public hearings by the tax-writing committees on specific tax legislative proposals has, in our view, exacerbated this problem.

Mr. Chairman, 75 years ago last month the 16th Amendment-- authorizing the imposition of an income tax -- was added to the Constitution. The Amendment contained but 30 words, and the ensuing income tax law of 1913 was only 16 pages long. Today, in the Amendment's diamond jubilee year, American taxpayers face a tax system that is not only unrivaled in complexity but that is ever-changing. Since 1981, tax legislation has come especially fast and furious: to say that the rapidity and magnitude of change are unparalleled is no overstatement.

For example, whereas the Tax Reform Act of 1969 affected 271 subsections of the Internal Revenue Code, the 1986 Act touched 2,704 provisions. The litany of tax changes in the 1980s is astounding: the Economic Recovery Tax Act of 1981 saw 483 subsections amended; the Tax Equity and Fiscal Responsibility Act of 1982 amended or added 530 subsections; and 1984's Deficit Reduction Act and Retirement Equity Act of 1984 combined to change 2,289 subsections. The net effect (including the 1986 Act, but excluding the Social Security Amendments Act of 1983 as well as the tax provisions of the Omnibus Budget Reconciliation Act of 1987), therefore, is that 6,006 subsections of the Code have been changed in less than seven years!

Thus, change has been piled upon change. A vast array of provisions have been enacted, revised, repealed, and in some cases reinstated within a period of a few years. The overall result has been confusion and uncertainty -- the utter inability to know what the substantive rules are and how to comply. To impose essentially no-fault penalties under such conditions is contrary to the American sense of fair play.

The Code's penalty provisions themselves have experienced the same explosion in number and complexity, without due regard to their potential cumulative effect. In 1975, the Internal Revenue Code contained 64 civil penalties; today, the number is more than twice that -- though there appears to be some disagreement concerning the precise number.

Not included in the total, moreover, are provisions of the Internal Revenue Code that have been characterized as "non-penalty penalties" -- that is to say, substantive provisions that operate in a clearly punitive fashion. Examples of such "non-penalty penalties" are the required overpayment of estimated taxes by large publicly held corporations and the draconian loss of all health care deductions where a single employee is inadvertently not offered COBRA continuation coverage.

The cumulative effect of legislative change has been staggering -- not only for taxpayers but for the government itself. When the rules are constantly changing and becoming more complex, the resulting confusion and uncertainty threatens the very existence of our self-assessment system. Penalties that are not based on taxpayer misconduct have no place in this environment.

Mr. Chairman, we are not suggesting that the substantive tax laws should remain static. Rather, we submit that, in light of the frequency and magnitude of such changes, fewer and more equitable penalty assertions are warranted.

For example, we submit it is inappropriate to assert penalties against taxpayers, acting in a non-negligent and non-fraudulent manner, for failing to abide by the Code's substantive provisions when, according to the General Accounting Office, the IRS's employees themselves have an error rate of 39 percent. We respectfully suggest that, when it comes to penalties, taxpayers should not be held to a higher standard than the agency that is interpreting and administering the law! Again, the GAO study should not be viewed as an indictment of the IRS but rather as a commentary on how confusing the overall system has become. Simplicity may have been a goal of the Tax Reform Act of 1986, but that goal has clearly eluded us.

Moreover, we suggest that, in enacting penalties in recent years, Congress has placed far too little emphasis on whether a provision can have a salutary effect on taxpayer behavior. In our view, penalties should have a single goal -- to encourage compliance by punishing voluntary, rather than wholly inadvertent, deviations from the prescribed and existing standard of conduct.

Where a penalty is enacted or increased on a retroactive basis, however, it cannot promote compliance. This leads us to conclude, as a corollary to our discussion of the philosophical basis for penalties, that retroactive penalties serve no legitimate tax-policy goal and should never be enacted. We similarly believe that penalties should never be viewed as a source of revenue. In our opinion, retroactive or revenue-inspired penalties place in jeopardy the moral support for both the penalty scheme and our entire self-assessment system.

The Contours of a Rational Penalty System

Once the philosophical (or moral) basis for the assertion of penalties is established, the contours of the penalty provisions themselves must be prescribed. Although specific taxpayer behavior may warrant particular or targeted penalty provisions, all penalty provisions should be characterized by the following:

First, **penalty provisions should be known and understandable to both taxpayers and the IRS.** A natural corollary to the principle that the substantive tax rule (standard of conduct) should be known is that the operation of a penalty provision should also be clear and discernible. Taxpayers must know not only what the substantive tax law rules are, but also the requirements of the Code's administrative provisions (for example, what are the relevant disclosure provisions or the prerequisites for obtaining "reasonable cause" relief?).

Second, **a penalty's severity should be appropriate to the taxpayer's culpability.** Penalty provisions do not exist in a vacuum. To have a salutary effect on the tax system, a penalty must be suited to the taxpayer behavior it is intended to affect. Specifically, the "punishment" must fit the "crime." One example of the opposite is the current negligence penalty, which is imposed on the entire amount of a tax deficiency, not simply on the portion attributable to negligence. For example, if the taxpayer's total tax underpayment was $1 million and only $100 of that underpayment was attributable to negligence, the penalty would be based on the $1 million underpayment!

Another, and perhaps the most egregious, example of a disproportionate penalty is the COBRA continuation coverage requirements, which is not even characterized in the Code as a penalty. The COBRA provisions would disallow the entire deduction for employer-provided health care in response to a single inadvertent failure to provide a timely notice to an employee -- even if the failure was corrected upon discovery. (In this regard, we note that a pending technical correction would partially ameliorate the harsh effect of the COBRA provision.)

Third, **the circumstances in which a penalty will not be asserted, even in the face of the taxpayer's failure to abide by the prescribed standard of conduct, should be identified.** In other words, the situations in which penalties will be waived, or abated, either as a matter of right or of the IRS's discretion, should be spelled out, either in the statute or implementing regulations or other guidance. In this regard, we submit that the IRS should be given discretion in applying penalties, but that discretion should not be unbridled: auditing agents should not be permitted to hold penalties over a taxpayer's head as a sort of Damoclean sword -- to be imposed if the taxpayer does not concede on the substantive issue.

Preliminary Recommendations

Mr. Chairman, TEI is in the process of preparing a detailed analysis of the Code's specific penalty provisions and of developing legislative recommendations that would adhere to the principles we have discussed today. We do not wish to prejudge the work of the Subcommittee or of the Chairman's private sector task force. We do wish, however, to set forth our preliminary recommendations.

First, there should be no penalty in the absence of negligence or fraud, that is, where the taxpayer does not engage in any proscribed conduct. Consequently, the penalty for substantial understatement of income tax liability (section 6661) should be repealed.

Second, the penalties for negligence and fraud should be refined and toughened, and the definitions of culpable conduct (negligence and fraud) should be clarified, either by statute or in implementing regulations. In other words, the Code should be amended to send a very clear message: not only will taxpayer misconduct not be tolerated, but it will be severely punished.

Specifically, the level of the negligence penalty should be substantially increased but should be based simply on an appropriately determined percentage of the amount of any deficiency attributable to negligence (not on the entire underpayment). We recommend, however, that the penalty interest provisions be repealed. We submit that the penalty interest provisions serve no compelling function other than increasing the amount of the penalty (which is accomplished much more easily by raising the level of the basic penalty); repeal of the penalty interest provisions will also make computation of the penalty easier.

The new negligence penalty should be abated where taxpayers can demonstrate the existence of reasonable cause for their position (as is the case under current law) or where they explicitly identify (adequately disclose) an item on their return. Such a waiver rule, together with the decision to tie the penalty to the amount of the deficiency attributable to negligence, should minimize the reluctance of the IRS and courts to impose the increased penalty in appropriate cases, thereby enhancing the deterrent effect of the penalty.

We also recommend that the level of the fraud penalty be substantially increased and that it should continue to be based on an appropriately determined percentage of the amount of any deficiency attributable to fraud. Similar to our recommendation concerning the negligence penalty, the penalty interest provisions should be repealed.

Third, to ensure that clear, administrable, and cost-sensitive standards of conduct (substantive rules) are being enacted, the IRS -- as the enforcement agency -- should be required to testify before both the House and Senate tax-writing committees on all tax legislation. The IRS's testimony should address (1) the ability of the IRS to administer the provision, (2) the estimated cost to the IRS of administering the provision, (3) the ability of taxpayers to comply with the provision, and (4) the estimated cost to taxpayers of complying with the provision. In addition, greater public participation in hearings on specific tax legislative proposals should be encouraged.

Fourth, all penalties should be reorganized into broad penalty categories (e.g., filing penalties), and there should be a gradation of penalties within certain groupings based on the severity of the taxpayer's infraction. This would permit the coordination of all penalties and facilitate the application of only the most appropriate penalty to specific conduct. The goal should be to ensure that the level of penalty turns on, among other things, how long the taxpayer's non-compliance continues (thereby providing an incentive to correct errors) and the significance of the triggering misconduct.

Fifth, taxpayer and IRS understanding of penalties should be enhanced by the following:

- o Placement of all the penalty provisions within a single chapter or subchapter of the Internal Revenue Code, with cross-references to and from substantive areas where appropriate.
- o Publication by the IRS of a comprehensive revenue procedure or other document (cited whenever a penalty is asserted) that details, by penalty category --
  - o the sources of review and assistance within the IRS for reviewing assessed penalties; and
  - o the standards that the IRS will apply in determining whether the penalty should be abated. (In determining whether a penalty should be waived, consideration should be

> given to the complexity of the tax issue, the period of time that has elapsed since the substantive provision was enacted, and whether implementing regulations have been issued; in appropriate cases, substantial compliance should give rise to a waiver of a penalty.)

Sixth, the subject of "non-penalty penalties" should be addressed. For example, we submit that Congress should recognize that the complexity of the tax laws (in conjunction with the rapidity with which they have been changed in recent years) makes it impossible for taxpayers to accurately estimate their tax liability. Consequently, corporations are faced with the choice of paying a penalty (under section 6655) for underestimating their liability or overpaying their taxes (in order to avoid the penalty). This problem could be eliminated if "large taxpayers" (which currently cannot base their estimated tax installments on their prior year's tax liability) were allowed to do so or the interest-on-overpayment provisions should be amended to pay interest to taxpayers that are effectively compelled to overpay their estimated taxes.

Similarly, we submit that the COBRA continuation coverage provisions should be amended. Specifically, we believe the statute should exact a penalty only for intentional or negligent noncompliance, and that good faith mistakes or de minimis errors should not put an employer's entire plan in jeopardy. We also submit that explicit relief should be provided in respect of multi-employer plans and foreign health plans.

* * *

Mr. Chairman, Tax Executives Institute appreciates the opportunity to present our preliminary views on the necessary reform of the Internal Revenue Code's civil penalty provisions. We look forward to working with the Subcommittee in the development of remedial legislation and would be pleased to respond to any questions you or other members of the Subcommittee might have.

PREPARED STATEMENT OF GARY C. ROHRS

Introduction

It is a pleasure to testify today before the Senate Finance Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service. My name is Gary C. Rohrs and I am here to testify for the National Society of Public Accountants (NSPA) on the topic of reforming tax penalties of the Internal Revenue Code.

I am an independent accountant from Independence, Missouri and enrolled to practice before the Internal Revenue Service. Moreover, I am a past president of the Independent Accountants Society of Missouri, and currently a member of the National Society's Board of Governors and the association's Federal Taxation Committee.

The services which I provide my clients are fairly typical of the other 21,000 members of NSPA, who for the most part are sole practitioners or partners in moderately sized public accounting firms. NSPA members provide accounting, auditing, tax preparation, tax planning, financial planning and management advisory services to 4 million individuals and small business clients.

I am pleased to inform the subcommittee that NSPA's testimony has the support of the Small Business Legislative Council (SBLC), of which NSPA is a member. SBLC is a permanent, independent coalition of ninety trade and professional associations that share a common commitment to the future of small business. The membership of SBLC represents the interests of several million small businesses in manufacturing, retailing, distribution, professional and technical services, construction and agriculture.

Framework or Philosophy For Subcommittee's Investigation

The National Society applauds the subcommittee for conducting this hearing on a timely topic of immense importance to American taxpayers and tax practitioners. In a press release announcing this hearing, Chairman David Pryor stated that "After years of patch-work legislation in the area of penalties, it is time for Congress to review the penalty provisions of the Internal Revenue Code in their entirety and work toward creating a rational and simplified penalty system". NSPA firmly supports the desire of this subcommittee to conduct a comprehensive review of Internal Revenue Code penalty provisions.

The National Society fully appreciates that penalties are necessary to the tax collection process. Penalties are important to encourage orderly compliance with the tax law and regulations. However, they should not be utilized as an alternative revenue source for purposes of the Federal budget process.

The tax law has become exceedingly complex and extensive. The penalty provisions of the Tax Code have also become complex and have increased substantially. This has resulted in difficulty for practitioners and a virtual impossibility for taxpayers to keep current with the changes in the law.

As a professional society, NSPA does recognizes that the penalty process is important for purposes of educating the American public about (1) the need to file, and (2) the proper reporting of income. On the other hand, the National Society firmly believes that the system should not penalize the taxpayer who acts in a responsible manner and makes every good faith effort possible to properly report income and pay Federal taxes.

In addition, penalties that are improperly imposed often have a negative influence on taxpayers and therefore, serve to foster a frustation on the part of the tax paying public. This type of situation often encourages a "get even" attitude among the public, resulting in non-compliance or the under-reporting of income. For these types of taxpayers, they rationalize that their actions are justified when measured against the penalty which they feel has been unjustly imposed.

A Statistical Analysis of the Penalty Provisions

In a paper released to the Commissioner's Advisory Group in December 1986, the IRS stated that the Federal government assessed 22 million penalties for a total of $5.7 billion for fiscal year ending September 30, 1985.

The Service also reported 4.5 million penalties were abated that year for a total of $2.6 billion. Further, the IRS reported in the same paper that 19.8 million penalties were computer generated in fiscal year 1985, which amounted to $3.8 billion.

The Society believes that these statistics highlight the tax penalty problem. First, these statistics show that there is a problem with the accuracy of penalty assessments, as indicated by the fact that $2.6 billion of tax penalties were ultimately abated for fiscal year 1985. In terms of total dollars assessed, this means that 45.6% of all penalties were ultimately abated that year*. Second, 90% of all penalties assessed during fiscal year 1985 were computer generated.

This fact might be the underlying reason that so many penalties are ultimately abated. These statistics may also indicate that the Service needs to adjust its assessment criteria. Third, some taxpayers will pay the penalty even if it would have been abated had the administrative appeal procedure been undertaken. This means that the Federal government has unfairly and illegally taken money from citizens and other taxpayers.

Examples Of Problems With Penalties Under the Tax Code

With approximately 150 penalty provisions in the Internal Revenue Code, it is very difficult to delineate every problem that might arise from the current penalty provisions for American taxpayers. However, as a broad policy position, the National Society recommends that

Congress review the following civil penalties or penalty categories:

1. The preparer penalties under the Tax Code;
2. Federal tax deposit and other payroll tax penalties;
3. The Section 6661 penalty for substantial understatement of liability;
4. Estimated tax penalties;
5. Failure to pay penalties;
6. Delinquency (failure to file) penalties;
7. Penalties pertaining to filing Form 1099, information returns; AND
8. The Section 6672 (100%) penalty, involving the failure to collect and pay over tax or the attempt to evade or defeat tax.

We would like to highlight with some examples, problems with various penalties under the Tax Code. These examples should not be considered an exhaustive list; but instead, they should be considered illustrative of the predicament which many taxpayers encounter when faced with a potential penalty assessment by the Service.

One particular problem involves the filing of Form 1099, information returns and the cross-matching of such forms by the Internal Revenue Service. NSPA appreciates the importance of the cross-matching program as a means of uncovering unreported income by taxpayers. Nevertheless, the National Society believes that the cross-matching program does not truely get to the heart of the non-compliance issue.

Under Section 6621(a) of the Code, an inadvertant failure to file an information return is generally treated in the same fashion as a late filing of a similar return. Should a taxpayer not file the Form 1099 at all under these circumstances, the possibility of the taxpayer "getting caught" and being assessed a $50 penalty for failure to file is probably very low. On the other hand, if the taxpayer files the information return late, the IRS will assess a $50 penalty against that taxpayer.

Independent accountants would invariably recommend to their client that he or she file the information return late, even if it means being subject to the $50 penalty of Section 6721(a). Putting aside the benefit of such constructive advice from a tax practitioner, the National Society believes that the cross-matching program is an excellent example of a situation where the IRS is catching the very people (who for the most part) are in good faith attempting to comply with the law; and not catching those persons who may have not filed an information return at all.

The National Society also believes that the current system of tax penalties is not accomplishing its primary objective, which is generally considered to be the promotion of increased tax compliance and deterrence. Instead, the current IRS procedures have only touched the surface of the non-compliance dilemma. There are other areas such as the "cash economy", which the IRS administrative procedures are not reaching as there is currently no effective way of tracing such funds.

Another example of a source of confusion for taxpayers is with respect to the reasonable cause exception under the tax penalty provisions of the Code. In general, a significant number of civil penalties are not imposed under the Code if the failure to comply with the tax law was due to reasonable cause and not to willful neglect. The reasonable cause exception (to various penalty provisions) is a subject which there is not uniform application under the law. Many taxpayers are confused as to the application or nonapplication of this exception itself. Much of this ambiguity or lack of uniformity is probably due in part to the high degree of computer generation of the penalties themselves.

Quite naturally, the members of NSPA are particularly concerned about the penalties imposed on tax return preparers. In general, these penalties were added to the Code by the Tax Reform Act of 1976 to regulate the conduct of unscrupulous preparers. Under the Internal Revenue Code, penalties are generally imposed on preparers due to acts of negligence, willful neglect, or intentional disregard of rules or regulations. However, missapplication of the preparer penalties by the Internal Revenue Service (and it does happen) could lead to a breakdown in the practitioner/IRS working relationship; which, without any lack of emphasis, is so very important to the tax compliance process.

Policy Recommendations For Review

The complexity of the tax law and regulations has become a well published fact in recent years. Since 1981, there have been 5 tax bills signed into law by

President Reagan. The passage of each tax act necessitates further technical corrections acts and the promulgation of additional IRS regulations. Effectively, the process has become unwieldly.

Under the guise of better enforcement of the law, 150 penalties have been included in the Tax Code to ensure compliance with this overburdened process. This Senate subcommittee hearing has been designed to bring reason back to the process. NSPA applauds this effort.

For purposes of the Subcommittee investigation, NSPA recommends that an attempt be made to combine and simplify the various penalty provisions under the Tax Code. Overlapping penalties or inconsistencies in enforcement of such penalties should be eliminated. Moreover, the trend towards using penalties as revenue raisers must be immediately stopped.

In order to improve compliance and enforcement, efforts must be made to encourage a more uniform application of the penalties themselves. This means that serious consideration should be given to the issue of whether penalties subject to a review committee are inherently more fair than those generated by a computer. The high degree of penalty abatements dramatically exemplifies the problem. More specifically, the ambiguity of when penalties apply and when they are imposed, should be eliminated.

The National Society strongly recommends that the Congress and the IRS conduct a media campaign to educate the public about the importance of tax compliance. There should be an emphasis on those civil penalties which are designed to address a taxpayer's failure to file or his or her failure to report income. The public should be educated and made aware of the consequences of non-compliance.

Efforts must also be made to eliminate inconsistencies in the application of the reasonable cause, negligence and willfulness standards contained in the penalty provisions themselves. This is especially important in the area of preparer penalties. In particular, penalties should not be imposed which involve areas of the tax law where no regulations or technical guidance exists, or where there is no clear trend with respect to court decisions.

With the constant changes in the tax law in recent years, many dead wood provisions remain in the Code, even though inoperative. For example, to the extent the matter of tax shelter abuses and deductions are becoming a non-issue, the duplicative and unnecessary penalties underlying the tax shelter could be eliminated.

Reform of the current tax penalty provisions of the Tax Code is an extremely arduous task. NSPA commends this subcommittee for conducting an investigation into such an important matter for the American public and tax practitioners. The National Society stands ready to discuss any of the Society's recommendations contained in this testimony. Thank you very much for inviting NSPA to testify at this most important hearing.

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* The 1986 IRS Annual Report (Table 14) indicates that 50.7% of all penalties (in terms of total dollars) were abated in fiscal 1986; an even higher figure than fiscal 1985.

STATEMENT

by

DAVID J. SILVERMAN, EA

MEMBER
GOVERNMENT RELATIONS COMMITTEE
NATIONAL ASSOCIATION OF ENROLLED AGENTS

ON

THE CIVIL PENALTY PROVISIONS
CONTAINED IN THE INTERNAL REVENUE CODE

I. General observations

It is our impression that where penalty provisions have been enacted for the willful failure to report income or for inflating deductions such penalty provisions have improved tax compliance. However, penalties that merely penalize taxpayers for failing to timely pay or file information returns have not increased compliance. These types of penalties merely extract additional tax from taxpayers who are struggling not to be buried under a blizzard of paperwork.

II. Late Payment Penalty (6651(a)(2)).

Philosophically this is the most difficult penalty to justify. This penalty treats the inability to pay as a civil violation of the Internal Revenue Code.

Charging an individual a 1/2% a month penalty up to maximum of 25% in addition to a current market rate of interest on a debt would be declared usurious by any court in the country. In fact such a lender would probably be jailed and the debt cancelled.

Treating the inability to pay as a violation of law is a throw back to a debtors' prison mentality. The inability to pay should not be confused with the willful failure to pay. The two are separate and distinct. Bankruptcy laws were enacted in response to this distinction. Penalties should be limited to violations of law.

III. Penalty for failure to timely deposit withholding taxes.(6656(a))

In many instances, the 10% penalty for failing to make a timely deposit of withholding taxes appears to be working against the purpose for which it was enacted; to insure the expeditious collection of withholding taxes. By way of example, if $ 10,000 is withheld in the period ending January 7 it must be deposited by January 10. If the deposit is not made on time a $ 1,000 penalty is incurred, beyond that it costs nothing extra to delay payment until the quarterly payroll report is filed on April 30. If April 30 falls on a Saturday the payment is not due until May 2, almost 3 months after the payment should have been made.

Once a failure to deposit penalty is incurred it costs nothing extra to delay payment until the end of the quarter. In the preceding example no provision exists for a taxpayer to cure a late deposit payment. A day late is treated the same as 2 1/2 months late. There should be some mechanism whereby a taxpayer can eliminate or reduce this type of penalty by an assertive showing that he attempted to deposit the required liability once he discovered that he inadvertently failed to make the required payment. A positive showing of a previous record of having made timely deposits should mitigate the assertion of this type of penalty. The failure to deposit penalty is one of the few failure to pay penalties that is not computed on the basis of the time value of money. It is very easy for a bookkeeper who has to make 13 deposits during a quarter to overlook a payment date by one day.

When the failure to deposit penalty is asserted against truly delinquent taxpayers, more likely that not, it ends up in the Service's uncollectable category whereas asserting this penalty where a taxpayer merely misses a deposit deadline does nothing to speed up or insure the prompt payment of withholding taxes.

We strongly urge Congress to amend this code section to require that the IRS take into account a taxpayer's timely compliance record together with his efforts to correct any delinquency before this penalty is asserted.

IV. 100% penalty fo\ the willful failure by a responsible person to pay over tax withheld (6672)

There is probably not a penalty that has engendered as much litigation as the 100% penalty for the failure by a responsible person to collect and pay over withholding taxes. In its zeal to collect trust funds IRS Collection Officers too often indiscriminately apply this penalty. More often than not the Service has attempted to impress a trust where none exists. A more judicious use of this penalty should become standard policy.

This penalty has a history of being applied on a guilty unless proven innocent basis. This code section should be amended so the burden of proof is shifted from the taxpayer to the IRS.

V. Penalties deducted from refunds.

Where a tax refund is due and the Internal Revenue Service has incorrectly assessed a penalty IRS procedure requires that the penalty be deducted from the amount of the refund. This is done before the taxpayer has been given an opportunity to respond to the penalty notice. Trying to get the Service to refund the penalty under such circumstances takes on the aspects of "major litigation".

VI. Interest Abatement (6404(e)(1).

Pursuant to section 6404(e)(1) of the Code, the Commissioner may abate an assessment of interest on a deficiency if the interest is attributable in whole or in part to any error or delay by an officer of employee of the Service (acting in an official capacity) in performing a ministerial act. The Commissioner may also abate interest on certain payments of tax to the extent that any delay in such payment is attributable to an officer or employee being dilatory in performing a ministerial act. An error or delay is taken into account only if no significant aspect of such error or delay can be attributed to the taxpayer involved. However, the definition of a ministerial act by the Commissioner set forth in temporary regulations 301.6404 2T (b)(2) does not consider the delay by the IRS in expeditiously completing a tax examination to be a failure to perform a ministerial act.

Examples 4 and 5 of the temporary regulation state that if a revenue agent is either sent to a training course or assigned other tasks and his supervisor decides not to reassign the agent's cases such delay is not a failure to perform a ministerial act.

Code section 6404(e)(1) was enacted so that taxpayers wouldn't be charged interest in those instances where the IRS has been "dragging its feet". If the Service does not perceive the inability to expeditiously complete a tax examination to be the failure to perform a ministerial act then the Congress should amend this code section so that a ministerial act is precisely defined.

Part of the Service's mission is to conduct tax examinations and it is completely unreasonable for them not to consider that their failure to promptly complete such examinations as not being a failure to perform their mission. Taxpayers should not be penalized because of such delays.

VII. Penalty abatement process

While most assessment notices inform a taxpayer that the penalty being assessed can be abated due to reasonable cause we find that the abatement process does not function well. It has been our experience that collection agents and correspondence clerks at the Service Centers, to whom most abatement requests are made, are not familiar with the abatement process. The correspondence that we receive bears this out in that the Service's reply to our request is simply not responsive to the facts.

