PENALTY AND INTEREST PROVISIONS IN THE INTERNAL REVENUE CODE

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED SIXTH CONGRESS

SECOND SESSION

JANUARY 27, 2000

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COMMITTEE ON WAYS AND MEANS

BILL ARCHER, Texas, *Chairman*

SUBCOMMITTEE ON OVERSIGHT

AMO HOUGHTON, New York, *Chairman*

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PENALTY AND INTEREST PROVISIONS IN THE INTERNAL REVENUE CODE

THURSDAY, JANUARY 27, 2000

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, DC.

The Subcommittee met, pursuant to notice, at 10 a.m., in room 1100, Longworth House Office Building, Hon. Amo Houghton (Chairman of the Subcommittee) presiding.

[The advisories announcing the hearing follow:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT

FOR IMMEDIATE RELEASE CONTACT: (202) 225–7601
October 26, 1999
No. OV–12

Houghton Announces Hearing on Penalty and Interest Provisions in the Internal Revenue Code

Congressman Amo Houghton (R–NY), Chairman, Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee will hold a hearing on the penalty and interest provisions in the Internal Revenue Code, including recent studies by the U.S. Department of the Treasury and the Joint Committee on Taxation that were mandated by the Internal Revenue Service (IRS) Restructuring and Reform Act of 1998 (P.L. 105–206). The hearing will take place on Tuesday, November 9, 1999, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.

Oral testimony at this hearing will be from invited witnesses only. Invited witnesses include Jon Talisman, Deputy Assistant Secretary for Tax Policy, U.S. Department of the Treasury; Lindy L. Paull, Chief of Staff, Joint Committee on Taxation; W. Val Oveson, National Taxpayer Advocate; and representatives from the National Association of Enrolled Agents, the American Bar Association, the American Institute of Certified Public Accountants, and the Tax Executives Institute. Any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

BACKGROUND:

In 1988 and 1989, the Subcommittee held a series of hearings on the penalty and interest provisions in the tax code. The hearings culminated in an overhaul of the penalty and interest regimes with the enactment of the Improved Penalty Administration and Compliance Tax Act, included in the Omnibus Budget Reconciliation Act of 1989 (P.L. 101–239).

In the IRS Restructuring and Reform Act of 1998, Congress directed the Treasury and the Joint Committee on Taxation to conduct studies to examine whether the current penalty and interest provisions: (1) encourage voluntary compliance, (2) operate fairly, (3) are effective deterrents to undesired behavior, and (4) are designed in a manner that promotes efficient and effective administration of the provisions by the IRS.

The Joint Committee on Taxation completed and released its study, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (Including Provisions Relating to Corporate Tax Shelters)*, on July 22, 1999. The Treasury completed its report, *Penalty and Interest Provisions of the Internal Revenue Code*, on October 25, 1999.

In announcing the hearing, Chairman Houghton stated: “It has been 10 years since Congress last took a comprehensive look at the interest and penalty regimes in the Code. The Subcommittee led the way then, and now the Subcommittee will review the provisions that were passed 10 years ago to determine whether these provisions are effective and promote fair treatment of taxpayers without undue complexity. We will also consider recommendations to improve upon these provisions."

FOCUS OF THE HEARING:

The focus of the hearing is to review the current penalty and interest provisions in the Code and to consider recommendations to simplify penalty administration and to reduce taxpayer burden. On October 26, 1999, Chairman Archer announced that the full Committee will hold a hearing on corporate tax shelters on November 10, 1999 (See Full Committee press release No. FC–14).

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit six (6) single-spaced copies of their statement, along with an IBM compatible 3.5-inch diskette in WordPerfect 5.1 format, with their name, address, and hearing date noted on a label, by the *close of business*, Tuesday, November 23, 1999, to A.L. Singleton, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Subcommittee on Oversight office, room 1136 Longworth House Office Building, by close of business the day before the hearing.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

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Note: All Committee advisories and news releases are available on the World Wide Web at "http://waysandmeans.house.gov".

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NOTICE—CHANGE IN TIME AND LOCATION

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT

FOR IMMEDIATE RELEASE CONTACT: (202) 225–7601
November 2, 1999
No. OV–12 Revised

Change in Time and Location for Subcommittee Hearing on the Penalty and Interest Provisions in the Internal Revenue Code Tuesday, November 9, 1999

Congressman Amo Houghton (R–NY), Chairman of the Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee hearing on the penalty and interest provisions in the Internal Revenue Code scheduled for Tuesday, November 9, 1999, at 10:00 a.m., in the main Committee hearing room, will now be held in room B–318 of the Rayburn House Office Building beginning at 3:00 p.m.

All other details for the hearing remain the same. (See Subcommittee press release No. OV–12, dated October 26, 1999.)

NOTICE—HEARING POSTPONEMENT

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT

November 9, 1999 CONTACT: (202) 225–7601
No. OV–12 Revised

Postponement of Subcommittee Hearing on the Penalty and Interest Provisions in the Internal Revenue Code Tuesday, November 9, 1999

Congressman Amo Houghton (R–NY), Chairman of the Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee hearing on the penalty and interest provisions in the Internal Revenue Code scheduled for Tuesday, November 9, 1999, at 10:00 a.m., in the main Committee hearing room, will now be held in room B–318 of the Rayburn House Office Building beginning at 3:00 p.m.

All other details for the hearing remain the same. (See Subcommittee press release No. OV–12, dated October 26, 1999.)