When denying an abatement request the Service should stop using the unresponsive phrase "your explanation does not meet our criteria of reasonable cause." Taxpayers deserve, and the National Office of the IRS should oversee that exact reasons for denying a reasonable cause request are given. Unresponsive denials only serve to transfer the matter to the PRO or appeals. Additionally, it is not unusual for a collection agent to inform a taxpayer that he has no authority to abate a penalty and that the penalty should be paid and a claim for refund filed. On a related point when a penalty has been asserted because the Internal Revenue Service misposted a payment, the misposted payment is often corrected but the penalty that had been asserted is not. Under such circumstances there should be a mandatory procedure for the concurrent removal of all penalties and interest charged.

I hope that my comments and observations will prove to be of assistance to the Committee in its examination of the penalty provisions contained in the Code.

Respectfully submitted

David J. Silverman, EA
Member,
Government Relations Committee
National Association of
Enrolled Agents

CIVPEN.80

TESTIMONY OF GLENN W. WHITE
DIRECTOR OF THE TAX DEPARTMENT, THE DOW CHEMICAL COMPANY
AND
VICE CHAIRMAN, TAXATION COMMITTEE
OF THE NATIONAL ASSOCIATION OF MANUFACTURERS

BEFORE THE
SUBCOMMITTEE ON OVERSIGHT OF THE COMMITTEE ON FINANCE
UNITED STATES SENATE

ON PENALTIES AND COMPLEXITY

MARCH 14, 1988

Thank you for the opportunity to appear today to address this important matter. My name is Glenn W. White. I am the Director of the Tax Department for The Dow Chemical Company. Today I am appearing on behalf of the National Association of Manufacturers (NAM), in my capacity as Vice Chairman of the NAM Taxation Committee.

Recent legislative enactments have included base broadeners that have been highly complex. These present incredible problems for individuals and small businesses. However, implementation of these provisions will be very difficult even for taxpayers having significant in-house compliance capability. The Internal Revenue Service (IRS) is reflecting these complexities in its inability to respond accurately to taxpayers' questions as well as in its public pronouncements about interpretative functions it must perform, such as the issuance of regulations.

The same legislative enactments that have embodied more complex provisions have also included provisions for raising additional revenues through increased compliance and penalties. Given the budget problems of the federal government, and the need to find novel approaches that at least appear to meet revenue targets, it has become popular to assume that increased compliance and penalties can generate significant amounts of revenue.

This simultaneous increase in both complexity and penalty provisions presents an awesome and fearsome regime for taxpayers to manage. Taxpayers are overwhelmed by the complexity of the new laws, and are not fully certain that they can comply with all the requirements of these laws. This should not surprise us since the IRS by its actions has shown that it cannot tell us what the law means in some fairly simple cases. Corporate taxpayers face problems far beyond issues the IRS cannot handle, because their issues are so complex.

The existing tax laws have over 125 penalty provisions. These are not neatly catalogued, and many lay as traps for the unwary that become obvious only after the year's results become known and taxpayers find the events of the year have led to unexpected results. An excellent example of this problem is the underpayment penalties for estimated taxes that depend on the taxpayer's ability to forecast earnings in advance.

All of this causes us to inquire: what is the purpose of a penalty under the Internal Revenue Code? Presumably, the penalty is there to insure that the provisions of the law are adhered to with reasonable care. In other words, penalties should bring about a better level of compliance, both in terms of reporting income and deductions properly and in terms of paying the taxes due promptly. Their purpose should be to deter inappropriate behavior and not to raise revenue.

Unfortunately, Congress has chosen over the years to use penalties to encourage certain behaviors, such as making certain distributions from qualified trusts or benefit plans. I suggest it would be better to give the organizations a longer term target to meet and demand that performance as a requirement for tax preferred status. Similarly, there have been attempts to use the revenue laws as a way to attack non-revenue problems, such as the requirement of gambling stamps and firearm transfer taxes, which are aimed more at curbing the activity than raising revenue. Burdening the IRS with these non-revenue tasks deflects them from their goal as an agency designed to raise the necessary revenue for the operation of government.

Another problem is that today's tax laws are overrun with situations where Treasury and the IRS have a license to write the law after the statutory provision has been enacted. This means that the operative provisions of the law are determined by technocrats who have no elected position. They are inclined to adopt rules that are particularly complicated and have a consistent pro-government and pro-revenue bias.

Several recent provisions reflect this bias, particularly the elimination of the practical capacity method of inventory accounting and the attempt to change the export sourcing rules. Neither of these changes is supported by the statute or legislative history. In particular, the new inventory rules are exceedingly complex to apply. The Treasury's operative rule seems to be that no regulation is too complex because its provisions can be managed by computers.

This reasoning is wrong, and leads to provisions that, because they are unadministrable, are likely to lead to some form of non-compliance. That, in turn, is likely to present penalty situations for the taxpayers involved. We now have a set of tax laws that may well be compliance-proof. The implications of that, in terms of taxpayer attitudes about compliance, are not encouraging. If these compliance burdens are harnessed with penalties like Section 6661 for motive power, taxpayer morale is going to sink to very low levels indeed.

We are concerned that innocent mistakes will be punished with penalties and that good faith efforts to comply may not suffice to avoid being penalized. Comments by some senior IRS representatives lead us to believe that may well be what will happen. One District Director has publicly stated that all audit assessments should be accompanied by penalties under Section 6661, since the fact that the deficiency has been set up shows that the taxpayer did not have substantial authority for the position taken on the tax return. While this extreme position does not yet seem to be the operating standard followed throughout the IRS at this time, many of us in the profession hear rumblings that indicate the National Office policy may be headed in this direction.

Penalties have become more severe both in terms of threshold of applicability and in raw amount. An example of the former is the Section 6661 penalty, ostensibly placed in the law to discourage taxpayers from taking unwarranted positions in their returns on the chance that such positions will not be detected unless the return is audited and the further chance that they may slide through even then. While tax planning based on this so-called "audit roulette" technique may have been useful for taxpayers whose returns are not always audited, it simply is not a sound theory when applied to taxpayers included in the large case audit program. Those returns receive a careful examination by revenue agents for each and every year.

Taxpayers who are subject to this systematic audit cannot rely on lack of detection. If the item is of any consequence it will be examined and the item which has no support will almost certainly be detected. If a position taken by the taxpayer is truly abusive, the negligence penalty should be applied and should work. If the position is not negligent, but represents a difference in view between the taxpayer and the government about how the law should be interpreted, the government should not have the club of a 20% penalty for use in beating the taxpayer into submission. This is particularly so in the case of small taxpayers who may not be able to afford a defense against such jawboning.

It is almost impossible to put together a large return with no items not subject to adjustment, either through mistake or disagreement about how the law is properly applied. I have never heard of a large case audit that was closed with no adjustment to the taxpayer's return. I do not believe that this shows a general intent to deliberately not comply with the law. Most professionals responsible for return preparation for large corporations feel a responsibility to prepare the return in thorough compliance with the law. I would like to think that this is a matter of ethics. However, it is at worst a matter of common sense. If the return is to be carefully audited and the preparer knows this in advance, it makes no sense to deliberately do a poor job of preparation. This is particularly so when the disallowed item gives rise to interest charges on the tax deficiency. A market interest rate on tax deficiencies is probably one of the best and fairest ways to induce careful compliance.

Tightening the standards of compliance under which penalties are applied is another aspect of recent tax legislation that makes the penalty situation unreasonable. An example of this is the 90 percent standard applied to estimates of tax due. There is a perception that it is easy to estimate the earnings of a corporation early in its taxable year. Our experience belies that assumption. There are years in which the early estimates of income are grossly optimistic and other years in which later events produce unexpected income that only a Pollyanna would have predicted.

Holding estimates to a standard of 90% of tax liability along with the elimination, for large corporations, of the ability to use the prior year's liability as a "safe harbor" produces a situation in which the taxpayer very often will be forced to deposit with the government large sums of cash that may exceed its actual tax liability by many millions of dollars. The taxpayer's choice is to place the unwarranted amount in the Treasury or face the implicit fact of a disallowed interest charge by way of the penalty under Section 6655.

Returning to Section 6661, another aspect of that penalty is that it was initially intended as a "no-fault" penalty to be levied at a very low rate on audit adjustments. Philosophically, the concept of a "no-fault" penalty is abhorrent. Setting that matter aside, this provision has now evolved into a 20 percent penalty that can be levied on an innocent mistake by the taxpayer even if reasonable care has been exercised. This is a powerful weapon, and the likelihood of it being abused in individual cases is great. Obviously, if a taxpayer makes an outright mistake on a tax return there is going to be no substantial authority for the position, and if it is indeed a mistake the taxpayer cannot put a statement in the return that indicates there is no position in support of the item. If such occurrences are made the subject of large penalties, then taxpayers will rightfully resent the tax system even more than they do now.

Taxpayers' goodwill is essential to the success of the system. Yet revenue estimates in all recent tax bills have relied in part on additional collections from the imposition of penalties. The schedule of amounts to be collected in income tax penalties for the 1987 through 1991 period exceeded $2 billion and grew from less than $350 million annually to more than $483 million annually over that time span. It is inevitable that the IRS will feel pressure to increase the imposition of penalties to satisfy these projections. That is entirely the wrong direction to go.

Penalties should fulfill—and be limited to—the role of insuring that good compliance is the rule and that those who decide to live outside the rules for filing returns and paying taxes are properly punished for failing to fairly participate in this burden of citizenship. To go beyond this purpose, however, and to expect to raise substantial amounts of revenue through penalties imposed on those who are already doing their best to comply with this very arcane and complex system is both unfair and callous.

The present attitude of the IRS is to settle what the law is by legislation. Where it perceives taxpayers doing something that it judges to be inappropriate, then rather than litigate the issue and find out whether the taxpayer has properly interpreted the law, the Treasury comes up here for a legislative fix. The problem with that is the provisions grow ever more complex as a result. Also, those who may have been overly ambitious in their tax planning tend to be "grandfathered" in to the detriment of all other taxpayers.

Having registered a complaint, what do we offer? We believe the Internal Revenue Code should be revised to provide a single penalty section. The penalties provided therein should be concise and situations which Congress believes warrant penalties should be precisely identified. More specifically, the penalties should be classified first as to the offense, fraud, and negligence, and then categorized as failure to file or failure to pay.

Deliberate offenses should be more heavily penalized than careless performance, and innocent mistakes should not be penalized at all. Penalties on the latter only serve to teach the taxpayer that their government is inclined to be harsh and unfair. The percentage level for fraud and negligence penalties might, on the other hand, be reviewed for adequacy, and intermediate levels of imposition might be considered. In no event, however, should penalties apply to amounts that are not the result of the penalized activity or position.

Since the government now receives a higher than market rate interest on assessed deficiencies, there is no need to punish non-negligent errors (i.e., innocent mistakes) with penalties. In the past, when interest rates were fixed at 6% non-compounded, some taxpayers may have felt that borrowing from the government was cheap. That certainly is not a fair characterization of the situation today.

Among the things the penalty system should not do is be a defined revenue source, so that levying penalties becomes a game of "gotcha" played by the IRS against the taxpayers. It is also inappropriate to levy large penalties against non-compliance where there is evidence of good faith effort on behalf of the taxpayer to comply.

The penalty provisions of the Internal Revenue Code should be designed to insure that everyone fairly complies with the law and pays the government the taxes that are due. They should not be designed to trap the unwary taxpayer or as a permanent source of growing revenue for the government. The latter should be accomplished only through the substantive provisions of the Code and not through legerdemain in the penalties area.

COMMUNICATIONS

Automatic Data Processing
Tax Center
502 West Covina Boulevard
San Dimas California 91773 2983
714 592-6411

ADP

March 17, 1988

Laura Wilcox
Hearing Administrator
205 Dirksen Office Building
Washington, D.C. 20510

Subject: Hearing Regarding Penalty Provisions of the Internal Revenue Code Senate Finance Subcommittee on Private Pension Plans and Oversight of the Internal Revenue Service

Dear Ms. Wilcox:

Regarding the referenced subcommittee hearing, Automatic Data Processing would like to submit the enclosed item for inclusion in the printed record of the hearing and for consideration in any legislation that may result therefrom.

Should you have any questions, please contact Lonnie Gabbert of my staff at (714) 592-6411, Extension 5585.

Sincerely,

Jan Tombow

Jan Tombow
Vice President, Product Planning & Development

JT:kd
LWHA

Enclosure

ISSUE

Authorized "reporting agents" are not recognized by the Internal Revenue Service as the "person" responsible for making Federal tax deposits under IRC section 6302. Therefore, "reporting agents" are not authorized by IRS to request abatement of the penalty under IRC section 6656 due to reasonable cause.

BACKGROUND

Automatic Data Processing (ADP) is a private corporation providing an automated payroll service to approximately 170,000 business Clients nationwide. In conjunction with payroll processing, ADP also provides a tax filing service and currently makes Federal tax deposits and files Federal employment tax returns on behalf of over 85,000 of our Clients.

The Federal tax deposits are filed on magnetic tape in accordance with IRS Revenue Procedure 86-33, IRB 1986-33, and consist of payments described in the Employment Tax Regulations (26 CFR Part 31) under IRC section 6302.

Federal employment tax returns are filed on magnetic tape in accordance with IRS Revenue Procedures 86-26 and 86-27, IRB 1986-22, including taxes described under IRC sections 3102, 3301-3302, and 3402-3403.

Under the authority of the above Revenue Procedures, ADP is a recognized "reporting agent" with authority to sign and file tax returns and to make tax deposits on behalf of our Clients. ADP assumes no liability and is not a third party within the meaning of IRC Section 3504.

The Revenue Procedures authorize ADP to respond to IRS notices on behalf of our Clients and to receive information regarding our filings. However, we are not "officially" recognized as a party to whom reasonable cause can be granted. If one of our Clients receives a penalty as a result of a filing made by ADP, we are not allowed to make a plea for waiver of the penalty due to reasonable cause.

PROPOSAL

ADP respectfully requests that Congress provide IRS with the authority to include "reporting agents" in the identification of persons who may request waiver of a penalty due to reasonable cause.

/kd

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SCHOOL OF LAW
405 HILGARD AVENUE
LOS ANGELES, CALIFORNIA 90024-1476

March 14, 1988

Laura Wilcox
Hearing Administrator
205 Dirksen Office Bldg.
Washington, D.C. 20510

Dear Ms. Wilcox,

I am submitting a copy of my article on civil tax penalties for inclusion in the record of the Senate Finance Subcommittee Oversight hearings on civil penalties in the Internal Revenue Code. Because of subsequent statutory changes in the penalty structure, my article is now somewhat outdated. Nevertheless, I believe that the comments on the negligence, fraud and delinquency penalties continue to have relevance in any appraisal of the overall penalty structure.

I was also the author of a Study prepared for the Administrative Conference of the United States on civil penalties. That report resulted in ACUS Recommendation 75-7 relating to civil tax penalties which largely incorporates the recommendations of the Study and the Article. For your convenience, a copy of Recommendation 75-7 is appended to the article at pp. 686-88.

I would be pleased to consult with the Oversight Committee staff on issues arising out of your present, very timely study of civil penalties.

Sincerely,

Michael Asimow
Michael Asimow
Professor of Law

CIVIL PENALTIES FOR INACCURATE AND DELINQUENT TAX RETURNS

Michael Asimow*

The Internal Revenue Code contains a mind-numbing assortment of civil penalties.[1] All are triggered by specific forms of behavior relating to taxation, are administered outside the criminal process,[2] and are determined either as absolute amounts[3] or as percentages of the tax or of the deficiency in the tax.[4] The penalties range from the well-known assessments for filing late

* Professor of Law, University of California, Los Angeles. The author gratefully acknowledges the assistance of the staff of the IRS Project of the Administrative Conference, particularly the Director, Charles Davenport, and the Research Director of the Administrative Conference, David Martin. Comments from the author's colleagues George Fletcher, William Klein, Ralph Rice, Gary Schwartz, and Murray Schwartz were extremely helpful.

1 The author counted 64 civil penalties.

2 In an interesting article, Professor Charney asserts that civil monetary penalties are essentially criminal sanctions. Charney, *The Need for Constitutional Protection for Defendants in Civil Penalty Cases*, 59 CORNELL L. REV. 478 (1974). Consequently, he argues that the penalized individual must receive the protections of the criminal process. If Charney is correct, the entire tax penalty structure would crumble. Given the present or foreseeable resources available to federal courts, it would not be possible to collect through criminal processes the vast number of penalties now assessed in civil proceedings.

The author, however, believes that it is not unfair to collect monetary penalties through civil processes as long as the penalties are called civil, because "civil" sanctions lack the element of condemnation implicit in "criminal" sanctions. Criminal protections apply, of course, if the sanction is imprisonment or expatriation. *See* Wong Wing v. United States, 163 U.S. 228 (1896); Kennedy v. Mendoza-Martinez, 372 U.S. 144 (1963).

In any event, the collectibility of monetary penalties through civil processes is so well established that it is unlikely Charney's argument will prevail in the foreseeable future. Helvering v. Mitchell, 303 U.S. 391 (1938). *See, e.g.*, Beall Constr. Co. v. Occup. Safety & Health Review Comm'n, 507 F.2d 1041 (8th Cir. 1974); United States v. J.B. Williams Co., 498 F.2d 414, 421 (2d Cir. 1974). *But cf.* United States v. LeBeouf Bros. Towing Co., 377 F. Supp. 558 (E.D. La. 1974), *appeal docketed*, No. 74-3140, 5th Cir., July 12, 1974, *noted in* 55 B.U.L. REV. 112 (1975).

3 *See, e.g.*, INT. REV. CODE OF 1954, § 6652(a)(1) ($10 penalty for failure to file statement of dividends or interest paid).

4 *See, e.g.*, *id.* § 6657 (bad checks in payment of taxes—one percent of the check).

returns[5] and for fraud and negligence[6] to such lesser known exactions as the $50 penalty for knowingly purchasing any filled cheese which has not been branded or stamped according to law.[7]

In December 1975 the Administrative Conference of the United States (ACUS) adopted a number of recommendations designed to improve the civil penalty structure.[8] The recommendations focus on several penalties most significant to general income tax law enforcement: those relating to inaccurate and to delinquent returns. In the area of inaccuracy penalties, the recommendations suggest a statutory redefinition of fraud and negligence, the creation of a new intermediate penalty for reckless or intentional inaccuracies short of fraud, and the utilization of a new method for computing the penalties. The Conference also proposed revisions of the delinquency penalty and improvement of the adminstrative and judicial review accorded in delinquency cases. This Article will discuss the recommendations and will suggest that they offer favorable prospects for alleviating a number of problems which plague the existing penalty structure.[9]

I. The Inaccuracy Penalties: Fraud and Negligence

A. *The Rationale for Civil Inaccuracy Penalties*

Civil monetary penalties are widely regarded as effective devices for encouraging compliance with the law.[10] They are particularly suited to preventing inaccuracy in tax returns because the taxpayer's decision to file an intentionally inaccurate return is normally based upon an economic calculation. Unconstrained by moral considerations, such taxpayers weigh the immediate tax saving from cheating against the loss if the inaccuracy is detected, discounted by the probability of escaping detection.

Even if detection were certain, the economic calculus would favor cheating if the only liability upon detection were payment of

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5 *Id.* § 6651(a)(1). The penalty for filing late returns will be referred to in text as the "delinquency penalty."

6 *Id.* § 6653. The penalties for fraud and negligence will be referred to in text as "inaccuracy penalties."

7 *Id.* § 7266(f).

8 41 Fed. Reg. 3984 (1976). ACUS Recommendation 75-7 is reprinted in the Appendix; hereinafter textual references will not be cited to the *Federal Register.*

9 I wrote a consultant's report favoring Administrative Conference Recommendation 75-7. This Article is based on my report.

10 *See, e.g.*, 2 Recommendations and Reports of the Administrative Conference of the United States, Recommendation 1972-6 (1972); Goldschmid, *An Evaluation of the Present and Potential Use of Civil Money Penalties as a Sanction by Federal Administrative Agencies*, *id.* at 896, 908-13, 916-19. For an economic analysis, see Becker, *Crime and Punishment: An Economic Approach*, 76 J. Pol. Econ. 169, 193-98 (1968).

the tax plus interest. The interest rate is currently seven percent, close to the prime rate as of September 1975,[11] but few taxpayers are able to borrow at the prime rate. Borrowing from the treasury by cheating on one's tax return is also attractive because, unlike other creditors, the government requires no loan application, makes no credit checks, and allows repayment to be delayed for a substantial time after audit.

The uncertainty of detection increases the potential profitability of cheating. Since only about two percent of all returns are audited,[12] the chances of escaping scrutiny are excellent.[13] Even if the return is audited, carefully concealed inaccuracies may not be detected by the examining agent.

The prevalence of inaccurate tax returns indicates the magnitude of the problem. Many returns contain errors—about two of every five in 1965, 85 percent of them in the taxpayer's favor.[14] Five percent of the returns in that year contained mathematical errors, mostly favoring the taxpayer.[15] Of course, many of the erroneous returns are attributable to the complexity of tax law and, to some degree, to perceptions that the law is unfair. But many of the errors must also result from the economic calculation that cheaters always prosper. These considerations are reinforced by the public attitude that cheating on taxes is extremely common and would be almost universal if there were no chance of getting caught.[16]

From the above analysis it seems clear that civil penalties have a definite role in tax administration. By increasing the risk of loss, they make it less attractive to obtain a government loan (or

11 Rev. Rul. 75-487, 1975 INT. REV. BULL. No. 45, at 26, *implementing* INT. REV. CODE OF 1954, § 6621(b).

12 COMMISSIONER OF INTERNAL REVENUE, 1974 ANNUAL REPORT 9, 19.

13 Recent improvements in the Internal Revenue Service (IRS) computer program which scientifically selects returns for audit may increase the probability of detecting certain forms of cheating.

14 Internal Revenue Service, The Role of Sanctions in Tax Compliance 2, Sept. 1968 (unpublished) [hereinafter referred to as IRS Sanction Study]. Estimates of unreported taxable income are contained in PRESIDENT'S COMM'N ON LAW ENFORCEMENT AND THE ADMINISTRATION OF JUSTICE, TASK FORCE REPORT: CRIME AND ITS IMPACT—AN ASSESSMENT 51, 113 (1967); Farioletti, *Some Results from the First Year's Audit Control Program of the Bureau of Internal Revenue*, 5 NAT'L TAX. J. 65 (1952).

15 IRS Sanction Study, *supra* note 14, at 2. The size of the math errors favoring the taxpayer was about one and one-half times those favoring the government. Compliance in the "low business return area is almost non-existent." Internal Revenue Service, Report of Task Force on Civil Fraud Penalty 1, Jan. 31, 1974 (unpublished) [hereinafter referred to as 1974 Civil Fraud Study].

16 The IRS Sanction Study contains a fascinating survey of taxpayer attitudes. IRS Sanction Study, *supra* note 14, at 53-87. It was commissioned by the IRS and conducted by the National Opinion Research Center at the University of Michigan. Some of the opinions revealed by the study were:

gift) by cheating on one's return. Unfortunately, however, the present penalty structure fails abysmally to provide a minimally

		Percent base	Percent	Significant variations among respondents
[17.] B.	A small proportion of taxpayers cheats heavily.	1,322		
	Agree		66.6	College educated, 76.3%; over $14,000, 74.5%; non-white, 55%.
	Disagree		22.9	
	Don't know		10.4	
D.	The reason that the average taxpayer is honest is because he has no choice since his income comes mainly from wages and salaries.	1,326		
	Agree		75.2	Lowest educated, 81.8%; self-employed, 80.6%.
	Disagree		21.2	Over $14,000, 34.5%.
	Don't know		3.6	
E.	Almost every taxpayer would cheat to some extent if he thought he could get away with it.	1,326		
	Agree		51.4	. . .
	Disagree		44.5	
	Don't know		4.1	
F.	People cheat on their taxes because they feel the tax laws are not fair to them.	1,326		
	Agree		42.6	Over $14,000, 61.8%.
	Disagree		48.8	Lowest educated, 42.1%; females, 45.9%.
	Don't know		8.6	
G.	Some taxpayers are tempted to cheat, but decide not to because they have heard about how the Government punishes tax cheaters.	1,326		
	Agree		70.1	Lowest educated, 78%; farmers, 76.5%; single males, 80%.
	Disagree		22.9	
	Don't know		7.0	
18.	When people do try to cheat by large amounts, what do you think are their chances of being caught?	1,321		
	Almost certain to be caught		24.2	
	Likely to be caught		21.3	
	60 percent chance of being caught		10.7	Lower educated sees a somewhat higher certainty of getting caught.
	50-50 chance		24.2	
	40 percent chance of being caught		7.7	
	Unlikely to be caught		5.8	
	Almost certain not to be caught		2.3	

adequate deterrent. Although the law provides for heavy criminal penalties for "tax evasion," a 50 percent penalty for "fraud," and a 5 percent penalty for "negligence," no meaningful penalty is imposed in ordinary cases of intentional cheating.

B. *The Existing Structure of Inaccuracy Penalties*

1. Fraud

a. *Conduct Penalized as Fraudulent.* Although the fraud penalty is infrequently imposed, it is quite severe. Internal Revenue Code section 6653(b) exacts a penalty of 50 percent of the underpayment if any part thereof is due to fraud. The tort and tax definitions of fraud seem at first glance to be very similar. The essential elements of a tort cause of action for fraud (deceit) include a misrepresentation, made with knowledge of or reckless disregard for the falsity of the statement, intended to induce the plaintiff to act or to refrain from acting, and justifiably relied upon by the plaintiff to his detriment.[17] According to the Internal Revenue Manual,[18] civil tax fraud[19] requires a false material representation of fact by the taxpayer, made with knowledge of the falsity, and intended to be accepted as truthful. The only apparent difference is that the tax concept of fraud requires actual knowledge of the falsehood and thus does not cover reckless disregard for the truth.[20]

Although more limited than the tort concept of fraud, the conventional definition of civil tax fraud would seem to describe

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19. What about people who try to cheat by small amounts—what do you think their chances of being caught are?	1,322		
Almost certain to be caught		10.7	College educated, 12.8%; over $10,000, 9%; non-white voted 21.8% for "certain".
Likely to be caught		12.6	
60 percent chance of being caught		6.6	
50-50 chance		24.4	
40 percent chance of being caught		11.0	
Unlikely to be caught		26.2	Over $14,000, 47.2%.
Almost certain not to be caught		4.5	
Don't know (volunteered response . . .)		4.0	

Id. at 66-69.

17 W. PROSSER, HANDBOOK OF THE LAW OF TORTS 685-86 (4th ed. 1971) [hereinafter cited as PROSSER].

18 2 CCH INT. REV. MANUAL § 4563.41 (1974).

19 INT. REV. CODE OF 1954, § 6653(b).

20 *See, e.g.*, Mitchell v. Commissioner, 118 F.2d 308 (5th Cir. 1941), where the court declared that civil fraud means "actual, intentional wrongdoing, and the intent required is the specific purpose to evade a tax believed to be owing." *Id.* at 310.

the behavior of taxpayers in a very large number of federal tax controversies. Indeed, any taxpayer who knowingly pads charitable contributions by as little as five dollars, understates tips or business income, or claims nonexistent or inflated deductions has committed fraud by the Manual's definition.[21] But the tax concept of fraud as administered and as interpreted by courts is very different from the conventional definition. In the leading case of *M. Rea Gano*,[22] the Board of Tax Appeals[23] provided an apt description of the sorts of conduct which both the Internal Revenue Service and the courts seem to consider necessary in a civil tax fraud case; *Gano* is often cited as the paradigm of civil fraud cases.[24] The Board noted:

> Isolated instances of discrepancy or occasional lapses from the rigid accountability contemplated by the law might conceivably be overlooked, but where the whole fabric of petitioner's tax accounting is permeated with gross error, where elaborate artifice is employed to accomplish the ends sought, where the evidence adduced in explanation on different occasions varies so as to make it all unreliable, where sworn statements are proven by records to be false, and where the errors both of law and of fact all tend to accomplish a reduction of apparent tax liability, the situation goes beyond mere fortuitous coincidence, or unintentional error. It evidences a purpose to evade.[25]

In order to establish that the civil fraud penalty is due, the government has consistently been required to make a showing akin to that described in *Gano*. Often, fraud arises from aggravated cases of failure to file.[26] The great majority of fraud cases relate to omitted income.[27] There will generally be a repetitious pattern of

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[21] Yet such conduct is penalized as negligent, if it is penalized at all. *See* text accompanying notes 66-70 *infra*.

[22] 19 B.T.A. 518 (1930), *acquiesced in*, IX-2 CUM. BULL. 21 (1930).

[23] The Board of Tax Appeals is the predecessor of the Tax Court.

[24] As of Dec. 26, 1975, *Gano* had been cited 239 times. P-H FED. TAXES CITATOR (1st Ser. 1930-1954, 2d Ser. 1954-1975).

[25] 19 B.T.A. at 533. Liability was asserted under section 250(b) of the Revenue Act of 1921 which covered "fraud with intent to evade tax." Revenue Act of 1921, ch. 136, § 250(b), 42 Stat. 264-65. Although the words "with intent to evade tax" have been dropped from the present statute, no change in meaning was intended. *See* note 53 *infra*.

[26] Lord v. Commissioner, 525 F.2d 741 (9th Cir. 1975) (six years); Anthony Russo, 34 CCH Tax Ct. Mem. 1151 (1975) (five years); Jules Klebanoff, 32 CCH Tax Ct. Mem. 832 (1973) (four years). *See* H. BALTER, TAX FRAUD AND EVASION 8-74-77 (1963) [hereinafter cited as BALTER]; Silver, *Civil Tax Fraud for Failure to File a Return*, 13 ARIZ. L. REV. 299 (1971). According to the IRS Sanction Study, of the 159 cases asserting fraud penalties for failure to file, only 2 involved a single year. Two years were involved in 21 cases, 3 years in 25 cases, 4 years in 31 cases. Eighty cases involved 5 or more years, including 38 which involved 8 or more years. IRS Sanction Study, *supra* note 14, at 144.

[27] Of the 670 cases closed between August and October 1965 in which the civil fraud penalty was asserted, 455 involved omitted income. In addition, 159

evasion, in which the same source of income is concealed or understated in several different years.[28] The amounts evaded tend to be relatively large.[29] Often there will be concealment: hidden bank accounts, double sets of books, forgeries, giving false information to the accountant, or lying to the Internal Revenue agent.[30] The message sent by the courts to the Service is both clear and clearly understood: You have not proved fraud unless you have established an overwhelmingly powerful case.[31] For example, the IRS asserted the fraud penalty against a waiter who reported only $865 as income from tips, failing to report $1,625. Only a single year was involved. The Tax Court judge rebuked the IRS in stinging terms:

> This seems to us another in the series of litigations in which respondent's agents in a mistakenly zealous crusade have lost sight of the forest in their preoccupation with something that is not even a small tree—more like a blade of grass. . . . Either petitioner consistently understated his income from tips in the years before and after [1954], or he did not. If he did, no reason appears why respondent's agents . . . should construct their case on a single year . . . . If he did not, and this we must assume . . . it is powerful affirmative evidence that the single omission in the year in dispute was not intentional . . . . [Why is it such powerful evidence?] We regret

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of the cases involved failure to file. There were 44 cases relating to fictitious or inflated personal deductions, 75 relating to fictitious or inflated business deductions, 58 relating to false exemptions, and 55 others. IRS Sanction Study, *supra* note 14, at 144. Owing to the fact that many cases involved several years and multiple issues, the number of cases in all categories totals more than 670.

[28] *See, e.g.*, Estate of Millard D. Hill, 59 T.C. 846 (1973), *acquiesced in*, 1973-2 CUM. BULL. 2 (5 years); Harold B. Schwartz, 32 CCH Tax Ct. Mem. 1071 (1973) (4 years); John B. Moody, 32 CCH Tax Ct. Mem. 999 (1973) (5 years). *See generally* BALTER, *supra* note 26, at 8-69-70, 8-72-73 (1963). The IRS Sanction Study indicated that of the 511 civil fraud cases studied which involved false returns, only 69 involved a single year. The numbers then increase sharply: 106 involved 2 years, 150 involved 3 years, 79 involved 4 years. There were 107 involving 5 or more years including 17 involving 8 or more years. IRS Sanction Study, *supra* note 14, at 144.

[29] *See, e.g.*, Estate of Upshaw v. Commissioner, 416 F.2d 737 (7th Cir. 1969), *cert. denied*, 397 U.S. 962 (1970) (over $950,000); Sam Shapolsky, 30 CCH Tax Ct. Mem. 157 (1971) (almost $400,000). *See* BALTER, *supra* note 26, at 8-71-72. The IRS Sanction Study substantiates the predominance of large deficiencies. Of the 511 civil fraud cases involving false returns, only 132 involved deficiencies under $2000. IRS Sanction Study, *supra* note 14, at 144.

[30] *See, e.g.*, Robert C. Moor, 32 CCH Tax Ct. Mem. 947 (1973); Hicks Co., 56 T.C. 982 (1971), *aff'd*, 470 F.2d 87 (1972). *See* BALTER, *supra* note 26, at 8-78-80.

[31] For cases in which the Service's showing was not strong enough, *see* Anthony Russo, 34 CCH Tax Ct. Mem. 1151 (1975) (fraud proved against stockholder but not against corporation); Robert C. Moor, 32 CCH Tax Ct. Mem. 947 (1973) (same); Estate of Kyler, 30 CCH Tax Ct. Mem. 1319 (1971); L. Glenn Switzer, 20 T.C. 759 (1953), *acquiesced in*, 1953-2 CUM. BULL. 6; Joseph Bozied, 28 CCH Tax Ct. Mem. 740 (1969).

> the loss of time to all concerned in this proceeding, which could assuredly have been put to better use.[32]

b. *Underuse of the Fraud Penalty.* Because the courts refuse to uphold the fraud penalty in any but cases of great culpability,[33] the penalty is seldom used. 3,500,000 returns were audited in one year,[34] but the fraud penalty was assessed only about 2,700 times.[35]

A recent IRS study[36] strikingly illustrates the underuse of the penalty. It concerns cases which were referred to the Intelligence Division for possible criminal prosecution but which were rejected. Since these cases bear earmarks of fraudulent behavior, they are likely candidates for the civil penalty. Yet the districts vary widely in their willingness to assert the penalty.

For example, in Wilmington the examining agents added the civil fraud penalty to 77 percent of such cases. In Cincinnati they did so in 55 percent. But the figure was only 26 percent in New Orleans, 20 percent in Philadelphia, and 6 percent in Dallas.[37] Reasons offered for the underuse of civil fraud penalties include the agent's misconception that cases rejected by the Intelligence Division for criminal prosecution are also rejected for the civil fraud penalty.[38] Another reason is the misperception of examining agents that the penalties would be set aside by reviewers, making the agents' efforts to document fraud a waste of time.[39] Poor training of agents in dealing with sophisticated fraud problems was also mentioned. An additional factor contributing to underuse of the fraud penalty is the requirement that an audit be suspended and the matter referred to Intelligence at the first indication that fraud is present. Because of powerful pressures on agents to complete a large volume of cases and to produce agreed cases, agents prefer not to refer a case for a time-consuming Intelligence investigation in which the examining agent often participates and which rarely produces an agreed case. The agent is further dis-

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32 Alfonso Castells, 20 CCH Tax Ct. Mem. 1442, 1443 (1961) (bracketed query inserted).

33 For additional reasons for underutilization of the fraud penalty, see text accompanying notes 38-40 *infra*.

34 COMMISSIONER OF INTERNAL REVENUE, 1965 ANNUAL REPORT 22.

35 IRS Sanction Study, *supra* note 14, at 12. The figure of 2,700 annual fraud penalties was extrapolated from a study of three months in 1965. During 1965 there were 8,786 fraud investigations. COMMISSIONER OF INTERNAL REVENUE, 1965 ANNUAL REPORT 29. Thus about 30 percent of the fraud investigations appear to result in civil penalties. However, this percentage may be low because the months studied may contain a disproportionate number of vacation days.

36 1974 Civil Fraud Study, *supra* note 15.

37 *Id.* at Exhibit B.

38 *Id.* at 2-3.

39 This is called a misperception because the appellate division upheld the fraud penalty in 67.9 percent of the cases appealed. *Id.* at 4-5.

couraged by constraints against opening up old returns, the usual practice in potential fraud cases.

Probably many of the reasons for underuse of the fraud penalty are insoluble, considering the resources available to the IRS and existing patterns of behavior. The more aggressive use of the penalty in some districts, however, has been attributed to strong administrative support for assertion of the penalty.[40] In the end, however, much of the blame for underuse of the fraud penalty must rest on judicial and administrative conceptions which limit it to cases of highly flagrant behavior.

c. *Burden of Proof.* Use of the fraud penalty is significantly constrained by burden of proof considerations. Not only does the Service have the burden of persuasion,[41] but it must satisfy it by *clear and convincing evidence.*[42] The severity of the Service's burden is reflected by judicial assertions that fraud

> implies bad faith, intentional wrongdoing and a sinister motive. It is never imputed or presumed and the courts should not sustain findings of fraud upon circumstances which at the most create only suspicion.[43]

Since taxpayers seldom admit having knowingly filed false returns with the intent to deprive the government of the correct tax, the taxpayer's state of mind must be established by circumstantial evidence. When the same pattern of evasion recurs over a long period of time, it could hardly have been an accident. If the taxpayer funnels income from an undisclosed source into a secret bank account, there is little doubt as to his[44] intentions. Requiring the Service to present some such objective evidence of intent implements the policy that proof of intent be both clear and convincing.[45]

d. *The Relationship Between Civil Fraud and Criminal Evasion.* Burden of proof considerations, however, are not sufficient to explain the apparent requirement of flagrancy in fraud cases. In the author's opinion, proof of intention is both clear and convincing when a taxpayer claims deductions which have been disallowed in the past or fails to report three-fourths of his income from tips, even in only a single year. But the negli-

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[40] 1974 Civil Fraud Study, *supra* note 15, at 3.

[41] INT. REV. CODE OF 1954, § 7454 (Tax Court); Paddock v. United States, 280 F.2d 563 (2d Cir. 1960) (district court refund suit).

[42] TAX CT. R. 142(b) (emphasis added); Carter v. Campbell, 264 F.2d 930 (5th Cir. 1959) (district court refund suit).

[43] Davis v. Commissioner, 184 F.2d 86, 87 (10th Cir. 1950).

[44] The use of masculine pronouns in this Article is intended to include both the male and female genders.

[45] *See, e.g.*, Valetti v. Commissioner, 260 F.2d 185 (3d Cir. 1958) (circumstantial evidence held insufficient).

gence penalty, not the fraud penalty, is generally asserted in such cases.[46] The reason appears to be that civil fraud is understood to mean something quite different from intentional inaccuracies in a tax return. Instead civil fraud is equated to criminal tax evasion.[47]

Criminal tax evasion is a felony designed and used to punish highly culpable conduct and deter tax cheating.[48] It is not typically employed against petty tax cheating. Instead, the cases generally involve large amounts of income and tax deficiencies,[49] patterns of conduct stretching over several years, and particularly reprehensible forms of concealment. Also, it has been used as a non-tax law enforcement tool against racketeers and drug dealers.[50] It seems generally understood that the condemnation of a criminal conviction, and the very real possibilities of imprisonment that go with it, are best reserved for such flagrant cases.

The intimate connection between civil fraud and criminal tax evasion can be easily documented. First, in its definition of civil fraud, the Internal Revenue Manual uses the words "tax evasion,"[51] which bespeaks its appreciation of the practical parallelism of the sanctions. Second, the IRS requires that all cases in which fraud appears be referred to the Intelligence Division, a group whose mission is criminal law enforcement. Third, the congruity between civil fraud and criminal tax evasion has been recognized

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46 *See* cases cited in notes 66-70 *infra*.

47 Under the Internal Revenue Code, "any person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof" is guilty of a felony. INT. REV. CODE OF 1954, § 7201.

48 1 CCH INT. REV. MANUAL, Policy 4-84, at 258 (1974); PRESIDENT'S COMM'N ON LAW ENFORCEMENT AND THE ADMINISTRATION OF JUSTICE, TASK FORCE REPORT: CRIME AND ITS IMPACT—AN ASSESSMENT 113-15 (1967) (report of the Justice Department on criminal tax fraud).

49 *See* Lipton & Petrie, *The Substantial Understatement Requirement in Criminal Tax Fraud Cases*, N.Y.U. 19TH INST. ON FED. TAX. 1175 (1961). It appears that the Justice Department reviewers refuse to accept criminal cases below certain de minimis amounts. Rabin, *Agency Criminal Referrals in the Federal System: An Empirical Study of Prosecutorial Discretion*, 24 STAN. L. REV. 1036, 1052 (1972).

50 9 CCH INT. REV. MANUAL § 9141.2 (1974). The Commissioner's annual reports for 1969, 1970, and 1971 indicate allocation of very substantial IRS resources against organized crime and drug figures. COMMISSIONER OF INTERNAL REVENUE, 1969 ANNUAL REPORT 27; COMMISSIONER OF INTERNAL REVENUE, 1970 ANNUAL REPORT 44-47; COMMISSIONER OF INTERNAL REVENUE, 1971 ANNUAL REPORT 36-38. However, the current Commissioner has drastically reduced the allocation of IRS resources to non-tax law enforcement programs. COMMISSIONER OF INTERNAL REVENUE, 1974 ANNUAL REPORT 27.

51 2 CCH INT. REV. MANUAL § 4563.41 (1974). Although the Manual does not specify whether it means "criminal tax evasion," the 1974 Civil Fraud Study acknowledged that the same state of mind is required to establish civil fraud and criminal tax evasion. 1974 Civil Fraud Study, *supra* note 15, at 19-20. The main differences are the burden of proof in civil and criminal cases and the "atmosphere" of the two types of trial.

by cases holding that a criminal conviction collaterally estops the taxpayer from denying civil fraud.[52] Fourth, the civil fraud penalty was, until 1954, phrased in language which closely paralleled the criminal provision. The penalty was asserted if deficiencies were "false or fraudulent with intent to evade the tax."[53] And an analysis of the legislative history of the civil and criminal sanctions shows an intertwined development.[54] Finally, in some districts the civil fraud penalty is rarely asserted in any non-criminal case.[55]

The close association of civil fraud with criminal tax evasion explains why civil fraud cases tend to be limited to taxpayers whose conduct is highly culpable. There is no clear cut distinction between fraud cases in which both the criminal and civil sanctions are asserted and those in which only the civil penalty is claimed. For example, the special agent or reviewer might recommend that only the civil penalty be asserted because the case lacks sufficient

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52 Tomlinson v. Lefkowitz, 334 F.2d 262 (5th Cir. 1964), *cert. denied,* 379 U.S. 962 (1965); John W. Amos, 43 T.C. 50 (1964), *aff'd,* 360 F.2d 358 (4th Cir. 1965). The rationale for collateral estoppel is that the willfulness requirement for criminal tax evasion (INT. REV. CODE OF 1954, § 7201) contains all the elements essential to prove civil fraud (*Id.* § 6653(b)).

53 INT. REV. CODE OF 1939, § 293(b), 53 Stat. 88. Apparently no substantive change was intended by the simplification of language. *See* 10 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 55.09 n.85.1 (1970).

54 Although committee reports on these provisions are almost completely lacking, the language of the statutes and the timing of their enactment tend to show that criminal and civil fraud statutes were designed to penalize approximately the same kinds of conduct.

The present statutes can be traced back to the Act of 1864. Section 15 provided for a fine and imprisonment in case of "any false or fraudulent list, [or] return . . . with intent to defeat or evade" tax. Using parallel language, section 14 of the same statute provided for a 100 percent civil penalty "in case of the return of a false or fraudulent list or valuation . . . ." Act of June 30, 1864, ch. 173, §§ 14-15, 13 Stat. 223, 227. The 1894 Act retained these penalties and added an additional 100 percent civil penalty for a "willfully false or fraudulent list or return." Act of Aug. 27, 1894, ch. 349, § 29, 28 Stat. 554.

The 1909 corporate tax was a jumble of penalties. It preserved the two penalties from the 1864 statute, and changed the penalty added by the 1894 Act to cover "any return made with false or fraudulent intent." It added a new criminal penalty in case of a "false or fraudulent return . . . with intent to defeat or evade the assessment." And it added still another penalty of between $1,000 and $10,000, which might have been either civil or criminal, in case any corporation rendered a "false or fraudulent return." Act of Aug. 5, 1909, ch. 6, § 38, 36 Stat. 116-17. Later statutes also contained an assortment of confusing civil and criminal penalties. The wording of the statutes varied but yielded no clear pattern of different wording for civil and criminal penalties. *See* Act of Oct. 13, 1913, ch. 16, §§ F, G, I, 38 Stat. 171-79; Revenue Act of 1916, ch. 463, §§ 9(a), 14(a), 14(c), 16. 18, 39 Stat. 763, 772-73, 775-76; War Revenue Act, ch. 63, §§ 1001, 1004, 40 Stat. 325-26 (1917). Finally, the 1918 statute established the pattern of civil and criminal penalties of today's law. Revenue Act of 1918, ch. 18, §§ 250(b). 253, 40 Stat. 1083, 1085. A more detailed chronology of legislative history of the civil and criminal penalties is in IRS Sanction Study, *supra* note 14, at 113-20.

55 *See* notes 36-37 & accompanying text *supra.*

deterrent value to justify the effort needed to obtain a conviction.[56] The agent might conclude that the circumstances are not egregious enough to persuade a jury, although they might persuade a Tax Court judge. Or he may think that the government's proof is clear and convincing, but not quite beyond a reasonable doubt. Perhaps the agent found procedural errors, such as an unlawful search and seizure, which would probably abort the criminal case but which might pass muster in a civil case.[57]

A 1968 study of civil fraud by the IRS provides some information on the distinction between civil fraud and criminal tax evasion.[58] The study classified the civil fraud cases arising during a three-month period by the amounts of penalty asserted and by the number of years involved. This analysis indicated that the likelihood of prosecution increased very sharply as the size of the deficiency[59] increased and as the number of years involved in-

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[56] The resources expended are not only the prosecutorial resources of the Justice Department and the IRS staff. The Service also knows that prosecuting trivial criminal cases will lower its percentage of convictions, a highly important consideration for law enforcement agencies. Juries and judges are less likely to convict in such cases. Moreover, it is believed that judges will become impatient with the Service if a large number of trivial cases begin to clog the dockets. This reluctance to prosecute trivial cases has damaging consequences for the entire program of criminal tax enforcement. *See* IRS Sanction Study, *supra* note 14, at 11-14.

[57] It is not clear at present whether the exclusionary rule applies in civil tax cases. The Tax Court has held that it does apply. Efrain T. Suarez, 58 T.C. 792 (1972), 61 T.C. 841 (1974), *appeal dismissed*, No. 74-2663, 5th Cir., Dec. 4, 1974. *See also* Meister v. Commissioner, 504 F.2d 505, 511 (3d Cir. 1974) (leaving the question open), *cert. denied*, 421 U.S. 964 (1975).

[58] IRS Sanction Study, *supra* note 14. This study considered all 670 cases closed during August, September, and October, 1965 in which civil fraud penalties were imposed (civil fraud penalties of $9.1 million were paid); 154 of these were recommended by the Intelligence Division for criminal prosecution and 98 were actually prosecuted. Thus, during the three-month period studied, 23 percent of the civil fraud cases were recommended for prosecution and 14 percent were actually prosecuted. *Id.* at 139-43. However, the number of criminal cases seems too low since 1,393 criminal cases were recommended for prosecution in 1965, a figure suggesting that nearly 350 cases should have been recommended in the study period. COMMISSIONER OF INTERNAL REVENUE, 1965 ANNUAL REPORT 31. The 1,393 figure apparently excludes wagering tax cases but includes some criminal tax offenses not covered by the study, such as aiding someone else in filing a false return. Still, the number of criminal cases seems low, particularly in light of the 1974 Civil Fraud Study which found that in most of the districts studied the civil fraud penalty was not recommended in the overwhelming majority of the cases rejected by Intelligence. 1974 Civil Fraud Study, *supra* note 15, at Exhibit B. Thus, in those districts, there would have been very few civil noncriminal fraud cases.

[59] There were 511 false return cases altogether. Of these, 103 were recommended for prosecution (20 percent). But of the 143 civil fraud cases in which the civil penalty was under $1,000 (meaning that the deficiency was under $2,000), only 11 (or 8 percent) cases were recommended for prosecution. Where the penalty was between $5,000 and $7,500, however, there were 40 cases, nine of which were recommended for prosecution (23 percent). And where the penalty was between $30,000 and $50,000, 14 of the 19 cases were recommended for

creased.[60]

2. Negligence

As in the case of fraud, the tort and tax concepts of negligence appear superficially similar. The Internal Revenue Manual provides this definition of negligence:

> Negligence, in the generally accepted legal sense, is the omission to do something which a reasonable man, guided by those considerations which ordinarily regulate the conduct of human affairs, would do, or doing something which a prudent and reasonable man would not do.[61]

The reasonable person standard has historically been the principal means by which the law of torts has distinguished between those accidents which should or should not give rise to legal accountability. A person who causes an accident by failing to take the care which a reasonable person would have taken must pay the resulting damages. But if the person takes reasonable care, and an accident nevertheless occurs, he is not liable.

The law of torts draws sharp distinctions between negligent conduct and conduct bearing a higher degree of culpability. The conduct of an actor who unjustifiably proceeds in disregard of a known and substantial risk of harm is described as reckless, not

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prosecution (74 percent). IRS Sanction Study, *supra* note 14, at 144.

The same pattern occurred in the 159 cases relating to failure to file. Only 10 percent of the cases involving penalties under $1,000 were recommended for prosecution. Of the cases involving penalties between $3,000 and $5,000, 33 percent were recommended. Of those involving penalties in excess of $15,000, 62 percent were recommended for prosecution. *Id.*

60 Of 511 cases involving false returns, 69 involved only a single year. Of these, 3 were recommended for prosecution (4 percent). Of the 150 cases involving three years, 20 were recommended for prosecution (13 percent). But of the 79 cases involving four years, 31 (39 percent) were recommended for prosecution. Of the 17 cases involving eight or more years, seven (or 41 percent) were recommended. *Id.*

However, the pattern does not hold up very well for the failure to file cases. Of those involving two years, 33 percent were recommended for prosecution. Only 20 percent of those involving three years were recommended but 48 percent of those involving four years were recommended. Only 13 percent of those involving five years were recommended but 35 percent of those involving six years were recommended. *Id.*

Less complete data are provided by the 1968 Sanction Study on the amount of adjusted gross income of taxpayers involved in fraud cases. The figures relating to income are available only for the 154 cases in which criminal prosecution was recommended by the Intelligence Division. These show that 53 of the cases (34 percent) involved incomes of $30,000 and over. 40 of the cases (26 percent) involved incomes between $15,000 and $29,999. But only 5 involved incomes under $5,999 (3 percent) despite the vastly larger number of returns filed showing low rather than high incomes. *Id.* at 142.

61 2 CCH INT. REV. MANUAL § 4563.1(2) (1974). *See also* A.R.M. 23, 2 CUM. BULL. 231 (1920).

negligent.[62] And if the actor wished the damaging consequences of his act to occur, or knew they were substantially certain to follow even if he did not desire them, this conduct is described as intentional.[63] One of many differences between negligence and conduct of higher culpability is that only reckless and intentional torts can give rise to punitive damages.[64]

Although some of the tax cases which apply the negligence penalty seem to involve conduct which is negligent within the traditional tort meaning of the term,[65] the sort of conduct typically found subject to the negligence penalty is reckless or intentional. For example, in one "typical" case[66] a group of waitresses kept no records of their tips. One waitress reported income of about $1,000. By a process of reconstruction based upon the hours worked, the Tax Court found her income to be over $4,000. In sustaining the penalty, the court remarked, "petitioners have not even made a plausible argument to explain their fantastically low reporting of tip income."[67] In another case,[68] a bookmaker reported $14,000 income in one year and no income in the next year. In sustaining the IRS determination which increased the reported sums by $38,000 in one year and $8,000 in the next year, the court added the negligence penalty.[69] Another negligent taxpayer[70] claimed deductions which he knew perfectly well were not allowable and arbitrarily increased his allowable deductions. An almost limitless number of similar cases can be found.

Can the conduct of the taxpayers in such cases be described as "negligent," as that word has traditionally been understood? Hardly. I believe that any reader who has had the slightest contact with

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62 *See, e.g.*, PROSSER, *supra* note 17, at 31-32.

63 *Id.*

64 *Id.* at 184.

65 *See, e.g.*, Leroy Jewelry Co., 36 T.C. 443 (1961), in which the corporate taxpayer hired a new bookkeeper, but failed to instruct her properly or to check her work. The bookkeeper did not understand the intricacies of dealing with intercompany sales and failed to include the proceeds of such sales in the tax return. The negligence penalty was imposed on the plausible theory that it was careless to fail to take precautions against such errors by a relatively unskilled employee.

66 Arthur J. McQuatters, 32 CCH Tax Ct. Mem. 1122 (1973).

67 *Id.* at 1126.

68 Thomas L. Stutts, 34 CCH Tax Ct. Mem. 1303 (1975).

69 *See also* Joseph Forni, 34 CCH Tax Ct. Mem. 1089 (1975); Harry R. Fawcett, 34 CCH Tax Ct. Mem. 1164 (1975); Elmer Krassner, 33 CCH Tax Ct. Mem. 990 (1974); A.L. Farnsworth, 32 CCH Tax Ct. Mem. 902 (1973); Theodore Lockabey, 33 CCH Tax Ct. Mem. 493 (1974); David Kamerman, 31 CCH Tax Ct. Mem. 480 (1972). Quite frequently in these cases the taxpayers fail to maintain minimally adequate books and records, thus forcing the Service to resort to indirect methods of proof.

70 James V. Summers, 31 CCH Tax Ct. Mem. 463 (1972). *See also* Byron H. Farwell, 35 T.C. 454 (1960), *acquiesced in*, 1961-2 CUM. BULL. 4; William Stinson Jr., 33 CCH Tax Ct. Mem. 830 (1974), *appeal docketed*, No. 75-4265, 2d Cir., Oct. 29, 1974.

tax matters would be willing to describe their conduct as much more than a mere careless accident. Instead, their behavior was almost certainly intentional. Knowing the truth, they chose to make false statements on their returns, intending to deprive the government of the correct tax. At the very least, their conduct must have been reckless: Although they maintained no proper records, they placed numbers on the return, knowing there was a substantial risk that the figures were wrong and that the government would very probably be deprived of the correct tax.

Despite the sharply drawn distinctions between levels of culpability in tort law, a plaintiff can recover on a negligence theory by reason of actions which were in fact intentional or reckless. If he is not seeking punitive damages, the plaintiff might choose to allege negligence to avoid the necessity of proving a more culpable state of mind. In tax law, on the other hand, the concept of negligence includes reckless or intentional conduct because there is no greater penalty for reckless or intentional conduct short of the flagrant behavior punishable as civil fraud.

The legislative history of the negligence penalty gives no indication of what sort of conduct Congress meant to cover. The history is sparse, to say the least. By the Revenue Act of 1918, Congress for the first time added a negligence penalty to the traditional fraud penalties which had long been a part of the income tax statutes. Section 250(b) of the 1918 Act exacted a five percent penalty "if the understatement is due to negligence on the part of the taxpayer, but without intent to defraud . . . ."[71] The committee reports say nothing of what Congress had in mind.[72]

The negligence penalty today is still five percent of the underpayment.[73] Because of the surprisingly broad range of conduct to which the negligence penalty is currently applied, it might be appropriate to carve out a new penalty to treat reckless or intentional conduct more severely.

C. *Including the Excluded Middle*

The five percent negligence penalty does not provide a sufficient deterrent against tax cheating. Yet there is nothing between

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[71] Revenue Act of 1918, ch. 18, § 250(b), 40 Stat. 1083.

[72] In addition to creating the negligence penalty, the 1918 Act made basic changes in the fraud and delinquency penalties. But the applicable Senate Report speaks only in generalities of avoiding duplication of penalties and of making clear the precise offense to which the penalties apply. S. REP. No. 617, 65th Cong., 3d Sess. 18 (1918).

[73] INT. REV. CODE OF 1954, § 6653(a). This subsection also subjects intentional disregard of rules and regulations (without intent to defraud) to a five percent penalty. The intentional disregard penalty is discussed in text accompanying notes 106-19 *infra*.

this token penalty and the 50 percent penalty, which is reserved for blatantly culpable conduct. Between careless inaccuracies and quasi-criminality lies an immense middle ground: an endless array of cases involving reckless or intentional overstatement of deductions or understatement of income which lack the flagrancy necessary for imposition of the fraud penalty. In light of the vital role played by civil penalties in deterring the filing of inaccurate returns,[74] this excluded middle represents a serious statutory deficiency. A number of different approaches tailored to discourage garden-variety cheating might be suggested.

1. Raising the Negligence Penalty

One approach would be simply to raise the negligence penalty to a substantial level—say 25 percent. This large penalty would presumably provide an effective deterrent to tax cheating.

The question of whether such a heavy penalty is appropriate for unintentional conduct is analogous to the issue of whether negligence should be considered a sufficient mens rea for the imposition of criminal sanctions. Although this position is defended by some commentators,[75] others take the view that punishment for negligence is inappropriate.[76] In comparison with a person who committed reckless or intentional misconduct, a careless person is less blameworthy, less in need of rehabilitation, and less likely to be deterred by the threat of punishment. Similarly, a negligent taxpayer's conduct in filing his return does not rest upon economic calculations: As a result, the deterrent effect of increasing the penalty for that conduct would be slight.

Although a heavy penalty for negligence would be unduly harsh, a light penalty is appropriate. Such a penalty can be justified as serving to compensate the treasury for the costs of an expensive audit[77] and to express institutional disapproval of care-

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[74] *See* text accompanying notes 10-11 *supra*.

[75] *See, e.g.*, Fletcher, *The Theory of Criminal Negligence: A Comparative Analysis*, 119 U. PA. L. REV. 401 (1971). The Model Penal Code defines criminal negligence as involving "substantial culpability." MODEL PENAL CODE § 2.02 (2)(d) (Tent. Draft No. 4, 1955). This means, according to the Comment, that the jury must find fault and find it was substantial. Although expressing some doubts about whether negligence should be punished at all, the Comment acknowledges that some legislators believe that it can cause an actor to use additional care. Yet the Comment points out that negligence should not generally be sufficient as the mens rea required for specific crimes. *Id.* at Comment 3.

[76] *See, e.g.*, Hall, *Negligent Behavior Should Be Excluded from Penal Liability*, 63 COLUM. L. REV. 633 (1963); Kadish, *Some Observations on the Use of Criminal Sanctions in Enforcing Economic Regulations*, 30 U. CHI. L. REV. 423 (1963).

[77] Making the taxpayer bear the cost of audit has been advanced as a justification for the fraud penalty. Helvering v. Mitchell, 303 U.S. 391 (1938). Whether five percent of the deficiency is adequate to cover the cost of audit is

lessness by differentiating between justifiable and negligent errors.[78]

2. A Sliding Scale

A second possibility would be to create a new penalty with a sliding percentage scale.[79] The statute might provide a penalty of from 5 to 25 percent for inaccurate tax returns. The lowest penalty would be reserved for simple negligence; the 25 percent penalty would be employed in cases of intentional inaccuracies; and the levels between 5 percent and 25 percent could be used for grossly negligent and for recklessly prepared returns. Presumably, the Tax Court[80] would adjudicate the level of the penalty along with the deficiency. It would have power to set the penalty at the level requested by the IRS or any lower level down to 5 percent or to remove it altogether. The 50 percent penalty would be retained for returns characterized by highly culpable tax evasion.

The advantage of this proposal is that it preserves a token penalty for relatively non-culpable negligence while imposing a rather stiff 25 percent penalty for purposeful cheating. The Service and the courts would develop expertise in setting an appropriate penalty between 5 percent and 25 percent if the conduct seemed less than intentional but more than merely careless. This approach avoids difficult problems of statutory definition which must be faced in creating a new fixed-level penalty between the existing ones.[81]

The sliding scale proposal, however, suffers from one great vice: The discretion it confers is too broad. Abuses of discretion would be inevitable and difficult to police. The result would come to resemble the uneven standards of sentencing in criminal cases with large and unjustified discrepancies from judge to judge, and from district to district.[82] Sentencing disparities seem to defy

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beyond the scope of the present study and would require detailed cost accounting analysis by the Service.

78 *See* Fletcher, *supra* note 75, at 419.

79 *See* Balter, *The Line Between Negligence & Fraud*, N.Y.U. 12TH INST. ON FED. TAX. 15, 40 (1954). Another approach would be a penalty of *x* dollars plus *y* percent of the tax. The *x* dollar figure would be flexible, depending on the size of the deficiency, culpability, and other factors, but the percentage figure would be fixed. The discussion in the text of a sliding percentage would be applicable to this combination as well.

80 The district court or Court of Claims would set the penalty level in refund suits. It might be sensible to centralize adjudication of this penalty in the Tax Court, however, to minimize forum shopping.

81 *See* text accompanying notes 91-98 *infra*.

82 To name only a single crime—income tax evasion—the discrepancies in sentencing practice are disturbing. Seventeen percent of convicted taxpayers in Georgia received jail sentences in 1974, while no criminal tax offenders have been sentenced to jail in South Dakota since 1946; but 60 percent of tax convictions in

reform, but that is hardly an argument for extending them to new domains.[83]

Theoretically, abuses in administering a flexible statute could be rectified by appeal to the Tax Court. Through case-by-case adjudication, the judges would gain experience and perhaps develop a consensus on the kind of penalty that would be appropriate for various forms of cheating.[84] But the expense of litigation would make judicial review impracticable for many taxpayers. And Tax Court dockets would be swelled with disputes over the proper level of penalty.

The great majority of IRS officials and private tax lawyers interviewed on this subject were opposed to a flexible penalty as conferring too much discretion on IRS employees.[85] A Tax Court judge stated that the responsibility for setting the correct penalty level would be unwelcome and onerous. Writers in the administrative law field generally urge that discretion be narrowed whenever it is feasible to do so.[86] Although flexible standards are in use in other nations,[87] there is little information on how they function

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Florida and 100 percent in the Southern District of Alabama led to imprisonment in 1974. Address by Commissioner Donald Alexander to Southern Federal Tax Institute, Sept. 25, 1974, in U.S. TAX WEEK, Oct. 4, 1974, 1195-96.

83 Even worse, the system might come to resemble the administrative remission of the draconian penalties and forfeitures provided under the customs law. *See* 19 U.S.C. §§ 1592, 1618 (1970). *See generally* Dickey, *Customs: Fines, Forfeitures and the Mitigation Procedures—Sections 529 and 618 of the Tariff Act of 1930*, 30 BUS. LAW. 299 (1975). The statute provides for forfeiture of the goods, or a penalty equal to their value, even though the amount of duty understatement is far less. Either fraud or negligence can trigger the penalty. The Customs Service then mitigates the penalty to an amount which is a multiple of the duty understatement. Although it has not published its standards, the penalty is said to be about two to ten times the amount of the understatement. These matters are resolved by negotiation, not through judicial review. For example, it was reported that Standard-Kollsman was originally penalized $42.5 million, a penalty which was ultimately mitigated to $1.6 million. Wall St. J., Nov. 6, 1974, at 1, col. 6.

84 Since tax litigation can occur in the federal district courts and the Court of Claims as well as the Tax Court, divergent approaches and inconsistencies would inevitably develop. Forum shopping would be encouraged. *See* note 80 *supra*.

85 Both the administrators and a majority of the practitioners favored the fixed-level 25 percent penalty described in text accompanying notes 88-98 *infra*.

86 *See, e.g.*, K. DAVIS, DISCRETIONARY JUSTICE: A PRELIMINARY INQUIRY (1969).

87 Great Britain exacts a penalty "not exceeding 50 pounds" for negligent or incorrect returns. R. WILLIAMS, COMPREHENSIVE ASPECTS OF TAXATION 325 (30th ed. 1971). In France, the penalties for returns not made in good faith can be lowered by the administrator depending on the gravity of the offense. HARVARD LAW SCHOOL, INTERNATIONAL TAX PROGRAM, TAXATION IN FRANCE 953-54 (1966). In the Netherlands, there is a penalty of "up to 100 percent" of taxable income when the omission is due to fraud or gross negligence. BNA TAX MANAGEMENT FOREIGN INCOME PORTFOLIO NO. 150-2d, BUSINESS OPERATIONS IN THE NETHERLANDS, A-30 (1971).

and what kinds of problems they have created. Despite the advantage of the sliding scale approach, it should not be adopted.

3. An Additional 25 Percent Penalty: A Recommendation

ACUS Recommendation 75-7(b)(3) suggests a third approach to the problem: a new intermediate penalty which would apply to reckless or intentional inaccuracies which fall short of the flagrancy required to impose the 50 percent penalty.

The advantage of this proposal is that it preserves both the token but useful 5 percent penalty for negligence and the heavy 50 percent penalty for serious tax evasion without conferring excessive discretion on the IRS. The new penalty would be high enough so that a taxpayer would at least weigh it in deciding whether to cheat. Consequently, it should improve the deterrent force of the penalty structure.[88]

The intermediate penalty would not encounter the problems in administration which hinder the utilization of the fraud penalty.[89] Cases in which the intermediate penalty is asserted would not have to go to the Intelligence Division first; consequently, the penalty could more readily be asserted in small cases. Even if the case were referred to the Intelligence Division, rejection by Intelligence would not suggest that the new penalty is inappropriate. Moreover, because the burden of proof under the proposed penalty would be on the taxpayer,[90] the Service's case need not be prepared with the thoroughness required for the fraud penalty. As a result, examining agents would not need to be as well trained or sophisticated. Agents would not be compelled to lavish as much time in gathering evidence, a use of time which is discouraged by the unremitting pressure on agents for great quantities of closed cases.

A difficult problem in creating an intermediate penalty is defining the kind of conduct sufficient to trigger it. Formulation of a definition compels the draftsman to recognize that the terms "negligence" and "fraud" are now used in a way far different from their conventional meanings. This difficulty was dealt with in ACUS Recommendation 75-7 in three ways. First, negligence

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88 The new penalty might discourage a particular form of cheating which is perceived by some tax administrators as quite significant. Larger corporations often make deliberate, easily detected errors on their returns, hoping that the examining agent will be satisfied with detecting these errors and will fail to unearth more subtle errors. Also, this tactic conserves capital by deferring an appreciable part of the tax, at the cost of only interest and (conceivably) the 5 percent negligence penalty. *See* KIPLINGER WASHINGTON LETTER, Sept. 6, 1974. Since this tactic is based entirely on rational economic analysis, the existence of a new 25 percent penalty might be an effective deterrent.

89 *See* text accompanying notes 33-45 *supra*.

90 *See* text accompanying notes 99-100 *infra*.

would be defined[91] and the 5 percent penalty retained. Second, the term "fraud" would be dropped.[92] The 50 percent penalty would apply to a "willful attempt to evade payment of tax."[93] This is the same language employed by the statute making tax evasion a felony.[94] The purpose of this change in definition would be to confirm the quasi-criminal character of the 50 percent penalty. Third, reckless or intentional conduct which falls short of willful tax evasion would be penalized at a rate of 25 percent of the deficiency.[95]

The decision to establish the intermediate penalty at the 25 percent level seems appropriate. The maximum penalty for long-term delinquencies which are not treated as fraud[96] has long been 25 percent.[97] It seems reasonable to treat returns with intentional but nonfraudulent inaccuracies consistently with nonfraudulent delinquencies.

The existence of three penalties which draw sharp lines be-

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91 Negligence is defined as "failure to exercise reasonable care in keeping records or in preparing the tax return." ACUS Recommendation 75-7(b)(1)(i). The objective is to confine the negligence penalty to true cases of negligence.

92 Prosser declares that "fraud" is "a term so vague that it requires definition in nearly every case." PROSSER, *supra* note 17, at 684.

93 ACUS Recommendation 75-7(b)(4)(i).

94 INT. REV. CODE OF 1954, § 7201. If the proposed reform of the federal criminal law is enacted, the language of section 7201 will be altered and the language of the 50 percent penalty should receive a conforming amendment. The crime of "tax evasion" is defined in the proposed law as follows: "[W]ith intent to evade liability for a tax . . . he files a tax return that understates the tax . . . ." S. 1, 94th Cong., 1st Sess. § 1401 (1975).

95 "Reckless conduct" is defined "as meaning that in keeping records or preparing the tax return, the taxpayer has consciously disregarded a substantial risk that an underpayment would occur . . . ." ACUS Recommendation 75-7(b)(3)(i). "Intentional conduct" means "that in keeping records or preparing the tax return, the taxpayer knew that an underpayment would occur or was substantially certain to occur." *Id.* The Recommendation goes on to assure that a taxpayer could not be treated as reckless by reason of a "bona fide disagreement with the Internal Revenue Service as to the interpretation of the tax law or its application to facts disclosed on a tax return." *Id.*

This approach avoids the use of the phrase "gross negligence." This phrase has been condemned as excessively confusing. *See* PROSSER, *supra* note 17, at 181-84; Elliott, *Degrees of Negligence*, 6 S. CAL. L. REV. 91 *passim* (1933). Under the proposal in the text, "gross negligence" would still be penalized as negligence; but if it crossed the line into reckless conduct (*e.g.*, putting numbers on the return, knowing there was a substantial risk that they were not correct), the higher penalty would be applied.

96 *See* note 26 & accompanying text *supra*.

97 INT. REV. CODE OF 1954, § 6651(a)(1). However, prior to 1918, the delinquency penalty was 50 percent of the tax rather than 25 percent. *E.g.*, Revenue Act of 1916, ch. 463, § 16, 39 Stat. 775. The 1918 Act reduced the maximum delinquency penalty to 25 percent. Revenue Act of 1918, ch. 18, § 1317, 40 Stat. 1147. The 1935 Act introduced the gradations of 5 percent per month up to 25 percent. Revenue Act of 1935, ch. 829, § 406, 49 Stat. 1027. Similarly, the maximum penalty for nonpayment of the tax is 25 percent of the tax. INT. REV. CODE OF 1954, § 6651(a)(2).

tween negligent, reckless or intentional, and willfully evasive behavior might prove somewhat confusing. But the penalty structure would be greatly clarified by the adoption of Treasury regulations giving examples of the sorts of conduct intended to be covered by the various penalties.[98] Such regulations would, of course, be illustrative and non-exclusive. They would guide IRS personnel and tax practitioners concerned with correctly evaluating a client's exposure to penalties, but would not prevent the IRS from applying the penalties to new forms of evasion.

a. *Burden of Proof for the 25 Percent Penalty.* ACUS Recommendation 75-7(b)(3)(ii) clearly places on the taxpayer the burden of disproving the necessary state of mind for the 25 percent penalty.[99] This decision is eminently reasonable; a taxpayer possesses the facts concerning his own state of mind. True, the government has the burden of proof for establishing fraud, but this reflects the quasi-criminal character of the 50 percent penalty.

Removing the burden of proof from the government is in fact essential if the 25 percent penalty is to cover the excluded middle. Many rather obvious cases of intentional cheating now escape the 50 percent penalty solely because of the onerous burden of proof placed on the Service to establish the taxpayer's state of mind.[100] However, if the 25 percent penalty were asserted in such cases, it would be rather unlikely that the taxpayer could convince the factfinder that the inaccuracy was merely an accident. Consequently, the 25 percent penalty would be applied.

b. *Lesser Included Offenses.* Under present law, if the IRS pleads but fails to prove fraud, and fails to plead negligence in the alternative, the court has no power to attach the negligence penalty.[101] This seems to reward the taxpayer unduly for what is probably either a pleading error by the government or a tactical decision that pleading negligence tends to weaken its fraud case.

ACUS Recommendation 75-7(b)(3)(ii) proposes that if the IRS pleads the 25 percent penalty, the court should be empowered to impose the lesser penalty for negligence, even though the IRS has not alleged it. Recommendation 75-7(b)(4)(ii) also proposes that if the IRS pleads the 50 percent penalty but fails to sustain its burden, the court should be empowered to impose either of the lesser penalties. In the latter case, however, the Recommendation

[98] Although there appeared to be a consensus for this proposition at the ACUS plenary session, it was perhaps inadvertently omitted from the final draft of Recommendation 75-7.

[99] The burden of going forward is initially on the IRS which asserts in its deficiency notice that the understatement of tax was intentional. The burden of going forward and the burden of persuasion then shift to the taxpayer to disprove the IRS's contention.

[100] *See* notes 41-45 & accompanying text *supra*.

[101] *See* BALTER, *supra* note 26, at 8-6-7.

requires that the Service must first have proposed the lesser penalties and the taxpayer be given the opportunity to present evidence to establish his nonliability for the lesser tax.[102]

c. *Reliance on Preparers as a Defense.* A recurring claim in civil penalty cases is that the error was made by a return preparer, not the taxpayer. In fraud penalty cases, this defense has often been successfully asserted. The cases consistently point out that the state of mind necessary to establish fraud must be personal to the taxpayer.[103] The negligence cases, however, are not so consistent. Often, the preparer's negligence has appropriately been attributed to the taxpayer, because the taxpayer was personally negligent in failing to discover and correct the preparer's error or in failing to establish internal controls against the particular error.[104] However, the preparer's negligence should not be and generally is not attributed to the taxpayer if the taxpayer's conduct is not negligent.[105]

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[102] The requirement that the Service have "proposed" the lesser penalty was added out of concern that taxpayers might choose to stand silent and rely upon failure of the Service to carry its burden of proof to establish willful evasion. They might not realize that such silence would virtually assure liability for the 25 percent penalty. The ACUS wanted to be sure that such a taxpayer would have notice of the lesser penalties in order to properly make the tactical decision about whether to present any proof about state of mind. The ACUS's concern on this point, however, seems excessive. Taxpayers in fraud cases are usually represented by counsel who can be expected to be aware of the lesser included offenses. Taxpayers who are pro se seem unlikely to make a tactical decision to offer no evidence; if they did elect to remain silent, the judge would presumably warn them of the consequences of the decision. The ACUS recommendation seems likely to add procedural confusion to penalty litigation with very little real benefit to taxpayers. A motion to delete this proviso narrowly missed adoption at the ACUS plenary session.

[103] *E.g.*, Davis v. Commissioner, 184 F.2d 86 (10th Cir. 1950); Mitchell v. Commissioner, 118 F.2d 308 (5th Cir. 1941); Fred Draper, 32 T.C. 545 (1959), *acquiesced in*, 1960-1 CUM. BULL. 4. But if the taxpayer withholds the necessary information from the preparer, this is a strong indicium of fraud. *E.g.*, M. Rea Gano, 19 B.T.A. 518 (1930), *acquiesced in*, IX-2 CUM. BULL. 21 (1930); Harold B. Schwartz, 32 CCH Tax Ct. Mem. 1071 (1973).

[104] *E.g.*, Mitchell v. Commissioner, 118 F.2d 308 (5th Cir. 1941); Vern W. Bailey, 21 T.C. 678 (1954); Leroy Jewelry Co., 36 T.C. 443 (1961); L.B. Vocelle, 27 CCH Tax Ct. Mem. 1174 (1956).

[105] *E.g.*, L.L. Moorman, 26 T.C. 666, 680 (1956), *acquiesced in*, 1956-2 CUM. BULL. 7; R.E. Nelson, 19 T.C. 575 (1952), *acquiesced in*, 1953-2 CUM. BULL. 5; Rhett W. Woody, 19 T.C. 350 (1952), *acquiesced in*, 1954-1 CUM. BULL. 7; Golden Nugget, Inc., 28 CCH Tax Ct. Mem. 755 (1969); Frank D. Scotten, 25 CCH Tax Ct. Mem. 1054 (1966), *aff'd on other grounds*, 391 F.2d 274 (5th Cir. 1968); Andrew S. Harrill, 23 CCH Tax Ct. Mem. 1340 (1964); Joseph P. Marcelle, 15 CCH Tax Ct. Mem. 1174 (1956). However, the language of some cases would support the proposition that the negligence of the preparer is automatically attributed to the taxpayer, even if the taxpayer cannot be said to have been personally negligent in any respect. American Properties, Inc., 28 T.C. 1100 (1957), *aff'd per curiam*, 262 F.2d 150 (9th Cir. 1958); Joseph Forni, 34 CCH Tax Ct. Mem. 1089 (1975) (alternative holding). Such holdings seem unwarranted and should be disapproved.

The same principles should be applied under the new 25 percent penalty. If the taxpayer has furnished all necessary information to the preparer, he should be liable for the penalty only if he intentionally or recklessly failed to discover and correct the preparer's error.

D. *The "Intentional Disregard" Penalty of Section 6653(a)*

Section 6653(a) imposes a penalty of five percent of the deficiency for "intentional disregard of rules and regulations (but without intent to defraud)."[106] Neither the purpose nor the present function of this language is clear.

There is no legislative history to explain the enactment of this penalty in 1921, three years after the negligence penalty. But the 1921 Act may have responded to the Treasury's concern that negligence penalties would not be applied when the taxpayer felt that a regulation was invalid and filed his return without conspicuously disclosing his departure from the regulation.[107] Early negligence rulings suggest that this problem recurred frequently.[108] The Treasury may have wished to obtain legislative confirmation of its view that the negligence penalty should be applied to intentional failures to follow the regulations.

ACUS Recommendation 75-7(b)(2) proposes deletion of this penalty. This recommendation is justified because the penalty is confusing and superfluous. If it is designed to penalize taxpayers who decline to follow a disputed regulation,[109] the penalty is inappropriate and should be repealed. When there is a bona fide dispute of law—over the validity of a regulation, a ruling, or any other position taken by the IRS—the taxpayer should be allowed to assert his position without penalty and without conspicuously red-flagging the item.[110] But if the taxpayer's legal position is not maintained in good faith, or if the item is concealed or misde-

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[106] INT. REV. CODE OF 1954, § 6653(a).

[107] The original language imposed a five percent penalty upon "intentional disregard of authorized rules and regulations with knowledge thereof." Revenue Act of 1921, ch. 136, § 250(b), 42 Stat. 265.

[108] A.R.M. 105, 4 CUM. BULL. 322 (1921). *See generally* Hoffman, *Intentional Disregard of Rules and Regulations*, 28 TAXES 111 (1950).

[109] Journal Co., 46 B.T.A. 841 (1942), *rev'd on other grounds*, 134 F.2d 165 (7th Cir. 1943).

[110] *See* ABA COMM. ON PROFESSIONAL ETHICS, Opinion 314, *reprinted in* 51 A.B.A.J. 671 (1965). The ACUS took care that its newly proposed penalty for "reckless" conduct would not penalize a taxpayer for "a bona fide disagreement with the Internal Revenue Service as to the interpretation of the tax law or its application to facts disclosed on a tax return." ACUS Recommendation 75-7(b)(3)(i). This language was added to Recommendation 75-7 by an amendment at the ACUS plenary session. Although it is not completely clear on the disclosure point, the Recommendation should not be read to require the taxpayer to conspicuously red-flag the disputed item.

scribed on the return, or if the point is not truly disputable,[111] a penalty may well be appropriate. However, the intentional disregard penalty is unnecessary. The inaccuracies produced by the taxpayer's position would give rise to a penalty for negligence, recklessness, intentional conduct, or willful evasion.

If the intentional disregard penalty is used to reach garden-variety intentional cheating,[112] it is obviously unnecessary since the negligence penalty is now routinely applied to such conduct. And it would seem to make little sense to penalize both negligent and intentional cheating at the same level of five percent.

If the intentional disregard penalty is intended to penalize failure to file returns,[113] it is again superfluous. The delinquency penalty alone should be used for this purpose. It seems arbitrary to sometimes charge delinquent taxpayers with a five percent penalty[114] in addition to the delinquency penalty. The Service should be precluded from applying the inaccuracy penalties solely because of a delinquency in filing, unless the delinquency is to be treated as fraud.[115] In such a case, the IRS, by statute, is allowed to collect the fraud but not the delinquency penalty.[116]

If the intentional disregard penalty is intended to cover failure to keep books and records required by the regulations,[117] it is misdirected. A penalty directed at failure to keep records should not be tied to the tax deficiency. Instead, such a penalty could be a fixed dollar amount or a percentage of the entire tax due (whether or not there is a deficiency). It makes no sense to excuse a taxpayer from a penalty for failure to keep records just because his return has no deficiency; the damage to the government in extra

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111 An example of such an assertion would be a claim that the proceeds of embezzlement are not taxable.

112 *See, e.g.*, Edward T. Lysek, 34 CCH Tax Ct. Mem. 1267 (1975); BALTER, *supra* note 26, at 8-10-11. *See also* Nessen, *The Line Between Negligence and Civil Fraud: The Operation of Two Penalty Provisions Against Underpaying Taxpayers*, N.Y.U. 20TH INST. ON FED. TAX. 1117, 1119-20 (1962). Nessen struggles to explain the intentional disregard penalty as applying to "orneriness" rather than to a true intention to evade. *Id.*

113 *See, e.g.*, Robert P. Lord, 60 T.C. 199 (1973), *rev'd on other grounds sub nom.* Lord v. Commissioner, 525 F.2d 741 (9th Cir. 1975).

114 Under present law, the five percent penalty is based upon the entire tax, not just the deficiency, if the return is filed even one day late. *See* text accompanying notes 129-38 *infra*.

115 ACUS Recommendation 75-7(b)(5) would presumably achieve this result, but the change in law should be made clear.

116 INT. REV. CODE OF 1954, § 6653(d). The relationship between the inaccuracy and delinquency penalties is addressed in greater detail in text accompanying notes 129-36 *infra*.

117 *See, e.g.*, Boynton v. Pedrick, 228 F.2d 745 (2d Cir. 1955), *cert. denied*, 351 U.S. 938 (1956) (failure to keep inventories was intentional disregard); Berkley Mach. Works & Foundry Co., 27 CCH Tax Ct. Mem. 1487 (1968), *aff'd per curiam*, 422 F.2d 362 (4th Cir. 1970) (failure to keep records was negligent).

audit costs is the same whether a deficiency is present or not. However, there is probably no need for a separate penalty for failure to keep records, because in most such cases the inadequacy of the records will result in a deficiency. Unless the taxpayer is found to be without fault,[118] that deficiency would be based on conduct which is negligent, reckless, intentional, or quasi-criminal.[119] Consequently, it would trigger the inaccuracy penalty of 5 percent, 25 percent, or 50 percent.

E. *The Deficiency on Which Inaccuracy Penalties Are Computed*

Inaccuracy penalties are currently computed on the *entire* deficiency if *any part* of it is caused by negligence or fraud.[120] ACUS Recommendation 75-7(b)(5) proposes that when only part of the deficiency is due to taxpayer negligence or fraud the inaccuracy penalties should be based on only that part.[121]

The recommendation is clearly warranted; the present method of computation quite frequently produces a disproportionate and unfair penalty. For example, a taxpayer might have fraudulently concealed a source of income and evaded taxes of $5,000. But in the same year, he might have claimed excessive depreciation on machines in his factory, causing an additional deficiency of $80,000. This deficiency might be caused by a good-faith but erroneous use of the wrong method of depreciation. In such a case, the statute requires a civil fraud penalty of $42,500 even though the fraud caused a deficiency of only $5,000. The taxpayer must pay an extra $40,000 solely because a non-culpable error happened to occur in the same year. If the $5,000 deficiency were attributable to negligence, the penalty would be $4,250—more than 80 percent of the portion of the deficiency attributable to negligence.

The effect of the existing method of computing penalties may discourage the IRS from seeking a fraud penalty.[122] According to some IRS personnel, agents often will not assert the fraud penalty in cases where the total deficiency is very large but only a small part is apparently due to fraud.

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118 *See* Haman v. Commissioner, 500 F.2d 401 (9th Cir. 1974).

119 *See, e.g.*, Norman W. Meyers, 27 CCH Tax Ct. Mem. 1535 (1968), *aff'd*, 435 F.2d 171 (3d Cir. 1970), *cert. denied*, 401 U.S. 957 (1971).

120 INT. REV. CODE OF 1954, §§ 6653(a)-(b).

121 Examples of fraud cases include Levinson v. United States, 496 F.2d 651 (3d Cir. 1974), *cert. denied*, 419 U.S. 1040 (1975); Lowy v. Commissioner, 288 F.2d 517 (2d Cir. 1961), *cert. denied*, 368 U.S. 984 (1962); Estate of Millard D. Hill, 59 T.C. 846 (1973), *acquiesced in*, 1973-2 CUM. BULL. 2. Examples of negligence cases include Abrams v. United States, 449 F.2d 662 (2d Cir. 1971); Byron H. Farwell, 35 T.C. 454 (1960), *acquiesced in*, 1961-2 CUM. BULL. 4.

122 For a discussion of the extent and of other causes of underuse of the fraud penalty, see text accompanying notes 33-40 *supra*.

Some IRS personnel defend the existing statute by arguing that it would be an administrative burden to separate the items making up the deficiency, but this objection is unconvincing. A requirement that the IRS distinguish between the extreme situations making up willful tax evasion, the less flagrant intentional inaccuracies, the still less flagrant negligent inaccuracies, and non-negligent errors which present bona fide disputes of law imposes a modest burden. After all, an examining agent must separately state and support each distinct item in the deficiency notice; he should have no difficulty making a judgment about the degree of culpability involved in each item.

Even if adoption of ACUS Recommendation 75-7(b)(5) will create some additional burden, however, the present system, which can and often does create wildly arbitrary penalties, is simply not acceptable.[123] The Part which follows offers a suggestion which would markedly decrease these administrative burdens.

1. Single-Item Deficiencies and Burden of Proof

One problem with computing the 50 percent penalty[124] on only the part of the deficiency attributable to willful evasion arises where the taxpayer has previously been criminally convicted of tax evasion.[125] The present practice in criminal cases, relying on the indirect net worth method of proof,[126] is to assert relatively conservative deficiencies. For example, frequently no estimate is made of the amount of income spent for personal consumption, since it would be difficult to establish the figure beyond a reasonable doubt. However, in the later civil penalty proceeding the IRS asserts a larger deficiency which includes an estimate of personal consumption or other items not considered in the criminal case. The criminal conviction serves as conclusive proof of fraud,[127] and only the amount of the deficiency on which the civil penalty is based remains to be established. On that issue, the taxpayer has the burden of proof.[128]

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123 The well-reasoned report of the American Bar Association Tax Section made this same suggestion. 24 TAX LAW. 893 (1971). For some reason, however, the Section decided that it had no objection to assertion of negligence penalties against non-negligent items on the return; their sole objection was to the fraud penalty. 25 TAX LAW. 590 (1972).

124 This problem arises only in civil fraud cases because a criminal conviction is conclusive proof of civil fraud.

125 INT. REV. CODE OF 1954, § 7201.

126 In a net worth case, the taxpayer's income is assumed to be equal to the increase in his net worth plus expenditures during the taxable period. *See generally* Duke, *Prosecutions for Attempts to Evade Income Tax: A Discordant View of a Procedural Hybrid*, 76 YALE L.J. 1, 11-13 (1966).

127 *See* note 52 *supra*.

128 BALTER, *supra* note 26, at 10-44-46.

Under present law, the fraud penalty automatically applies to the entire deficiency, even though the deficiency proved in the criminal case is less than that established in the civil case. But under the revision proposed by ACUS Recommendation 75-7(b)(5), only that part of the deficiency proved in the criminal proceeding would automatically be subject to the penalty. Suppose, for example, that the criminal conviction of a taxpayer was based on the net worth method of proof and a claimed deficiency of $40,000. It is followed by a civil proceeding based on an asserted deficiency of $100,000. Only $40,000 of the civil deficiency would, under ACUS Recommendation 75-7(b)(5), be automatically subject to the fraud penalty. Fresh proof of fraud would be needed for the other $60,000, even though the entire deficiency would generally be attributable to the same conduct.

The IRS would be required to prove that the additional $60,000 of deficiency was as fraudulent as the $40,000. But this would force the IRS to repeat in the civil case the proof that it had furnished in the criminal case. Requiring this repetition would sacrifice the benefits of the doctrine of collateral estoppel in the civil case. Real judicial economies are obtained by not insisting that the government prove the taxpayer's state of mind twice.

ACUS Recommendation 75-7(b)(4)(ii) deals with this problem by shifting the burden of persuasion to the taxpayer to disprove fraud once the IRS has established the presence of fraud as to any part of the deficiency. Thus, after the criminal conviction established fraud as to $40,000 of the deficiency, the burden would shift to the taxpayer to prove by a preponderance of the evidence that some or all of the remaining deficiency was not attributable to fraud. In most cases, the taxpayer could not sustain this burden, since the entire deficiency would be characterized by a uniform state of mind.

Of course, the burden shifting proposed by ACUS Recommendation 75-7(b)(4)(ii) would apply to deficiencies based on multiple items as well as those based on single, indivisible items. Once the Service establishes fraud as to one of the items, the burden would shift to the taxpayer to disprove fraud as to the remaining items. But the taxpayer should find it easy to do so in cases like the hypothetical with which this Part began—a $5,000 deficiency based on fraud and an $80,000 deficiency based on a good-faith depreciation error. In sum, ACUS Recommendation 75-7(b)(4)(ii) would prevent unconscionably harsh penalties in cases of multiple-item deficiencies but would preserve the government's present advantage in civil fraud cases following criminal convictions.

Shifting the burden of proof to the taxpayer would also alleviate the IRS's concern about the administrative burdens of applying the fraud penalty only to fraudulent parts of the deficiency. The IRS would not have to sustain a heavy burden as to each item in the deficiency—only as to one, just as it does now. The taxpayer would then have the onus of showing that the remaining items are not subject to penalty.

2. Inaccuracy Penalties and Late Returns

Another problem under present law arises in cases where the return is filed late. Although inaccuracy penalties are usually computed upon the deficiency in the tax, the statute requires that they be based upon the *entire* tax if a negligent or fraudulent return is filed even one day late.[129] For example, suppose a fraudulent return declares that the tax due is $10,000, but the correct tax is $14,000. The return is filed one day late, but the late filing, in itself, would not be considered fraudulent. Ordinarily, the fraud penalty would be $2000, and the delinquency penalty $700.[130] Under present law, the government cannot collect both penalties.[131] But because the fraudulent return was filed late, the fraud penalty rises to $7000—much more than the two penalties combined. This result seems indefensibly arbitrary.

This problem was not addressed by the ACUS. Nevertheless a logical approach can be developed by applying several policies. The first policy is that the inaccuracy and delinquency penalties should operate independently. If a return is inaccurate, the penalty for inaccuracy should be no greater simply because the return happens to be filed late. And if a return is filed late, the delinquency penalty should not be affected by whether the return is accurate. The second policy[132] is a limitation on the first. The maximum civil penalty for any combination of inaccuracy and delinquency should be 50 percent of the entire tax. This seems to be a reasonable limitation since criminal penalties are available for particularly flagrant inaccuracies or delinquencies.

This approach will be tested in four different situations in which under present law the fraud (or negligence) penalty is applied to the entire tax due:

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129 INT. REV. CODE OF 1954, § 6653(c)(1).

130 The delinquency penalty for a delinquency of less than one month is five percent of the entire tax. *Id.* § 6651. *See* notes 162-73 & accompanying text *infra*.

131 INT. REV. CODE OF 1954, § 6653(d). Note that the IRS currently is not prohibited from collecting a negligence penalty in addition to a delinquency penalty when the only negligence is the late filing.

132 This policy is inherent in the existing prohibition of collecting for both fraud and delinquency. *See* INT. REV. CODE OF 1954, § 6653(c).

(1) An inaccurate return is filed late, but the lateness itself is not fraudulent. The inaccuracy penalty should be based on the deficiency only, but the delinquency penalty should be based on the entire tax. The combination of the two penalties should not exceed 50 percent of the entire tax.

(2) An accurate return is filed late, and the lateness itself is fraudulent. The fraud penalty should apply to the entire tax. This result is necessary to prevent the taxpayer from "making sport" of the fraud penalty by waiting to file a correct return until he discovers that an investigation of his affairs has begun.[133] If the lateness in filing is by itself fraudulent, the filing of a return should not necessarily reduce the applicable penalty.[134] In this situation the IRS should be prevented from collecting the delinquency penalty in addition to the fraud penalty, since the amount of the penalties would then exceed 50 percent of the tax.

(3) An inaccurate return is filed late, and the lateness itself is fraudulent. The fraud penalty again should apply to the entire tax. Since the penalty would be 50 percent of the tax, no additional inaccuracy penalty should be assessed.

(4) An inaccurate return is "corrected" by an amended return. As under present law, the amended return should be ignored and an inaccuracy penalty collected.[135] Once having filed

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[133] Charles F. Bennett, 30 T.C. 114 (1958), *acquiesced in*, 1958-2 CUM. BULL. 3.

[134] In many cases, however, the filing of an accurate return before the IRS has begun investigating the taxpayer's affairs would suggest that the lateness in filing was not fraudulent. Although the filing of an accurate return does not necessarily reduce civil penalties, the IRS ordinarily will not undertake criminal prosecutions when the taxpayer comes forward and admits his culpability before he has reason to believe that a tax investigation has started. *See* IRS Sanction Study, *supra* note 14, at 46; Letter from ABA Section of Taxation to Secretary of the Treasury, June 12, 1961, *quoted in* ABA SECTION OF TAX. BULL., Oct. 1961, at 32.

[135] In other words, the additional tax paid with the amended return does not reduce the deficiency on which the inaccuracy penalty is computed. George M. Still, Inc., 19 T.C. 1072 (1953), *aff'd on other grounds*, 218 F.2d 639 (2d Cir. 1955). *See* Gelfand, *Penalty Problems*, 32 TAXES 289 (1954). A related problem occurs in cases in which the original return is audited and a deficiency is asserted based on non-penalizable items. The taxpayer pays the deficiency. Then the return is re-audited and fraud is asserted. Such a re-audit is permitted, even of the same items, in cases of fraud. INT. REV. CODE OF 1954, § 6212(c). The taxpayer is not allowed to reduce the deficiency on which the penalty is computed by the items asserted during the first audit. *See* Levinson v. Commissioner, 496 F.2d 651 (3d Cir. 1974), *cert. denied*, 419 U.S. 1040 (1975); Gelfand, *supra* at 289-90. As contended by a dissenting opinion in *Levinson*, this result seems contrary to section 6211(a)(1)(B) which appears to permit a deficiency to be decreased by amounts previously assessed as deficiencies. 496 F.2d at 655-56 (dissenting opinion). However, the result in *Levinson* seems appropriate as a matter of policy; the fraud penalty should not be less because the IRS made two audits rather than one. But the result is not appropriate if *different items* are dealt with in the two audits because the fraud penalty should not apply to items of the de-

an inaccurate return, the taxpayer should be compelled to take the consequences. Obviously, however, the prompt filing of an amended return as soon as an error in the original return is discovered tends to show that the taxpayer never possessed a culpable state of mind.[136]

3. Calculation of Penalties on Multiple-Item Deficiencies

ACUS Recommendation 75-7(b)(5), which calls for computing a penalty on only the portion of a deficiency attributable to culpable conduct, is ambiguous: It is not clear how to calculate the penalty when only part of a deficiency was caused by wrongful conduct. For example, suppose taxable income as reported on the return was $32,000, resulting in a tax of $8,660. Income of $4,000 was omitted fraudulently[137] and another $8,000 was omitted due to an innocent error. Total taxable income should have been $44,000 and the correct tax $14,060. The deficiency, therefore, was $5,400. There are several different methods of computing the portion of the $5,400 deficiency attributable to the fraud. The problem is that the tax deficiency spanned several tax brackets—42 percent, 45 percent, and 48 percent.

One possible approach to allocating the deficiency would be to prorate the penalty. Since only one-third of the items which increased the tax were attributable to fraud, only one-third of the deficiency would be considered attributed to fraud. Consequently, the fraudulent portion would be $1,800 and the penalty $900. A second approach would be to use the lowest applicable brackets by starting from the originally reported taxable income, $32,000, and assuming that the fraudulently omitted item was the next income. This procedure would utilize only the 42 percent bracket; the deficiency applicable to the fraud would be $1,680, and the penalty $840. A final approach would be to use the highest applicable brackets by starting with the correct taxable income of $44,000 and subtracting the fraud items. This would utilize the 48 percent bracket; the fraudulent item would produce a deficiency of $1,920 and a penalty of $960.

The second approach clearly should be rejected: There is no reason to use the method of calculation most favorable to a culpable taxpayer. The third method produces the largest penalty and

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ficiency which are not themselves fraudulent. *See* text accompanying notes 120-23 *supra*. If the statute were amended as suggested by ACUS Recommendation 75-7(b)(5), the problem in *Levinson* would not arise unless the item causing the deficiency in the first audit was reclassified as penalizable because of information developed in the second audit. Such a case is Papa v. Commissioner, 464 F.2d 150 (2d Cir. 1972).

136 *See* note 134 *supra*.

137 Similar problems, of course, could arise from application of the other inaccuracy penalties, or any combination of them.

is probably the most appropriate, for the taxpayer probably imagined that the fraud would relate to the highest applicable bracket. But the first method, calling for a proration, seems to be the simplest. Since the IRS has expressed concern about the administrative burden of ACUS Recommendation 75-7(b)(5), it would probably be best to adopt this method, which would cause the fewest computational difficulties.[138]

F. *Publicity of the Willful Evasion Penalty*

Unlike its practice in criminal tax cases, the IRS does not publicize instances in which the 50 percent penalty for fraud has been imposed. The name of a taxpayer who litigates the penalty appears in a reported case, but the public generally takes no notice. And if the case is settled administratively, there is no publicity at all because of a statutory ban on disclosure of tax return data, except as authorized by the President.[139] This statute is based on the wise policy that taxpayers in a self-assessment system are entitled to confidentiality.

This policy, however, does not apply in criminal cases.[140] Not only is the return introduced in evidence, but the IRS affirmatively publicizes the details of the crime. ACUS Recommendation 75-7(c) proposes the enactment of legislation to allow publicity of cases in which the civil fraud penalty is imposed. The cases arising under the fraud penalty are characterized by high culpability,[141] and the same publicity policies should apply to criminal and civil tax fraud.[142] Having committed a serious wrong against the fisc, a taxpayer should be treated as having given up the right to privacy of his return.

An argument against the proposal to publicize civil fraud dispositions is that there is a difference between fraud cases which are prosecuted criminally and those which are only civil. As we have seen, the most blatant cases of fraud are selected for criminal prosecution, while somewhat less gross patterns of conduct are accorded exclusively civil treatment.[143] Such a distinction could, arguably, support a difference in the policy toward publicity of the

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138 If the legislative history of the new statute expressed a preference for proration, this approach could be readily adopted in the regulations. It would not be necessary to clutter the statute with the proration formula.

139 INT. REV. CODE OF 1954, §§ 6103, 7213.

140 Treas. Reg. §§ 301.6103(a)-1(e), (f), (g), (h) (1973). The civil fraud penalty would become the willful evasion penalty if Recommendation 75-7(b)(4)(i) is adopted.

141 *See* text accompanying notes 22-32 *supra*.

142 These publicity policies would not apply to such lesser penalties as negligence or the 25 percent penalty proposed by ACUS Recommendation 75-7(b)(3)(i).

143 *See* notes 46-60 & accompanying text *supra*.

sanction. Perhaps only the names of the worst offenders should be dragged before the public.[144]

I am not persuaded by this argument. Civil fraud cases are characterized by highly blameworthy conduct, much worse than ordinary tax chiseling. Taxpayers who engage in such conduct have lost the right to privacy of tax data, and it makes no difference that some evasions are even more flagrant.[145]

The publicity of civil fraud penalties is important because of the strong deterrent effect of publicity.[146] As the existence of this

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[144] That persons assessed with civil fraud penalties have not been accorded the protections of a criminal trial is irrelevant. Criminal procedures are not required to assess civil money penalties. *See* note 2 *supra*. Publicity of civil sanctions is routine outside the tax area. Assuming that procedural due process has been provided—and the protections given to taxpayers far exceed those required by due process—there should be no constitutional basis for attacking the publicity of civil money penalties.

[145] One problem with this proposal is that some settlements with the IRS would not preclude the taxpayer from filing a claim for refund and bringing suit on it. Publicity is appropriate only when there has been a final disposition: a Tax Court or appellate decision which is final, a settlement after petitioning the Tax Court (INT. REV. CODE OF 1954, § 6512(a)), or a settlement accompanied by the signing of Form 870 AD which contains a waiver of the right to sue for a refund. Some (but not all) cases have held the waiver in Form 870 AD not binding on the taxpayer. J. GARBIS & R. FROME, PROCEDURES IN FEDERAL TAX CONTROVERSIES §§ 12.10-.12 (1968). Nevertheless, execution by the taxpayer of such a waiver still seems to provide sufficient finality to make publicity reasonable. But other non-final settlements should not be publicized until the right to sue for a refund has expired.

[146] The effectiveness of this publicity is strongly indicated by the survey of taxpayer attitudes commissioned by the IRS. The survey asked:

	Percent base	Percent	Significant variations among respondents
34. Do you think it is proper for newspapers to report about people prosecuted for tax cheating?	1,322		
Yes		67.2	College, 75.6%; males, non-white, 56.7%.
No		29.8	Higher by single non-white females.
Don't know		3.0	
35. If the papers do give a lot of publicity to a prosecution for tax cheating, do you think this is sort of extra punishment for the person accused of cheating?	1,322		
Yes		81.5	Females, 87.1%; rural also a bit higher.
No		16.6	Higher by single non-white males.
Don't know		1.8	
36. If there were more publicity about people who are prosecuted for tax cheating, do you think this would make more people try to cheat, fewer people try to cheat, or wouldn't it make any difference?	1,324		

penalty begins to sink into the public consciousness, taxpayers may revise the economic calculations which lead them to commit tax fraud. Moreover, publicity is itself a severe sanction, one which to many people would be worse than any money penalty. The potency of publicity as a deterrent and as a sanction is strongly suggested by a survey commissioned by the IRS.[147] A surprisingly large

More people would cheat	1.2	
Fewer people would cheat	61.0	Non-white, 55.8%.
No difference	35.5	
Don't know	2.3	

IRS Sanction Study, *supra* note 14, at 78.

[147] *Id.* at 78-79. Interviewers then asked these questions:

	Percent base	Percent	Significant variations among respondents
37. What if the government did not take tax cheaters to court but only collected the taxes owed plus a fine of 50 percent of the taxes owed and did release information about these cases to the newspapers? Do you think that would result in more people attempting to cheat, fewer people attempting to cheat, or wouldn't that make any difference?	1,318		
More (ask A)		12.7	Higher by youngest ages; females, 9.2%.
Fewer (ask A)		48.5	
No difference (ask A)		31.7	Higher education, 43.9%; non-white, 40%.
Don't know (Go to Q. 38)		7.1	Farmers, 19.1%.
A. Unless don't know: Why do you think so?	1,124		
Publicity alone would deter, scandal would hurt business, family, offend neighbors (no mention of fine).		34.2	
Fine alone would deter (no mention of publicity).		6.9	
Publicity and fine would deter, knowledge of IRS ability to catch cheaters would deter others, emphasis on getting caught.		9.7	
No difference, dishonest people would cheat anyway.		27.0	
Fine and publicity not enough, should go to jail or to court.		7.5	
Cheating worth the risk, if sure of not going to jail or to court, 50-50 chance of getting caught.		6.7	
Other		6.0	
Don't know		2.1	

Id.

number of respondents—more than one-third—thought that cheating would be reduced by publicity alone, without a money penalty. Thus there is reason to suppose that publicity of civil tax fraud sanctions might improve tax compliance.

G. *Statistical Information on Penalties*

Present IRS data collection procedures yield little information about the imposition of penalties. There is no information about how many penalties are assessed, what the circumstances of the offenses are, how much money is collected, or how many penalty cases are settled rather than litigated.

Other than a few internal IRS studies based on very limited samples,[148] it is simply not possible to find out, for example, how often the negligence penalty is imposed. A recent article in a tax journal complained that in the Los Angeles district the negligence penalty was being routinely imposed in all cases of substantial deficiencies.[149] But a newspaper story about the same district observed that the civil fraud penalty had been used in only 70 cases in the first quarter of fiscal 1976 and "the negligence penalty [was] used even less."[150] Each of these accounts is disturbing, one suggesting overuse and the other underuse of the negligence penalty. Presumably, both descriptions cannot be correct, but there is no authoritative set of statistics to which one can refer.

ACUS Recommendation 75-7(a) addresses this problem. It recommends that the IRS compile and publish statistical data, together with analytic discussions, on civil penalties. At the plenary session of ACUS, the Chief Counsel of the IRS indicated his agreement with this recommendation and stated that it would be implemented if manpower and budgetary constraints permit.

H. *Proposed Statutory Language*

The following is suggested as new statutory language to replace present Internal Revenue Code section 6653:[151]

> (a) Negligence.—If any part of an underpayment of any tax required to be shown on a return is due to negligence,

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[148] IRS Sanction Study, *supra* note 14; 1974 Civil Fraud Study, *supra* note 15.

[149] *Shop Talk*, 43 J. TAX. 64 (1975).

[150] Lawrence, *Some Pay for the Good Life; Others Deduct*, L.A. Times, Dec. 27, 1975, pt. 1, at 1, 12, col. 4. Many interviewed in connection with this study thought that the negligence penalty was seriously underutilized by examining agents. *See* Balter, *The Line Between Negligence and Fraud*, N.Y.U. 12TH INST. ON FED. TAX. 15, 37 (1954).

[151] Present section 6653(e), relating to stamp taxes, has no logical connection to the balance of section 6653 and should be made an independent code section.

there shall be added to the tax an amount equal to 5 percent of such part of the underpayment.[152] Negligence means failure to exercise reasonable care in keeping records or in preparing the return.

(b) Reckless or intentional conduct.—If any part of an underpayment of any tax required to be shown on a return is due to reckless or intentional conduct (but without willful tax evasion), there shall be added to the tax an amount equal to 25 percent of such part of the underpayment.

(1) This amount shall be in lieu of any amount determined under subsection (a).

(2) Reckless conduct means that in keeping records or preparing the return, the taxpayer has consciously disregarded a substantial risk that an underpayment would occur.

(3) Intentional conduct means that in keeping records or preparing the return, the taxpayer knew that an underpayment would occur or was substantially certain to occur.

(c) Willful tax evasion.—If any part of the underpayment of any tax required to be shown on a return is due to willful tax evasion, there shall be added to the tax an amount equal to 50 percent of such part of the underpayment.

(1) This amount shall be in lieu of any amount determined under subsections (a) and (b).

(2) Willful tax evasion has the same meaning as willful attempts to evade tax under section 7201.

(3) If willful tax evasion consists of failing to file a return by the date prescribed by law for filing such return, there shall be added to the tax an amount equal to 50 percent of such tax, whether or not a return is filed.

(d) Definition of underpayment.[153]—For purposes of this section, the term "'underpayment" means the excess of the correct tax over the amount of tax shown upon the return if a return was made by the taxpayer,[154] or the entire tax if no return was made by the taxpayer. An amended return shall not be treated as a return for this purpose.[155] This calculation shall be made without regard to any credit for an overpayment for any prior period and without regard to any adjustment under sections 6205(a) and 6413(a).

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[152] The penalty would apply to all taxes for which a return is filed. The present negligence penalty applies only to income and gift taxes. There is no apparent reason for this limitation.

[153] This section greatly simplifies the wording of the present section 6653(c) by combining provisions for all of the taxes covered by the penalty and eliminating some confusing language which appears to have been ignored by the courts anyway. *See* note 135 *supra*.

[154] This provision changes existing law which applies the penalty to the entire tax if the return is filed late. *See* INT. REV. CODE OF 1954, § 6653(c)(1).

[155] *See* note 135 *supra*. Although the present statute is confusing, this provision regarding amended returns is consistent with existing case law.

(e) Prevention of duplicate penalties.—In the event that a taxpayer fails to file a return within the time prescribed by law, or fails to pay a tax shown on the return, or underpays estimated tax, and

(1) Negligence, recklessness, and intentional conduct penalties precluded.—If a penalty is assessed under a section specifically relating to such conduct, no penalty shall be assessed under subsections (a), (b), or (c) of this section solely by reason of such conduct.[156]

(2) Willful tax evasion penalty precludes other penalties.—If a penalty is assessed under subsection (c), no additional penalty shall be assessed under sections specifically relating to such conduct.[157]

(3) Combination of penalties.—If a penalty is assessed under a section specifically relating to such conduct, and a penalty is also assessed under subsections (a) or (b) by reason of inaccuracies in the return, the sum of the penalties shall not exceed 50 percent of the correct tax.

(f) Innocent spouse.—In case of a joint return under section 6013, subsections (a), (b), and (c) shall not apply to the tax of a spouse unless the spouse engaged in the conduct described in those subsections.[158]

(g) Lesser included penalties.[159]—A court which is adjudicating the taxpayer's liabilities for additions to the tax described in subsections (a), (b), or (c) shall have power to find the taxpayer liable for the penalties described

(1) in subsection (a) if the Secretary or his delegate has determined that the taxpayer is liable for the penalty described in subsection (b), and

(2) in subsections (a) or (b) if the Secretary or his delegate has determined that the taxpayer is liable for the penalty described in subsection (c).

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[156] This provision changes existing law which permits a negligence penalty to be piled atop a delinquency penalty when the only negligence is non-filing. *See* text accompanying note 113 *supra*. This provision is not intended to prevent the IRS from determining that the non-filing constitutes willful tax evasion, even though it has previously assessed a delinquency penalty. The amount previously paid by reason of the delinquency penalty, however, would be offset against the willful evasion penalty, since the IRS would not be entitled to collect both penalties.

[157] This provision restates existing law. *See* INT. REV. CODE OF 1954, § 6653(d).

[158] Although existing law gives relief to an innocent spouse only in the case of fraud penalties (INT. REV. CODE OF 1954, § 6653(b)), there seems to be no reason not to extend relief for the other civil penalties as well.

[159] This provision changes existing law, which does not allow the court to assert a lesser included penalty if it is not claimed by the IRS. *See* BALTER, *supra* note 26, at 8-6-7. ACUS Recommendation 75-7(b)(4)(ii) suggests that if the IRS asserts the willful evasion penalty, the court cannot impose a lesser penalty until the IRS first proposes it and the taxpayer is given a clear opportunity to present evidence of non-liability. For a discussion suggesting that this proviso is unnecessary, see note 102 *supra*.

(h) **Burden of proof.**—In any proceeding in a court, including the Tax Court, to determine whether the taxpayer is liable for the penalties described in this section, the burden of persuasion to establish willful tax evasion, as described in subsection (c), shall be on the Secretary or his delegate. Such proof shall be by clear and convincing evidence. If the Secretary or his delegate proves that any part of the deficiency for any year or return is attributable to willful tax evasion, the burden of persuasion will shift to the taxpayer to establish the absence of willful tax evasion with respect to the remainder of the deficiency for such year or return. The burden of persuasion to establish the absence of negligence, described in subsection (a), or recklessness or intentional conduct, described in subsection (b), shall be on the taxpayer.[160]

II. THE PENALTY FOR DELINQUENCY IN FILING RETURNS

Section 6651(a)(1) provides a penalty for failure to file a return on time. The penalty is five percent of the amount of the tax for each month or fraction of a month that the return is late; the maximum delinquency penalty is 25 percent of the tax. The penalty does not apply if the taxpayer establishes that the delinquency "is due to reasonable cause and not due to willful neglect."[161]

A. *The Level of the Delinquency Penalty*

1. The Rate of Accrual

ACUS Recommendation 75-7(d)(1)(ii)(A) proposes a decrease in the rate at which the delinquency penalty accrues. It suggests that the penalty be five percent for the first month, and either two percent, one and one-quarter percent, or one percent for each subsequent month.[162] The present 25 percent ceiling would be retained.

The existing penalty rises too steeply. The five percent penalty for the first month, or fraction thereof, is justifiable since it supplies an important incentive to get the return in on time. The existence of the penalty seems widely understood by the public, who always queue to file returns on the afternoon and evening of April 15. The Postal Service publicizes the fact that post offices

[160] The burden of proof for fraud is currently dealt with in section 7454. The suggested placement of a burden of proof provision within the penalty statute reflects the importance of burden of proof considerations in distinguishing negligence and reckless or intentional conduct from willful tax evasion. *See* text accompanying notes 99-102 *supra*.

[161] INT. REV. CODE OF 1954, § 6651(a)(1).

[162] Under these options, the penalty would continue to increase for 11 months, 17 months, and 21 months, respectively. Under present law, the penalty increases only for five months.

stay open late on the 15th to receive and postmark mail before the deadline. It always does a brisk business.

The legislative judgment that the maximum penalty is 25 percent of the tax is also appropriate. Failure to file is unquestionably a serious problem, warranting a heavy penalty. Serious instances of non-filing are prosecuted as misdemeanors[163] or can even be treated as tax evasion (a felony).[164] Whether or not the non-filing is treated as a criminal offense, it can be subject to the 50 percent civil fraud penalty.[165] Therefore a maximum 25 percent penalty for non-fraudulent failure to file seems about right. The 25 percent delinquency penalty is consistent with the ACUS Recommendation 75-7(b)(3) for a 25 percent penalty for reckless or intentionally inaccurate returns. That penalty also was designed to cover tax cheating which is not quasi-criminal.

Although the minimum and maximum delinquency penalties are appropriate, the delinquency penalty escalates too quickly. A penalty of five percent per month (or fraction thereof) is a 60 percent annual effective rate on the entire tax, not simply on a deficiency as in the case of the inaccuracy penalties.[166] A 60 percent annual rate of interest would be viewed by all as exorbitant. And the penalty provided in the very next subparagraph, for failure to *pay* the tax shown on the return, is only .5 percent per month—one-tenth the rate of the section 6651(a) penalty.[167]

Moreover, the rapid escalation of the penalty seems to create

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163 The criminal sanction for failure to file (INT. REV. CODE OF 1954, § 7203) should probably be transformed from a misdemeanor into a felony, on the theory that the harm to the public from non-filing is at least as great as from fraudulent filing. This is the proposal of the National Commission on Reform of Federal Criminal Laws. *See* 2 WORKING PAPERS OF THE NATIONAL COMMISSION ON REFORM OF FEDERAL CRIMINAL LAWS 751 (1971). *See also* Remarks of Joseph Sneed to Tax Section of the American Bar Association, Washington, D.C., May 20, 1973, in 27 TAX LAW. 15 (1973); IRS Sanction Study, *supra* note 14, at 38-40. However, failure to file remains a misdemeanor in the legislation currently before Congress. S.1, 94th Cong., 1st Sess. § 1412 (1975).

164 Spies v. United States, 317 U.S. 492 (1943).

165 *See* note 26 *supra*.

166 INT. REV. CODE OF 1954, § 6651(a)(2).

167 By this analogy, however, I do not mean to suggest that the penalties for non-filing and for non-payment of the tax shown on the return should be the same. The significant difference in the behavior associated with these two penalties warrants different treatment. When a taxpayer files a return on time but does not pay the tax due, he gains little respite from the hot breath of the tax collector. Very soon he gets a bill for the unpaid tax, and collection efforts soon follow. But by not filing a return at all, the taxpayer is left alone for a substantial time—perhaps forever. At a minimum, about six months will elapse before the computer alerts the IRS to the taxpayer's failure to file. Then he will receive an inquiry, not a bill. And if the taxpayer has not previously filed, a much longer respite is likely. Consequently, the risks and losses to the government, and the gains to the taxpayer, are considerably greater in the case of non-filing than in that of non-payment.

an undesired side effect. For the first five months after the due date, there is intense pressure to correct any discovered instances of non-filing. But after the five months, there is no additional pressure to do so, other than fear of civil fraud or criminal penalties. Would it not be better if the penalty kept on increasing, month by month, so that there would still be an incentive to file as soon as possible?

The legislative history of section 6651(a) shows that the delinquency penalty has been steadily relaxed. Originally, it was 50 percent of the entire tax for even the shortest delinquencies.[168] Then in 1918 the penalty was reduced to 25 percent.[169] Finally, the 5 percent month-by-month escalation was added in 1935.[170] Each of these changes made good sense: The 1918 amendment placed the delinquency penalty at about the right level, as compared to the inaccuracy penalties, and the 1935 amendment distinguished between long and short-term delinquencies.[171]

ACUS Recommendation 75-7(d)(1)(ii)(A) builds on the 1935 amendment by proposing that the rate of accrual be slowed down, so as to further distinguish between long and short-term delinquencies in filing. The penalty would thus be less onerous for relatively short delinquencies, and the period in which there would be an incentive to correct the delinquency voluntarily would be lengthened. Each of the rates of accrual proposed in the Recommendation would have this effect, although the author's preference is for the slowest accrual: five percent for the first month and one

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168 Revenue Act of 1916, ch. 463, § 16, 39 Stat. 775, *amending* Revised Statutes, tit. 35, ch. 18, § 3176 (2d ed. 1878). Like other early income tax statutes, the 1916 Act contained some confusing additional penalties for failure to file. It provided a "penalty of not exceeding $10,000" in the case of corporate non-filing or fraud. Revenue Act of 1916, ch. 463, § 14, 39 Stat. 773. And it provided that individuals who fail to file on time are liable to "a penalty of not less than $20 or more than $1000." *Id.* § 18, 39 Stat. 775. Although it would certainly be arguable from the context that these latter "penalties" were criminal rather than civil, they were apparently viewed as civil penalties and could be readily compromised for low amounts. However, the 50 percent penalty of section 3176 of the Revised Statutes could not be compromised. R. MONTGOMERY, INCOME TAX PROCEDURE 498-502 (1918).

169 Revenue Act of 1918, ch. 18, § 1317, 40 Stat. 1146, *amending* Revised Statutes, tit. 35, ch. 18, § 3176 (2d ed. 1878). But the Act also continued a parallel penalty of "not more than $1000" in the event of failure to make a return. Revenue Act of 1918, ch. 18, § 253, 40 Stat. 1085.

170 Revenue Act of 1935, ch. 829, § 406, 49 Stat. 1027. It was thought that the existing penalty was too "severe." S. REP. No. 1240, 74th Cong., 1st Sess. 12 (1935).

171 Presumably the flexible penalties previously in the law (*see* notes 168-69 *supra*) were also designed for the same purpose. But they contained no guidance for exercise of discretion by the IRS. Gradation of the penalty on a strict month-by-month basis seems superior to a discretionary range. *See* text accompanying notes 79-87 *supra.*

percent per each additional month, increasing after 21 months to the maximum of 25 percent of the tax.

2. Delinquencies of a Fraction of a Month

The present statute charges a full month's penalty for a delinquency of only a *fraction* of a month. It seems difficult to justify a rule which treats a delinquency of one day the same as a delinquency of an entire month.

ACUS Recommendation 75-7(d)(1)(ii)(B) suggests that the monthly rate should be prorated on a *semi-monthly* basis. This represents a compromise between the position of the IRS, that charging a monthly penalty for fractions of a month was necessary for administrative convenience, and a conceptually proper approach, which would call for daily proration. The IRS's position that prorations of the penalty are administratively inconvenient is not persuasive. Someone must, in any event, count the months and days of delinquency in order to compute interest.[172] Making a daily proration of the penalty is not a significant extra burden. However, the compromise position of ACUS Recommendation 75-7(d)(1)(ii)(B) is justifiable if it is assumed that the rate of accrual is slowed down. If the penalty is increasing at the rate of only one percent, one and one-quarter percent, or two percent per month, a daily calculation is much less important than under present law in which the penalty increases at the rate of five percent per month.[173]

Recommendation 75-7(d)(1)(ii)(B) does not propose semi-monthly proration in the *first* month of delinquency. The full five percent penalty should probably apply to a delinquency of even a single day in the month in which the return is due. This provides a substantial incentive for filing a return absolutely on time. It would be unwise to encourage taxpayers to think that the return need only be filed sometime around the due date.

B. *Administration of the Delinquency Penalty and Judicial Review*

ACUS Recommendation 75-7(e) proposes that taxpayers

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172 INT. REV. CODE OF 1954, § 6601(a).

173 The severity of this provision under present law suggests that it should not be strictly interpreted. Consequently, the result in the recent case of Label-Matic, Inc. v. United States, 74-1 U.S. TAX CAS. ¶ 9380 (N.D. Cal. 1974) seems correct. In *Label-Matic* the return was filed on August 16. This was one day into a new monthly period and the IRS argued that an additional five percent was therefore due. But August 15 was a Sunday. It was not clear whether section 7503 (which extends due dates falling on weekends to the following Monday) was applicable to section 6651, but the court held that it was. This is an eminently sensible result and the regulations should be amended to incorporate it.

against whom delinquency penalties[174] are asserted should be accorded administrative settlement procedures and access to Tax Court review similar to those accorded with respect to inaccuracy penalties. In order to appraise the wisdom of this proposal, it is necessary to survey the existing administrative and judicial review process in delinquency cases, and to consider the sorts of factual issues which arise.

1. Administrative Process in Delinquency Cases

The failure-to-file penalty, among others,[175] is automatically charged by computer at IRS service centers. However, the penalty is abated if the taxpayer establishes that the delinquency is "due to reasonable cause and not due to willful neglect."[176] This Part considers the administration of the penalty and judicial review of reasonable cause determinations.

If an explanation for the delinquent filing accompanies the return,[177] the processing section at the service center decides whether reasonable cause existed. If no explanation accompanies the return or the processing section fails to accept an explanation tendered with the return, the computer sends the taxpayer a bill for the penalty. This bill contains the telephone number of a local office with which the taxpayer can communicate concerning the bill.

A taxpayer who calls the local office speaks to an employee who has access via a computer terminal to data concerning the taxpayer's account. If satisfied with the taxpayer's explanation, the employee has authority to abate the penalty. Alternatively, the taxpayer can write to the service center where tax examiners will consider the explanation and are authorized to abate the penalty. The personnel who review these explanations accept the taxpayer's word concerning factual matters. If the facts asserted by the taxpayer fit the employee's conception of reasonable cause, the penalty is abated. Unless the return happens to be audited at a later date,[178] there is no occasion to investigate the taxpayer's version of how the delinquency occurred.

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174 ACUS Recommendation 75-7(e) covers both the failure-to-file and failure-to-pay penalties set forth in section 6651. The failure-to-pay penalty is not considered in this Article, but the issues raised are very similar.

175 Other computer generated penalties include those for failure to pay the tax shown on the return (INT. REV. CODE OF 1954, § 6651(a)(2)), underpayment of estimated tax (*id.* § 6654), failure to file return required of exempt organization (*id.* § 6652(d)(1)), and failure to deposit payroll taxes (*id.* § 6656).

176 *Id.* § 6651(a)(1).

177 This is the procedure mandated by the regulations. Treas. Reg. § 301.6651-1(c)(1), T.D. 7133, 1971-2 CUM. BULL. 417.

178 *See* 2 CCH INT. REV. MANUAL § 4562.1(2) (1975).

If the taxpayer fails to pay the bill or otherwise respond to the notice sent by the service center, three more letters are sent demanding payment in increasingly urgent and threatening tones. Finally, the matter is termed a tax delinquency account and referred to collection personnel in the taxpayer's district. Personnel in collection will generally provide the taxpayer with a final chance to explain the delinquency. If the explanation is not accepted by the revenue officer to whom the matter is assigned, the taxpayer can negotiate with the officer's group manager. Then collection efforts begin.

At any point in this process, the taxpayer can pay the penalty and submit a claim for refund. The claim will be scrutinized by the same group of tax examiners at the service center who examine explanations submitted before payment of the penalty. If the claim for refund is rejected, the taxpayer can sue for a refund in the federal district court or the Court of Claims.

No doubt, many of the explanations for delinquency submitted by taxpayers are accepted by the personnel responsible for considering them. If his explanation is rejected, however, the options open to a taxpayer are markedly different from those available in connection with audits. If a deficiency is asserted after an audit (with or without inaccuracy penalties), an elaborate negotiating apparatus is open to the taxpayer before he must pay the tax. He can negotiate with the revenue agent's group chief, a district conferee, and finally the appellate division. If the matter is not disposed of through negotiation, the taxpayer can file a Tax Court petition, still without paying the tax.[179] While the litigation is pending, he can negotiate further with Regional Counsel. Only if the litigation is decided adversely to him must the taxpayer finally pay the tax.[180]

In comparison, the administrative process available prior to paying a delinquency penalty is very sparse. The taxpayer has the opportunity to send a letter to a tax examiner at the service center, speak over the telephone toll-free with a local employee, or try to convince a revenue officer to whom the delinquent account has been assigned.[181] In order to negotiate further with the IRS, he must pay the penalty and file a claim for refund. If it is denied, he can litigate in the district court or Court of Claims. The Tax

[179] INT. REV. CODE OF 1954, § 6213(a).

[180] Payment of the tax can be delayed still further by filing an appeal, however, the taxpayer must then post a bond to insure payment of the deficiency. INT. REV. CODE OF 1954, § 7485.

[181] The IRS personnel interviewed in connection with this study strongly felt that it was difficult to settle such a case with the revenue officer whose primary mission is collection rather than abatement.

Court is not open to him.[182]

2. Reasonable Cause for Late Filing

Failure-to-file cases may present many disputable issues of law and fact.[183] Late filing is excused if the taxpayer establishes that a delinquency was "due to reasonable cause and not due to willful neglect . . . ."[184] The test, then, is whether the taxpayer exercised ordinary business care and prudence.[185] Needless to say, this sort of test does not always lead to clear-cut and indisputable results. As in negligence cases of all sorts, litigation is often necessary to determine what is reasonable. Acceptable excuses include such relatively objective events as the death or the serious illness of the taxpayer or his family.[186] But how sick does one have to be on April 15? How about the taxpayer who suffers extreme mental depression around that time (whether or not attributable to his income tax problems)?

Quite difficult cases are presented by excuses based upon the errors of tax advisers, and the courts differ in their resolution of the issue. While the Tax Court reasons that negligent failure by an accountant or attorney to file on time is not an excuse,[187]

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[182] The Tax Court has jurisdiction only if a notice of deficiency has been sent by the IRS to the taxpayer. INT. REV. CODE OF 1954, §§ 6213(a), 7442. Such notices are sent only in cases of deficiencies in income tax, estate and gift tax, and excise taxes relating to private foundations and qualified benefit plans. INT. REV. CODE OF 1954, § 6212(a). Whether penalties are treated, for this purpose, the same as the taxes to which they relate depends on section 6659. Under section 6659(a), the section 6653 penalties (fraud and negligence) must be asserted in the same manner as deficiencies in taxes. But section 6651 penalties are excepted; no deficiency notice need be sent to collect a delinquency penalty other than one generated by an addition to tax resulting from an audit. INT. REV. CODE OF 1954, § 6659(b), Treas. Reg. § 301.6659-1(c) (1958). Consequently, the IRS sends no deficiency notice to collect a section 6651 penalty and the Tax Court has no jurisdiction (except in cases where the delinquency penalty is increased by a deficiency in tax). *See, e.g.*, Estate of Annunziata M. Scarengella, 60 T.C. 184 1973). But if the IRS unnecessarily sends a notice of deficiency, the Tax Court has jurisdiction. Daniel E. Hannan, 52 T.C. 787 (1969), *not acquiesced in*, 1971-2 CUM. BULL. 4.

[183] *See generally* Reisner, *Relief from Delinquency Penalties: The Internal Revenue Code*, 98 U. PA. L. REV. 183 (1949). *But see* note 204 *infra*.

[184] INT. REV. CODE OF 1954, § 6651(a)(1).

[185] Treas. Reg. § 301.6651-1(c)(1), T.D. 7133, 1971-2 CUM. BULL. 417. Alternatively, reasonable cause is that which would prompt an ordinarily intelligent and prudent businessman to have so acted under similar circumstances. Charles E. Pearsall & Son, 29 B.T.A. 747 (1934).

[186] 2 CCH INT. REV. MANUAL § 4562.2(1)(d) (1975).

[187] *See, e.g.*, Inter-American Life Ins. Co., 56 T.C. 497 (1971), *aff'd per curiam*, 469 F.2d 697 (9th Cir. 1972); Estate of Frank Duttenhofer, 49 T.C. 200 (1967), *aff'd per curiam*, 410 F.2d 302 (6th Cir. 1969). This rule seems considerably stricter than the comparable rule applicable to the negligence penalty. In those cases, it appears that negligence of an adviser is not automatically imputed

some courts of appeals disagree.[188] Courts accept good faith reliance on the opinion of a qualified tax practitioner that no return is due as an excuse,[189] but the application of this principle produces many disputes.[190] And what of cases where the law is unclear and the taxpayer has a reasonable belief that filing is not required?[191] Or of cases where the law is clear (although complex) and the taxpayer is ignorant?[192] Or when the taxpayer files on time but on the wrong form?[193] If an IRS employee erroneously advises the taxpayer that no return is due, this is an acceptable excuse,[194] but will the taxpayer be believed if he pleads reliance on oral misadvice?[195] The IRS policy is not to assert the penalty if a timely return is submitted unsigned, unless there is

to the taxpayer. *See* notes 104-05 & accompanying text *supra*. It is not apparent why these two negligence standards are applied differently.

188 Haywood Lumber & Mining Co. v. Commissioner, 178 F.2d 769 (2d Cir. 1950) (accountant's negligence is an excuse). *See* Estate of Anthony Geraci v. Commissioner, 502 F.2d 1148 (6th Cir. 1974), *cert. denied*, 420 U.S. 992 (1975) (expressing concern at the harshness of imputing the negligence of an attorney to an executrix who was ignorant of business matters).

189 *See, e.g.*, Estate of Oei Tjong Swan, 24 T.C. 829 (1955), *aff'd on other grounds*, 247 F.2d 144 (2d Cir. 1957).

190 *See, e.g.*, Estate of Crute, 33 CCH Tax Ct. Mem. 1073 (1974) (advice of accounting firm on executor's legal power sufficient); Hermax Co., 11 T.C. 442 (1948), *aff'd*, 175 F.2d 776 (3d Cir. 1949) (advice of public accountant not sufficient). *See* BALTER, *supra* note 26, at 8-22-30.

191 Some circuits uphold this excuse. Palm Beach Trust Co. v. Commissioner, 174 F.2d 527 (D.C. Cir.), *cert. denied*, 338 U.S. 825 (1949); Economy Sav. & Loan Co. v. Commissioner, 158 F.2d 472 (6th Cir. 1946). But the Tax Court disagrees with those cases. Stevens Bros. Foundation, Inc., 39 T.C. 93 (1962), *rev'd on other grounds*, 324 F.2d 633 (8th Cir. 1963), *cert. denied*, 376 U.S. 969 (1964); Tussaud's Wax Museums, Inc., 25 CCH Tax Ct. Mem. 1081 (1966) (tax avoidance plan didn't work despite good faith belief that it was valid and no return would be required). Yet even the Tax Court has waveied. *See* William N. Dillin, 56 T.C. 228 (1971), *acquiesced in*, 1975 INT. REV. BULL. No. 12, at 6 (no penalty when reasonable persons could differ on whether any tax was due).

192 *Compare* Orient Inv. & Fin. v. Commissioner, 166 F.2d 601 (D.C. Cir. 1948) (no penalty), *with* Robert A. Henningsen, 26 T.C. 528 (1956), *aff'd*, 243 F.2d 954 (4th Cir. 1957) (penalty upheld), *and* Gerta Runtch, 30 CCH Tax Ct. Mem. 856 (1971) (penalty upheld).

193 Commissioner v. Lane-Wells Co., 321 U.S. 219 (1944), held that this was not an excuse. Yet it would seem that even with reasonable prudence the wrong form would sometimes be selected. There must be cases where this excuse would be acceptable. *See, e.g.*, Hartford-Connecticut Trust Co. v. Eaton, 34 F.2d 128 (2d Cir. 1929).

194 2 CCH INT. REV. MANUAL § 4562.2(1)(c) (1975).

195 For example, the excuse was not accepted in Estate of Geraci v. Commissioner, 502 F.2d 1148 (6th Cir. 1974), *cert. denied*, 420 U.S. 992 (1975). *See generally* M. ASIMOW, ADVICE TO THE PUBLIC FROM FEDERAL ADMINISTRATIVE AGENCIES 29-78 (1973). If a revenue agent audits a previous year's return and fails to observe that the taxpayer is a personal holding company, would this serve as an excuse for failing to file a personal holding company return in subsequent years? Hugh Smith, Inc., 8 T.C. 660 (1947), *aff'd*, 173 F.2d 224 (6th Cir.), *cert. denied*, 337 U.S. 918 (1949) (yes); Hermax Co., 11 T.C. 442 (1948), *aff'd*, 175 F.2d 776 (3d Cir. 1949) (no).

willful intent to disobey the law or gross negligence,[196] but its discretion has sometimes been abused.[197]

3. Inadequacy of the Existing Administrative Process and Judicial Review

Considering the muddiness of many reasonable cause determinations, the administrative and judicial review available to delinquent filers prior to payment is inadequate. Can a taxpayer (especially an uneducated one) make a written presentation which will satisfy a harassed service center tax examiner? If he writes only that he was sick, or that his accountant made a mistake, this will not be enough. But perhaps he does not know he should write more. The opportunity to make telephone contact with personnel at a local office is certainly helpful, but IRS phone numbers are often busy. And when the taxpayer finally gets through, it may be hard to explain his excuse over the telephone. The IRS employee may not take the trouble to ask for additional but necessary details. Yet in a face-to-face negotiating session with trained IRS review personnel, the excuse might well be accepted.

If a taxpayer fails to persuade the IRS that his delinquency was due to reasonable cause, the form of judicial review now available is not adequate. Payment of the penalty before litigation is a serious hardship. And the formidable procedural requirements of suit in federal district court or the Court of Claims would require virtually all taxpayers to hire an attorney. Thus litigation would not be practicable where only a few thousand dollars of penalty is at stake. But if access to the Tax Court were allowed, the taxpayer could litigate before paying. Keeping the money while litigating may be of critical importance to the taxpayer's financial survival.[198] He would also have the benefit of the relatively simple procedures of the Tax Court, especially the provisions for small cases.[199] Here he can represent himself or be represented by his accountant.

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[196] 2 CCH INT. REV. MANUAL § 4562.6 (1975).

[197] *See* Vaira v. Commissioner, 444 F.2d 770 (3d Cir. 1971) (criticism of harshness of Service's position).

[198] For an eloquent statement in favor of Tax Court jurisdiction over penalties, see Enochs v. Green, 270 F.2d 558, 561-67 (5th Cir. 1959) (dissenting opinion). The Administrative Conference was advised of a number of cases in which taxpayers had at least a plausible ground for abatement of a penalty, but were financially unable to pay the penalty and claim a refund. Consequently, IRS collection efforts began and the taxpayers were financially ruined. *Cf.* Spencer Press, Inc. v. Alexander, 491 F.2d 589 (1st Cir. 1974); Professional Eng'rs, Inc. v. United States, 75-2 U.S. TAX CAS. ¶ 9781 (4th Cir. 1975).

[199] Section 7463 provides special procedures for disputes involving $1,500 or less. *See* TAX CT. R. 170-79, 183.

4. Legislative History of the Preclusion of Tax Court Review

Under the 1939 Code, no Tax Court review of delinquency cases was permitted.[200] The 1954 Code, however, was held by several courts to have authorized Tax Court review.[201] According to these cases, the IRS had to use the "deficiency notice" procedure before assessing delinquency penalties. The use of "deficiency notices" triggers Tax Court jurisdiction.[202]

The existing statute, which effectively precludes Tax Court review of reasonable cause determinations, was adopted in 1960. Congress accomplished this result by changing section 6659(b) so that delinquency penalties could be asserted without first sending a deficiency notice.[203]

The legislative history of the 1960 provision indicates that the IRS was inconvenienced administratively by the need to furnish deficiency notices before asserting delinquency penalties. The IRS prefers to assess delinquency penalties as soon as late returns are filed. If the penalty could only be asserted by a deficiency notice, the IRS feared that it would be unable to assert inaccuracy deficiencies when it later audited the return. Thus it felt that it would have to forgo immediate assertion of the delinquency penalty until it audited (or decided not to audit) the return in question.[204]

However, the IRS's concern on this point could be alleviated without depriving the delinquent taxpayer of access to the Tax Court. The provision which now prohibits the IRS from sending a second deficiency notice for the same year after a Tax Court petition has been filed is section 6212(c)(1).[205] That section could readily be amended so that the sending of a deficiency notice with respect to the delinquency penalty would not preclude the Service from sending a second notice in respect to a deficiency in the tax.[206] If section 6212(c)(1) were so amended, delinquent

200 *E.g.*, Granquist v. Hackleman, 264 F.2d 9 (9th Cir. 1959); United States v. Erie Forge Co., 191 F.2d 627 (3d Cir. 1951), *cert. denied*, 343 U.S. 930 (1952).

201 Granquist v. Hackleman, 264 F.2d 9 (9th Cir. 1959); Strawberry Hill Press, Inc. v. Scanlon, 273 F.2d 306 (2d Cir. 1959). *See* Enochs v. Muse, 270 F.2d 528 (5th Cir. 1959) (same result in case involving the section 6654 penalty for underestimation).

202 *See* note 182 *supra*.

203 Act of May 14, 1960, Pub. L. No. 86-470, 74 Stat. 132, *amending* INT. REV. CODE OF 1954, § 6659(b).

204 HOUSE COMM. ON WAYS AND MEANS, PROCEDURE FOR ASSESSING CERTAIN ADDITIONS TO TAX, H.R. REP. No. 1217, 86th Cong., 2d Sess. 1, 3 (1960), 1960-1 CUM. BULL. 840, 841-42. The Committee Report states that "in practically all of these cases, there is no dispute either as to law or fact." 1960-1 CUM. BULL. 842. But when the disputes occur, they present real difficulties. *See* text accompanying notes 183-97 *supra*.

205 INT. REV. CODE OF 1954, § 6212(c)(1).

206 Section 6212(c)(1) already contains many exceptions to the rule that only a single deficiency notice can be sent after a Tax Court petition is filed. For

filers could litigate the reasonable cause issue in the Tax Court, but the audit process would not be disrupted.

5. Should Delinquency Cases Be Treated Like Deficiencies?

The basic policy issue raised by ACUS Recommendation 75-7(e) is whether the opening of IRS appellate processes and Tax Court review to reasonable cause determinations would place an undue burden on those institutions. At the time of the 1960 amendment to section 6659, it was estimated that about one million delinquency and underestimation penalties were asserted each year. No one knows how many delinquency penalties are now asserted, or how many are disposed of after service center processing is completed.[207] If a very large number of taxpayers asserted all their rights to negotiate with the IRS, and then went to the Tax Court to delay payment of the penalty, those institutions might be swamped. If many of the claims by taxpayers had no merit, there would be an unjustifiable diversion of resources from more worthy tax dispute settlement processes.

But nobody really knows what would happen. IRS personnel interviewed in connection with this study saw no problem in placing delinquency matters within the same dispute-settlement process as other tax cases.[208] They did not anticipate that a very large number of delinquent taxpayers would pursue these rights and thereby create an undue administrative burden Indeed, when taxpayers had the right of Tax Court review between 1954 and 1960, the IRS did not complain of an excessive administrative burden[209]—only of the problem arising in the audit process which could easily be solved.

In the author's view, the risk that administrative and judicial review would swamp the IRS and the Tax Court is an acceptable one. After all, most reasonable cause determinations are straightforward and it seems unlikely that large numbers of taxpayers would pursue futile appeals. In any event, the patent inadequacy of the existing process strongly suggests that ACUS Recommenda-

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example, if the deficiency concerns a chapter 42 tax, the Service is precluded from sending a second letter only in respect to any act (or failure to act) to which the Tax Court petition relates. *Id.*

207 This is another annoying result of the IRS's failure to maintain statistics on the imposition of civil penalties. *See* text accompanying notes 148-50 *supra*.

208 However, at the plenary session of ACUS the Chief Counsel of IRS opposed this recommendation on the ground of excessive diversion of resources.

209 *See* text accompanying notes 203-06 *supra*. However, since the appellate decisions which cleared the way for Tax Court review only occurred in 1959, and the statute was amended in 1960, there was hardly an adequate period of time to test the results of the decisions.

tion 75-7(e) should be attempted. If it creates unmanageable problems, the law can be swiftly changed again.[210]

C. *Clarification of the Delinquency Penalty*

The wording of section 6651(a)(1) is obscure.[211] The penalty does not apply if the delinquency is "due to reasonable cause and not due to willful neglect." What is "willful neglect?" The two terms are contradictory: "Willful" seems to connote intentional conduct or a bad purpose. But "neglect" speaks of negligence, carelessness, or accident.

Clearly, the penalty is to be abated if the taxpayer has not been negligent. This is made sufficiently certain by the phrase "reasonable cause." The confusing phrase about willful neglect should be dropped, and ACUS Recommendation 75-7(d)(1)(i) so proposes.

To futher clarify the delinquency penalty, ACUS Recommendation 75-7(d)(2) urges the IRS to amend the regulations relating to failure to file by listing the grounds which it finds to be reasonable cause. The IRS has done so with respect to the failure-to-pay penalty.[212] A list of acceptable excuses for failure to file is contained already in the Internal Revenue Manual.[213] Incorporation of this list into the regulations would make these standards considerably more accessible to tax professionals.[214]

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[210] The analysis in this Part may well be applicable to other statutory penalties which contain reasonable cause exceptions. ACUS Recommendation 75-7 (e) covers the penalty for failure to pay tax shown on the return (INT. REV. CODE of 1954, § 6651(a)(2)). Other such penalties are the failure by exempt organizations to file returns (*id.* § 6652(d)(1)), failure to deposit payroll taxes (*id.* § 6656), and many others. It might also be applicable to the 100 percent penalty assessed against persons responsible for collecting taxes imposed on others who fail to do so. *Id.* § 6672. However, that provision is really a collection device, rather than a penalty, and may present different problems. Whether Tax Court review is needed in respect to these penalties is beyond the scope of this Article.

[211] A similar objection applies to the wording of sections 6651(a)(2)-(3). Even more striking is section 7273 which sets forth a 100 percent penalty for failure to conspicuously post certain tax stamps. The penalty is excused if the taxpayer establishes reasonable cause. But it is doubled if the failure is due to willful neglect or refusal.

[212] Treas. Reg. §§ 301.6651-1(c)(1)-(2), T.D. 7133, 1971-2 CUM. BULL. 415.

[213] 2 CCH INT. REV. MANUAL § 4562.2 (1975).

[214] In fact the present statement in the regulations is positively misleading. It states that the penalty will not apply "if the taxpayer exercised ordinary business care and prudence and was nevertheless *unable to file* the return within the prescribed time . . . ." Treas. Reg. §§ 301.6651-1(c)(1), T.D. 7133, 1971-2 CUM. BULL. 415 (emphasis added). But the penalty has often been excused in cases where the taxpayer was perfectly able to file the return but reasonably believed that he did not have to file. *See* text accompanying notes 174-97 *supra*.

CONCLUSION

The proposals which make up ACUS Recommendation 75-7 offer the prospect of greatly enhancing the usefulness of civil penalties against taxpayers who file inaccurate and delinquent returns. If these proposals are adopted by Congress, the proposed 25 percent penalty on reckless and intentional inaccuracies should provide an appropriate and effective deterrent against tax chiseling. Publicizing imposition of the 50 percent penalty should significantly augment its effectiveness. Slowing the rate at which the delinquency penalty accrues should make this penalty both fairer and more effective. At the same time, the obscure and misleading language of all of the penalties would be clarified. The recommendation would prevent unfair and freakishly high penalties, a possibility which now detracts from their usefulness. Finally, it would supply a much needed system of administrative and judicial review for delinquency penalties. In short, Recommendation 75-7 is a comprehensive attempt to update a long neglected but extremely important set of tax law enforcement tools. It deserves careful and sympathetic consideration from the IRS and from Congress.

APPENDIX

Internal Revenue Service Procedures: Civil Penalties
(Recommendation No. 75-7)
[41 Fed. Reg. 3984 (1976)].

(a) *Analysis of Effectiveness of Civil Penalties.* The Internal Revenue Service should annually compile and publish, for each taxpayer class and by year of tax returns, statistical data, together with analytic discussions, pertaining to the assessment and collection of civil penalties for underpayment of tax due to each of the different types of conduct now or hereafter provided as the basis for such penalties. Such data should be compiled for the purpose of evaluating the significance, effectiveness, and fairness of these civil penalties and should include: (1) the number and dollar amounts of penalties assessed, (2) the number and dollar amounts of penalties voluntarily paid by taxpayers, (3) the number and dollar amounts of penalties contested by taxpayers, (4) the number and dollar amounts of penalties sustained by court action and collected. In addition to making such data and analyses available to the public and to the Congress, the Service should consider and determine whether additional data and analyses should be compiled and prepared pertaining to the significance, effectiveness, and fairness of these and other civil penalties from the standpoint of the administration of the tax laws by the Service, enforcement of the laws by the courts, and compliance with the laws by taxpayers.

(b) *Structure and Application of Civil Penalties for Underpayment of Tax.* Legislation should be enacted which would restructure and alter application of the civil penalties for underpayment of tax, established in Section 6653 of the Internal Revenue Code, as follows:

(1) (i) The penalty for "negligence" should be retained. Negligence should be defined as failure to exercise reasonable care in keeping records or in preparing the tax return.

(ii) A taxpayer against whom this penalty is assessed should have the burden of proof to establish by a preponderance of the evidence that his conduct was not negligent.

(2) The present five percent penalty for "intentional disregard of rules and regulations (but without intention to defraud)" should be repealed.

(3) (i) A new penalty should be established for "reckless or intentional conduct (but without willful attempt to evade payment of tax)." The rate of this penalty should be fixed at a level near the midpoint (say 25%) between the rates of the penalties for negligence (now 5%) and for willful attempts to evade payment of tax (now 50%). Reckless conduct should be defined as meaning that in keeping records or preparing the tax return, the taxpayer has consciously disregarded a substantial risk that an underpayment would occur; provided, that it is not intended that the penalty to be established pursuant to this paragraph would apply to an underpayment resulting from a bona fide disagreement with the Internal Revenue Service as to the interpretation of the tax law or its application to facts disclosed on a tax return. Intentional conduct should be defined as meaning that in keeping rec-

ords or preparing the tax return, the taxpayer knew that an underpayment would occur or was substantially certain to occur.

(ii) A taxpayer against whom this penalty is assessed should have the burden of proof to establish by a preponderance of the evidence that his conduct was not reckless or intentional. In any case where the taxpayer succeeds in persuading the court that his conduct was not reckless or intentional, the court should be empowered to impose the lesser penalty for negligence, even though it had not theretofore been assessed by the Internal Revenue Service.

(4) (i) The present 50 percent penalty for "fraud" should be restated to apply only to "willful attempt to evade payment of tax," which should be understood to have the same meaning as under Section 7201 of the Internal Revenue Code.

(ii) The Internal Revenue Service should have the burden of proof to establish by clear and convicing evidence that an underpayment is attributable to the taxpayer's willful attempt to evade payment of tax. If the Service succeeds in persuading the court that a part of the underpayment is so attributable, the burden of proof should shift to the taxpayer to establish by a preponderance of the evidence that the remainder of the underpayment is not so attributable. In any case where the court is not persuaded that the taxpayer engaged in a willful attempt to evade payment of tax, the court should be empowered to impose the penalty for reckless or intentional conduct (proposed in c. above) [*sic*; (b)(3)(i)] or the penalty for negligence, provided that, before the court may impose either of such lesser penalties, the Service shall have so proposed and the taxpayer shall have had the opportunity to present evidence to establish that he is not liable therefor.

(5) In imposing the penalties for underpayment of taxes described above, each penalty rate should be applied only to the portion of the total underpayment that is attributable to conduct liable for penalty at such rate.

(c) *Publicity of Civil Penalty for Underpayment of Tax Because of Fraud.* The Internal Revenue Service should seek statutory instruction with respect to publicizing the imposition of the 50 percent civil penalty for underpayment of tax because of fraud (or, as recommended in paragraph (b)(4) of this section, restated as "willful attempt to evade payment of tax").[1]

(d) *Structure and Application of Civil Penalties for Failure to File Tax Return or to Pay Tax.* (1) Legislation should be enacted which would restructure and alter application of the civil penalties for failure to file a tax return or to pay a tax, established in Section 6651 of the Internal Revenue Code, as follows:

(i) The phrase "and not due to willful neglect" should be deleted from paragraphs (1), (2), and (3) of subsection 6651(a).

(ii) (A) The monthly rate of the penalty for failure to file a return, established in subsection 6651(a)(1), should be modified so as to extend the time period of lateness in filing a return which must elapse before the rate of penalty to be applied reaches the present ag-

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[1] Issuance of such publicity should be carried out in a manner consistent with Conference Recommendation 73-1, Adverse Agency Publicity.

gregate maximum rate of 25 percent. The table below sets forth three options for so modifying the monthly penalty rate, compared with present law.

	Penalty for first month (percent)	Penalty for each succeeding month (percent)	Period of lateness to reach maximum penalty (months)
Present law	5	5	5
Option 1	5	2	11
Option 2	5	1¼	16
Option 3	5	1	21

The penalty for failure to pay tax established by subsection 6651(a)(2) should be imposed in addition to, and not offset against, the foregoing penalty.

(B) The monthly rate of the penalty for each month after the first month of failure to file a return should be prorated on a semimonthly basis.

(2) The Internal Revenue Service should set forth, in the regulations under Section 6651 of the Internal Revenue Code, or in other form readily available to the public, the listing of acceptable reasons for late filing of a tax return that are set forth in the Internal Revenue Manual.

(e) *Procedures for Appealing Civil Penalties for Failure to File Tax Return or to Pay Tax.* With regard to civil penalties for failure to file a tax return or to pay tax established in Section 6651 of the Internal Revenue Code, taxpayers should be accorded administrative settlement procedures and the right to Tax Court review similar to those accorded with regard to civil penalties for underpayment of tax established in Section 6653 of the Code.

The Honorable David Pryor
Chairman, Subcommittee on Private
Retirement Plans and Oversight of
the Internal Revenue Service
Room 264 - Russell Office Building
United States Senate
Washington, DC 20510

RE: PENALTY PROVISIONS OF THE INTERNAL REVENUE CODE

Senator Pryor:

I am writing on behalf of Baird, Kurtz & Dobson, certified public accountants and the clients we represent. Baird, Kurtz and Dobson is a regional public accounting firm serving approximately 25,000 individual and small business clients throughout the Midwest. Many of these clients are located in your home state of Arkansas.

We applaud the Senate Finance Committee's decision to conduct hearings to review the penalty provisions of the Internal Revenue Code and its intention to establish a private sector task force to make recommendations to reform and consolidate the tax law penalty structure.

We are writing now in advance of the task force's implementation to add our comments and concerns regarding this subject matter. It is our sincere hope that the efforts of your subcommittee, together with the work of the task force and the penalty study group being organized by the Internal Revenue Service, will bring much-needed reforms to the penalty provisions of the Internal Revenue Code.

Our concerns regarding the penalty provisions of the Internal Revenue Code are:

1. We are concerned about the increasing reliance by Congress and the Internal Revenue Service on penalties as a source of revenue.

2. We are concerned that certain penalties are out of proportion to the taxpayer's culpability.

3. We are concerned about the retroactive imposition of the latest change in the substantial understatement penalty contained in Section 6661.

4. We are concerned about the provisions for waiving the imposition of certain penalties.

5. We are concerned about the proliferation of penalty provisions in the Internal Revenue Code.

<u>Penalties As A Source Of Revenue</u>

Historically, the primary purpose of monetary penalties was to foster compliance with the substantive provisions of the tax law -- the true source of revenue to the federal government. When one reviews the legislative and administrative activity of the last five years, however, it becomes increasingly apparent that monetary penalties are now being relied on as a continuing source of revenue by a deficit-conscious Congress and a budget-strapped IRS.

To elevate penalties to the status of a primary revenue source is, in our opinion, bad tax policy. In such a system, penalty assessments are anticipated, informally (if not formally) budgeted, and routinely made. They cease to act as the deterrent to noncompliance they were intended to be and become instead another component in the overall tax burden.

In a self-assessment system such as ours, we submit that there are better ways to raise revenue than the routine imposition of penalties.

Out of Proportion Penalty Assessments

It is a basic tenet of the American system of justice that the punishment must suit the crime. How is it, then, that we have allowed certain tax sanctions to become totally disproportionate to the offense?

A prime example of a disproportionate sanction is the penalty for failure to comply with the COBRA continuation coverage requirements. The stated purpose of the COBRA provisions was to establish the continuation coverage requirements for employer-provided group health plans and to provide for penalties for not complying with those requirements.

The penalties for a group health plan that fails to comply are:

1. The total disallowance of deductions for any contribution to any group health plan maintained by the taxpayer, and

2. The denial of the exclusion from gross income of employer provided group health coverage for all highly compensated employees of the employer.

We strongly believe that penalties as severe as these are unwarranted and unnecessary to ensure compliance with the purpose of the statute. Our experience indicates that it is highly unlikely that noncompliance with the COBRA provisions will be the result of an intentional act of the taxpayer. Rather, the noncompliance, if any, will result from an inadvertent violation made during the course of a good faith effort to comply.

In addition to being bad tax policy, the COBRA penalty provisions present a potentially more serious problem. Unless the COBRA penalty provisions are tempered, many business taxpayers are going to be forced to conclude that it is better to terminate their health care plans than risk the imposition of such severe penalties for an inadvertent violation. Although this is especially true for large employers participating in multi-employer plans or employers with foreign health plans, it also is a concern for the small and mid-sized businesses we represent. Such an action would defeat the very purpose of COBRA.

Other examples of penalty provisions with disproportionate sanctions can be found in Sections 6721 through 6724 dealing with the failure to file certain information returns. We believe that a $100,000 penalty for failure to file 2,000 or more Forms W-2 on magnetic media is unnecessarily severe, especially in view of the fact that the government is not deprived of the information on the forms -- the Forms W-2 are, in fact, filed, only on paper instead of magnetic media.

Substantial Understatement Penalty

The substantial understatement penalty contained in Section 6661 was originally enacted in 1981 and provided for a 10% penalty for "substantial understatements" of tax liability. The Tax Reform Act of 1986 increased the penalty amount to 20% and the Budget Reconciliation Act of 1986 raised it again, this time retroactively, to 25%.

We do not disagree that there should be sanctions for noncompliance that results in substantial understatements of tax. We believe, however, that a penalty rate of 25% is excessive and unnecessary to foster the necessary compliance. Furthermore, we are appalled that any increase in a penalty rate, and this increase in particular, would be applied on a retroactive basis.

It defies logic how a penalty provision can promote compliance when it is applied or increased retroactively. It is impossible for a taxpayer to comply with a provision that did not exist in its present form at the time the return was filed. We are forced to conclude that the changes to this provision were not intended to foster compliance, but were instead enacted to raise revenue. We submit that this is bad tax policy.

Penalty Waivers

Given the sheer magnitude of the Tax Reform Act of 1986 and the countless number of unanswered questions spawned by it and the 1987 Act, it is axiomatic to us that considerable restraint should be exercised by both Congress and the IRS in enacting and imposing penalties.

A penalty provision cannot and will not have the desired effect on compliance if the taxpayer does not know what the substantive tax law rules are. The meaning and reach of many of the recent legislative changes, however, are yet to be explained by mandatory regulations. In this climate of uncertainty, we believe that it is imperative to adopt a reasonable attitude towards the waiver of penalties and to openly communicate the prerequisites for obtaining such relief.

For example, the IRS recently announced that no penalties would be imposed for underwithholding on wages in 1987 or the failure of taxpayers to obtain identification numbers for their dependent children. We commend this action and the realization by the IRS that the confusion over the tax law requirements justified a waiver. A similar waiver is called for with respect to corporate taxpayers.

Proliferation of Penalty Provisions

As you indicated in your own press release, the proliferation of penalty provisions may have intimidated some businesses into settlement of tax disputes as a means of avoiding penalties rather than out of recognition of the merits of the government's legal position. We agree.

The flood of tax legislation in recent years has clearly left its mark on the penalty provisions of the Internal Revenue Code. Understanding and complying with the resulting patchwork of provisions represents a formidable challenge even to professional advisors. The penalty structure needs to be reformed, consolidated and realigned with its original stated purpose -- to foster compliance. Each penalty provision should be tested against a common set of standards:

1. Will the penalty provision foster compliance?

2. Does the punishment fit the crime?

3. Can the penalty be waived upon the showing of reasonable cause?

Once again, we commend the committee's desire to review this area. If we may be of any assistance to the committee or the task force in carrying out its charge, please contact the undersigned.

Sincerely yours,

Steven M. Bullard

Steven M. Bullard
Director of Tax Services

skm

UWEC University of Wisconsin-Eau Claire
Eau Claire, Wisconsin 54701

Department of Accountancy
715-836-2184

February 9, 1988

Ms. Laura Wilcox
Hearing Administrator
205 Dirksen Office Building
Washington, DC 20510

Dear Ms. Wilcox:

The present authority given to the Internal Revenue System to impose penalties on tax return preparers is a denial of due process, and therefore should be abandoned.

Also, the present system requiring tax return preparers to seek redress by suing for recovery of the assessed penalties in a U.S. District Court is not equitable. The filing fees, attorney fees, court costs, and lost time connected with suing in a District Court makes such an approach a travesty of justice as the monetary end does not justify the expenditures. Thus, the penalties are confiscatory, and erode public confidence in the government.

I, therefore, recommend, if Congress deems it necessary to control inept or unscrupulous tax return preparers, that Congress enact a system for enrolling all tax return preparers in order for them to charge for preparing returns. Standards of practice should be established for enrolled preparers so that breach of the standards would be cause to revoke, through due process, the tax preparer's enrollment.

Sincerely yours,

Edsel Grams

Edsel Grams, C.P.A.
Professor of Accountancy

EG/gjn

cc. Mr. Ed Mihalski
    Minority Chief of Staff

Accepting the Challenge of Excellence

HANSON & CADENAS
ATTORNEYS AT LAW

Ms. Laura Wilcox
Hearing Administrator
205 Dirksen Office Building
Washington, D.C. 20510

Re: Senate Finance Subcommittee on Private Pension Plans and Oversight of the Internal Revenue Service; Penalty Provision Hearings

Dear Miss Wilcox:

I am presenting this written statement, which incorporates two items of correspondence to the IRS, in order to highlight what I believe is a certain unfairness in the IRS's current administration of the Failure to Pay Penalty provided by IRC Section 6651, in certain context.

I have deleted the taxpayer's name in the attached correspondence for purposes of confidentiality.

As you are aware, the IRS is in the middle of a massive program of attempting to arrive at settlements in a vast number of cases which the IRS has designated as "tax shelters." I believe the "tax shelters" were particularly numerous and prevalent, from the early 70's to the early 80's at which time the legislators took cognizance of the fact that the situation was getting rampant. At around that time legislation was passed with regard to registration of tax shelters and authorization for enjoining unscrupulous promoters.

Nonetheless, some taxpayers were caught in the middle of this whole affair and have now arrived at varied settlements with the IRS with regard to shelters in which they had invested. In the case of certain taxpayers, the liability is often as much as ten or more years old and spans a number of years. Upon reaching settlements with the IRS, said taxpayers are often presented with astronomical tax liablities, including statutory additions of interest and penalties.

I believe that under certain circumstances, the IRS should be compelled to abate the failure to pay penalties and allow for an extension to pay tax due to such deficiencies. IRC Section 6161(b) and the regulations thereunder should indicate to the IRS that it should have some more leniency upon a taxpayers in the context of a deficiency as opposed to one's current liability. I have argued these points with the IRS in the case which is the subject of the two attached letters but said argument has fallen upon deaf ears. Any legislation in this regard should be made retroactive to alleviate the situation of the myriad taxpayers who have voluntarily settled tax shelter cases with the IRS. (Non-retroactive legislation will not help the vast majority of taxpayers affected by unfair penalties.) The Treasury should be funded by even-handed taxation, not by involuntary and unfair extractions in the forms of penalties, which together with interest charges exceeds the usury rate in most states.

Very truly yours,

RICARDO A. CADENAS

RAC:sp
Enclosures

HANSON & CADENAS
ATTORNEYS AT LAW
48 N.E. 15TH STREET
HOMESTEAD, FLORIDA 33030
(305) 248-0106

CARL HANSON
RICARDO A. CADENAS

KEY LARGO (305) 451-0177
FORT LAUDERDALE (305) 564-8663

December 15, 1987

William F. Nelson, Chief Counsel
Internal Revenue Service
1111 Constitution Avenue
Washington, D.C. 20224

Re: [redacted]
Taxable years 1976 through 1981, inclusive

Dear Mr. Nelson:

I am enclosing herewith a photocopy of a letter to the IRS Collection Division in Fort Lauderdale, FL, which should give you some background on my request.

I am writing this letter to your office since it is my understanding that your office provides guidance to the IRS in setting the standards for practices and policies regarding the settlement of matters which are deemed to be "tax shelters." The enclosed letter to the IRS Collection Division articulates some technical reasons why I think in this particular instance the IRS is wrong in imposing failure to pay penalty. I believe that the issue will ultimately be resolved, as a factual matter, in favor of my client, upon grounds which are independent from the subject of this request.

My principal premise is that, in the event the taxpayer is called upon to pay deficiencies for several years of back taxes, plus interest, and said deficiencies are rooted in transactions where the promotors were criminally convicted for defrauding the taxpayers, then the IRS should not profit from the situation by imposing the failure to pay penalty upon the deficiency determined against the victims of said crimes.

The taxpayers in this instance invested with [redacted] in various investments which I believe have been designated by the IRS under the term "[redacted]" and determined to be "an abusive tax shelter."

[redacted] was criminally convicted, on various counts, including mail fraud.

In the civil cases arising from the [redacted], at least in some instances, taxpayers were offered a settlement based upon cash investment, plus waiver of the potential imposition of penalties. As is often the case in this scenario, the offer of the IRS to waive, for example, the 5% negligence penalty is an enticement to taxpayers to settle with the IRS. It is often the case, however, that the deficiencies generated by such tax shelters encompass several years, dating back often as far as ten years or more. In these instances when a settlement is arrived at with the IRS, the taxpayer will be asked to pay the entire deficiency plus accumulated interest immediately and at one time upon assessment of the tax. The amounts of the liabilities are often so large so that it would constitute undue hardship, per se, to ask the taxpayer to make complete payment upon the deficiency owed.

In the instance of the above-referenced taxpayers, the entire deficiency plus additions to compromising the matter with the IRS was in the neighborhood of one and one-half million dollars. After some very substantial borrowing, the taxpayers made a payment to the IRS at the end of 1986 in the amount of $835,000. Promptly thereafter they submitted on Form 1127 an application for the extension of time to pay the balance which was summarily denied by the IRS.

I would request that I be provided with a statement regarding the specific grounds and standards on which requests for extension of time for payment of tax pursuant to the Form 1127 are granted or denied by the IRS.

I think that, in cases of tax shelters as discussed above, the IRS should make a special concession to the taxpayers, allowing for installment payment of the tax over a period of time, without imposition of the failure to pay penalty. The IRS concession in terms of such items as the negligence penalties are quickly effaced by the imposition of this failure to pay penalty. I believe that taxpayers will soon be weighing the effects of the substantial penalty and opting to let their cases go to trial rather than go along with the illusory benefits of a settlement. I can emphasize my principal premise that the IRS should not profit from taxpayers who have through the federal justice system been determined to be victims of crime.

I would appreciate your office's thoughts on this matter, and better yet some positive determinations so that the proposed failure to pay penalties may be abated in this instance.

Very truly yours,

RICARDO A. CADENAS

RAC:sp
Enclosure

EARL HALL, C.P.A., INC. P.S.
CERTIFIED PUBLIC ACCOUNTANT

P.O. BOX 10883
YAKIMA, WASHINGTON 98909
(509) 575-6892

March 7, 1988

Laura Wilcox, Hearing Administrator
205 Dirksen Office Building
Washington DC 20515

Ed Mihalski, Minority Chief of Staff
SH-203 Hart Office Building
Washington DC 20510

Re Pryor Hearings on Pension Penalties

Dear Ms Wilcox and Mr Mihalski

In the January 29 1988 issue of Tax Day Report, Senator David Pryor is quoted as stating some tax penalties have become so large that many taxpayers feel forced to compromise with the IRS over tax disputes to avoid their imposition" I would like to present the following case of a situation where the tax penalties were so large that the purpose of the penalty was thwarted

Prior to becoming my client the taxpayers established a Keogh plan in 1984 and made a contribution thereto in the amount of approximately $17,000 At the time of this contribution, their account was the only Keogh account in the bank in their hometown Taxpayers believed that the bank would handle all paperwork for the Keogh account include the filing of Form 5500-C (or 5500-R)

On July 26 1985, taxpayers received a letter from the bank stating that the bank would not be filing Form 5500-C They immediately went to a CPA in their hometown who requested an extension of time for filing the return and filed the return within the extension period

Because the taxpayers did not want to be involved in filing Forms 5500 every year they established a SEP for 1985 and made contributions to employee IRAs under the SEP for 1985 They made no contributions to the Keogh plan for 1985

In early September 1986, taxpayer read the instructions for the Form 5500-C and realized that a return was required, even though no contribution was made for the prior year On September 9, 1986 a Form 5500-C was filed with the Service Center in Ogden, Utah This filing was 40 days late and the client attached a letter explaining the late filing due to the confusion over filing requirements (Client filed a Form 5500-C because that was what had been filed the previous year, even though a simpler Form 5500-R could have been filed)

On October 17, the Ogden Service Center wrote requesting additional information due to errors in the taxpayer-prepared return This letter was replied to on October 31, 1986. However, the reply also included an error

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On January 15, 1987 the Fresno Service Center (a different center) wrote requesting an explanation for the late filing as well as requesting additional information By this time, taxpayer was concerned and, in the reply of February 13, provided a phone number for contact if all was not up to IRS standards

On May 11, 1987, the Fresno Service Center mailed another letter similar to the two written on January 15 Taxpayer mailed back copies of previous correspondence on June 15

On June 18, the Fresno Service Center advised that the penalty for late filing would be assessed, but would be reconsidered upon completion of requested data

On June 30, the Fresno Service Center responded to taxpayer's June 15 letter by repeating the request for resubmission

On July 13, the I R S assessed penalties totalling $10,075.

On July 22, I responded to the Fresno Service Center, including copies of previous client correspondence, explaining the facts, submitting an amended Form 5500-C because it was difficult to determine what information had been filed with the various requests and different Service Centers

On August 25, I again wrote the Fresno Service Center as the client was again billed for the $10,075

On October 8, I requested assistance from the Problem Resolution Office in Seattle as the client received yet another billing Shortly thereafter I received a call from a PRO in Seattle explaining that he had received the data and would be contacting the Fresno Service Center to follow up

In November, December and January I received phone calls from the PRO explaining that the resolution was still in progress

In January, 1988, the client was contacted for collection by a Revenue Officer from the Vancouver, Washington office The client referred the officer to me He indicated he was working a file sent to him by the Ogden Service Center and was totally unaware of any assessment from the Fresno Service Center or any contact with the PRO

On January 28, 1988, I mailed copies of the correspondence to the Revenue Officer who assured me that he would abate the penalty I requested him to contact the PRO so the case could be closed at all levels

In February, I received a call from the PRO who advised me that the Fresno Service Center had abated the penalty He indicated no knowledge of any contact by the revenue officer

On February 25, the Ogden Service Center returned a copy of te Power of Attorney filed with the Fresno Service Center in July because I had failed to include the plan number (001) on the Form 2848 I am assuming that is the reason I was unable to receive copies of correspondence relating to this case and had to have the client forward copies of all correspondence to me

Although I have been assured both by the Revenue Officer and the Problem Resolution Officer that the penalty has been abated, to date there has been no correspondence from either Ogden or Fresno indicating this

I have discussed this hearing with the client who has given permission to disclose their names and social security numbers if necessary to substantiate this letter. However, in the interest of privacy, I would prefer not to disclose this information unless it is subpoened.

A reasonable penalty for being 40 days late would not have been rejected, even though reluctantly accepted. However, in light of the client's willingness to comply with requirements that were incomprehensible to them and repeated requests for feedback from the I. R. S., the client was floored when faced with a $10,075 bill

To avert situations like this in the future, I would recommend the following actions:

1. Taxpayers should have to deal with only one I. R. S. office at a time. In this situation, there was simultaneous actions going on from the Ogden and Fresno Service Centers

2. If a taxpayer admits to confusion about action requested of him and provides a phone number and address for clarification, if additional information is required, a person from the I R S should contact the taxpayer to provide such clarification before assessing penalties

3. Files containing all correspondence regarding the taxpayer's case should be reviewed by a responsible person in the I. R S prior to penalties being assessed

4. Reporting requirements for qualified plans should be amended to provide for an election to eliminate the requirement to file for years when there is no activity in the plan except for interest or other portfolio income growth from previous investments. This could be done by filing a simplified return by checking a box indicating "frozen plan" or some similar alternative

5. There should be some reasonable limitation on penalties as a percentage of plan assets. Had the penalties not been abated, taxpayers would have been faced with a $10,075 penalty on a plan with approximately $17,000 in assets

I hope this case is helpful to the committee in its evaluation of I R S penalties and procedures

Yours very truly,

Earl Hall

Earl Hall

cc Client

PATTON, BOGGS & BLOW

March 28, 1988

Honorable David Pryor
United States Senate
Washington, D.C. 20510

Re: Penalties Imposed Upon Payors of Reportable Interest and Dividends

Dear Senator Pryor:

This letter is submitted on behalf of New York Life Insurance Company for inclusion in record of the hearings held on March 14, 1988 by the Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service with respect to civil tax penalties.

I.

Summary of Statement

In August 1983, Congress enacted legislation to require payors of interest and dividends to obtain certified taxpayer identification numbers ("TINs") from payees and to impose backup withholding where no TIN or an incorrect TIN is obtained. If the payor reports an incorrect TIN to the Internal Revenue Service (the "IRS"), an annual penalty of $50 per account is imposed unless the payor exercised "due diligence" in trying to obtain a correct TIN from the payee. To meet the due diligence standard for then existing (pre-1984) accounts, payors were required by the IRS to make a separate mailing to all payees by December 31, 1983. This was a significant burden on payors such as New York Life, which paid reportable interest on approximately 2.1 million accounts in 1983.

As described more fully in the enclosed memorandum, the Treasury and the IRS have taken the position that payors which missed the December 31, 1983 due diligence deadline, but came into full compliance after that date and before July 1, 1988, are nevertheless subject to the penalties (which can amount to millions of dollars annually) for all years prior to 1988. Thus, under this administrative interpretation, a payor which achieved full compliance (i.e., completed the separate mailing to all payees) in 1986 is nevertheless subject to these penalties for 1986 and 1987. This is unfair to the affected payors since no taxpayer should be subject to a penalty for any period from and after the date it is in full compliance. It is also unsound public policy since it will discourage taxpayers from complying with new requirements at the earliest possible date.

II.

Discussion and Analysis

A. Background.

The Interest and Dividend Tax Compliance Act of 1983 amended the Internal Revenue Code to require payors of reportable interest and dividends to obtain certified TINs from payees and to impose backup withholding where no TIN or an incorrect TIN was obtained. Under section 6676(b) of the Internal Revenue Code, an annual penalty of $50 per account, without limitation as to the total penalty, is imposed on payors who report an incorrect TIN to the IRS. An exception to this penalty is allowed for payors who have exercised "due diligence" in trying to obtain the correct TIN from a payee. For the reasons explained below, the due diligence requirement has been inappropriately applied by the IRS to penalize payors for periods when they are admittedly in full compliance with the law.

1. Separate Mailing Requirement. During the period October-December 1983, the IRS issued three sets of Temporary Regulations which interpreted the due diligence exception to require payors of interest and dividends to solicit certified TINs from all existing (i.e., pre-1984) accounts. These regulations generally required payors to make the initial solicitation by way of a separate mailing no later than December 31, 1983. Thereafter, payors were required to make annual follow-up solicitations, which could be included in regular mailings of other materials to payees. Payors who have made the initial separate mailings and the follow-up mailings are considered by the IRS to have exercised the required due diligence.

2. IRS Enforcement Position. The IRS initially took the position that a payor who did not make the required initial separate mailing by December 31, 1983 was subject to the penalty under section 6676(b) for each account with a missing or incorrect TIN and that this penalty applied for each year after 1983 until the account was closed or a certified correct TIN was obtained. For this purpose, the IRS takes the position that when a payor obtained a certified TIN from a payee after December 31, 1983, the payor continued to be subject to the penalty if the certified information did not exactly match the information contained in the records of the Social Security Administration (e.g., the payee used a middle initial with the payor, but the Social Security Administration records showed a middle name).

Under this enforcement approach, a payor could not relieve itself of the "original sin" of failing to make a timely separate mailing even if it (1) made the required separate mailing on an untimely basis, (2) made all required follow-up mailings, (3) obtained a certified (but "incorrect") TIN and (4) imposed backup withholding on any accounts for which there was an incorrect or missing TIN. Under this approach, large payors of interest and dividends (e.g., life insurance companies, banks, thrift institutions, credit unions, and brokerage houses) remained subject to penalties in the millions of dollars for each year after 1983 simply because they did not, for whatever reason, make the required separate mailing by December 31, 1983.

On October 21, 1987, the IRS announced that it would exercise its administrative discretion to permit payors who committed "original sin" to relieve themselves of penalties for 1988 and subsequent years if a separate mailing for pre-1984 accounts was made during the limited time period beginning October 26, 1987 and ending December 31, 1987. Without any published explanation whatsoever, the IRS stated that no credit would be given for untimely separate mailings made between January 1, 1984 and October 25, 1987. (See IRS Notice 87-71.)

On November 23, 1987, the IRS modified this position to permit payors who had committed "original sin" to relieve themselves of penalties by making the required separate mailing at anytime after December 31, 1983 and by June 30, 1988. However, and without any published explanation of its reasons, the IRS continued to adhere to its original position that any such untimely mailing would be given effect to eliminate the penalty under section 6676(b) only for 1988 and subsequent years. (See IRS Notice 87-74.) This position has since been incorporated into the most recent set of Temporary Regulations on this subject. (Temp. Treas. Reg. § 35a.9999-1, Q&A-56.)

B. The IRS Position Must Be Reversed.

Under the IRS approach, a separate mailing made after 1983, regardless of when made, is only effective to eliminate penalties for 1988 and subsequent years. Thus, a mailing made in 1986 is effective to eliminate penalties in 1988 but is not effective to eliminate penalties in 1986 or 1987. For the following reasons, this enforcement position must be reversed:

- Congress Did Not Mandate Such An Approach. The applicable provisions of the Code do not themselves contain any specific deadline by which a payor must have solicited certified TINs for its pre-1984 accounts.

- The IRS Position Thwarts The Congressional Purpose. The legislation purpose underlying the TIN and certification and backup withholding provisions -- to require payors to exercise reasonable efforts to obtain certified TINs on their interest and dividend-paying accounts and, failing that for whatever reason, to collect and report backup withholding -- is best served by policies that encourage payors to solicit TINs as quickly as possible and not by extending their exposure to continuing penalties for an arbitrary period of time.

- The IRS Position Is Unfair. Payors who made separate mailings prior to the IRS' change in administrative position were acting in good faith and were attempting to perform their obligations in furtherance of the legislative purpose. They should not be penalized for so acting. The IRS position does precisely that by inequitably placing payors who made good faith, albeit late, efforts to solicit TINs on an equal footing with payors who completely disregarded their statutory obligations and the IRS' regulations.

- The IRS Position Is Bad Precedent. A failure in this instance to give effect to separate mailings until 1988 will discourage compliance efforts in the future for similar provisions.

III.

Proposed Solution

Payors who made the required separate mailing after the original December 31, 1983 deadline should be relieved from penalties under section 6676(b) for the year in which the mailing was made (provided the mailing was early enough to permit proper reporting by the payor for that year) and for all subsequent years (not just 1988 and future years).

Very truly yours,

PATTON, BOGGS & BLOW

By: Donald V. Moorehead

Donald V. Moorehead

Law Offices of
PETER M. GUNNAR, P.C.

March 21, 1988

File No. 170-0

Senator David Pryor, Chairman
Subcommittee on Oversight & Pensions
Senate Finance Committee
United States Senate
Washington, DC 20510

Dear Senator:

Re: Civil Penalties Under the Internal Revenue Code

First, may I thank you for your efforts to pass a meaningful Taxpayer's Rights Bill and urge your continued effort in this pursuit.

This letter is offered as comment with respect to the review of civil penalties under the Internal Revenue Code ("Code") by your Subcommittee on Oversight and Pensions of the Senate Finance Committee. Such review is long overdue.

My comment is fairly short. It is that there ought to be a general provision in the Code which authorizes the court called upon to impose any penalty in the Code to reduce or suspend any such penalty upon a showing of mitigating circumstances and such mitigating circumstances should include the taxpayers lack of sophistication, the taxpayer's reasonable reliance on expert advice or opinion, or the reasonableness of the position taken by the taxpayer.

The theoretical support for such a provision goes far back into our common law history. When faced with the rigidity of early English Common Law, the King directed his Lord Chancellor to exercise "the conscience of the King." Thus arose the courts of chancery, the equity side of the law. We in our wisdom have combined the law courts and the equity courts into one court system. In so doing in the field of taxation, we have in many respects removed the power of the judge to exercise governmental conscience.

Rigidity in punishment results in injustice. While the Congress and the Treasury can prescribe statutes and rules for all of us, they cannot deal with each factual situation. On the other hand, when the citizen faces the bar of justice, he or she brings along all the facts and background to his or her particular case. If the judge is to apply the laws and regulations justly, such judge must have the power and duty to consider the facts and circumstances of the citizen before the court. Otherwise the decision is mechanistic and rigidity replaces justice.

Some examples may assist in understanding.

Example 1. A taxpayer, with a fourth grade education and recognizably unsophisticated, on the advice of an unregistered tax counselor in his small town, claims substantial deductions to which the taxpayer clearly is not entitled. The results in a substantial underpayment and the Service imposes a fraud penalty. Appearing pro se, the taxpayer fails to prove his innocence in the face of the Service's case. The court should have the power to mitigate the penalty.

Example 2. The taxpayer claims deductions based upon what he honestly thought were competent appraisals and legal advice. The

Service proves that the appraisal was spurious and that the legal advice was erroneous. The court should have the right to mitigate the punishment.

Example 3. This one is near and dear to my heart. It deals with tax shelter registrations. Orally for our two years and just recently in our writing, the Service has held that obligations which the owner of a proposed trade or business is unconditionally bound by contract, by other legal documents, by statute, and by debt instruments to pay in the amount of the deductions anticipated are not to be included in the investment base of the tax shelter ratio when they are projected to be offset in large part by income from the trade or business. However, those same deductions must be included in the deduction and credit denominator of the ratio. The Service's position is unreasonable and, in my opinion, dead wrong. Computed correctly, the tax shelter ratio is a little above 1 to 1, while computed as the Treasury requires, it is about 17 to 1. If the taxpayer cannot include currently payable expenses contracted or imposed by statute in the investment base, but must use them in the denominator, it is no wonder the ratio is grossly distorted.

However, I cannot subject my client to the risk of getting the wrong judge on a bad day because the only penalty which the court can impose on this case exceed $315,000. The court has no power to mitigate that penalty because the taxpayer's position is reasonable, though, on a very close call, the court holds for the Service. Thus, the Treasury can continue what to most practitioners I have talked to is clearly an unreasonable position because none of us want to play roulette with such huge penalties even being a remote possibility.

In conclusion, failure to permit the court to mitigate penalties casts on the nation's judiciary aspersions that it cannot fairly and justly administer the law in the cases before it. The end result is that neither the bar nor, more importantly, the American citizenry will view our federal tax system is fair or equitable. In a state where the legislature found the taxing authorities rigid, arrogant, and uncompassionate, it created a state tax court. I had the privilege of sitting as that court's first judge. No one is more keenly aware than I am that the success of voluntary compliance rests on the public perception that the tax law and its administration are perceived by the taxpayers as fair, just, and equitable.

Very truly yours,

PETER M. GUNNAR, P.C.

Peter M. Gunnar

PMG:le-C6

清水

STEVEN G. SHIMIZU
CERTIFIED PUBLIC ACCOUNTANT

February 10, 1988

Laura Wilcox Hearing Administrator
205 Dirksen Office Building
Washington, DC 20510

Dear Laura:

Penalties should be implemented when there is an intentional disregard of the new law. Penalties should not be automatic without contact with the taxpayer.

Thank you in advance for your consideration.

Sincerely,

Steven G. Shimizu
Certified Public Accountant

1601 - 116th N.E. SUITE 111 • BELLEVUE, WASHINGTON 98004 • (206) 454-2570