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT

FOR IMMEDIATE RELEASE CONTACT: (202) 225–7601
January 18, 2000
No. OV–14

Houghton Announces Hearing on Penalty and Interest Provisions in the Internal Revenue Code

Congressman Amo Houghton (R–NY), Chairman, Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee will hold a hearing on the penalty and interest provisions in the Internal Revenue Code, including recent studies by the U.S. Department of the Treasury and the Joint Committee on Taxation that were mandated by the Internal Revenue Service (IRS) Restructuring and Reform Act of 1998 (P.L. 105–206). **The hearing will take place on Thursday, January 27, 2000, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.**

Oral testimony at this hearing will be from invited witnesses only. Invited witnesses include Jon Talisman, Deputy Assistant Secretary for Tax Policy, U.S. Department of the Treasury; Lindy L. Paull, Chief of Staff, Joint Committee on Taxation; W. Val Oveson, National Taxpayer Advocate; and representatives from the National Association of Enrolled Agents, the American Bar Association, the American Institute of Certified Public Accountants, and the Tax Executives Institute. Any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

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In 1988 and 1989, the Subcommittee held a series of hearings on the penalty and interest provisions in the tax code. The hearings culminated in an overhaul of the penalty and interest regimes with the enactment of the Improved Penalty Administration and Compliance Tax Act, included in the Omnibus Budget Reconciliation Act of 1989 (P.L. 101–239).

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ternal Revenue Service Restructuring and Reform Act of 1998 (Including Provisions Relating to Corporate Tax Shelters), on July 22, 1999. The Treasury completed its report, *Penalty and Interest Provisions of the Internal Revenue Code*, on October 25, 1999. On November 10, 1999, the full Ways and Means Committee held a hearing on the corporate tax shelter issue

In announcing the hearing, Chairman Houghton stated: "It has been 10 years since Congress last took a comprehensive look at the interest and penalty regimes in the Code. The Subcommittee led the way then, and now the Subcommittee will review the provisions that were passed 10 years ago to determine whether these provisions are effective and promote fair treatment of taxpayers without undue complexity. We will also consider recommendations to improve upon these provisions."

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Chairman HOUGHTON. On behalf of Mr. Coyne, if I can associate myself with you, and Mr. Hayworth, we are delighted that you are here today, and thanks very much. The hearing will begin.

I doubt that there is anyone on this panel who has not heard more than one heart-breaking story from constituents who find themselves facing crushing back taxes and penalties and interest payments because they simply were unable to comply with a Tax Code they have no hope of understanding. Albert Einstein once said that compounded interest is the most powerful force in the universe, and taxpayers whose interest payments far exceed their underlying taxes certainly can appreciate the truth of those words of his.

Just yesterday the staff here met with representatives of a group of investors who were defrauded by an enrolled agent. His promotional materials targeted working people, promising them “quality investments for folks that dream about owning a piece of the country.” Pretty appealing.

So according to the Willamette Week, before an investor gave him any money, he would assign the investor a portion of his cattle-breeding operation’s expenses. The investor then claimed those expenses as a tax deduction. The agent prepared nearly all of his investors’ tax returns, which enabled him to assign them enough deductions to claim a refund for all of the taxes they paid in the previous three years. When investors got their refund checks, they paid him 75 percent and kept the remaining 25 percent.

Today, nearly all of the investors face back taxes, and penalties and interest going back in some cases into the 1970s, because their deductions were disallowed. One of these investors, a fellow called Ed Van Scoten, says the IRS is trying to collect about a half million dollars from him and, in quotes, “who are they trying to kid,” he asks? “they could never get $500,000 from me if I worked 5 lifetimes,” end quote.

In some cases, individual investors first receive notice from the IRS of their 1981 to 1986 tax liability beginning in early 1998, and the interest clock of course was running all this time. The unscrupulous will always prey on the unsuspecting, but something is seriously wrong with a penalties and interest regime that adds to the problems faced by the victims of this sort of scam.

Furthermore, as you know, we have to do more to make our tax laws and the penalties and interest regime easier to understand.

In 1988 and 1989, this subcommittee, under our friend, Chairman J.J. Pickle, held a series of hearings on penalty and interest reforms. The result was a major overhaul of the penalty and interest system. None of the Members on the dais today were on the subcommittee at that time. That is true, isn’t it? You weren’t on here. However, counsel for both the subcommittee majority and minority, Mike Superata and Beth Vance, were instrumental in seeing those changes become law.

In 1998, this subcommittee shepherded through Congress the IRS Restructuring and Reform Act. In that legislation, Congress directed the Joint Committee on Taxation and the Department of the Treasury to study the Tax Code and to examine whether the penalty and interest provisions encouraged voluntary compliance, operated fairly, deterred undesired behavior, and whether they are designed to promote effective administration by the IRS.

So we are here today to review the reports by the Joint Committee and the Treasury. I am also looking forward to hearing from the National Taxpayer Advocate Val Oveson, who is literally on the front line every day dealing with taxpayer problems with these provisions.

As we all know, we rely on voluntary compliance with our tax laws. The Federal Government depends on tax receipts to fund Social Security, Medicare, education, defense, highways and of course other critical functions. Each year, the government collects more than a trillion and a half dollars in tax receipts. But each year, billions of dollars are lost because individuals and businesses avoid paying their share. The Treasury estimates that the government lost more than $127 billion in 1998, and that is $127 billion that the rest of us must make up in higher taxes.

So the penalty system does serve a critical purpose and it deters noncompliance by imposing costs on noncompliance, and it penalizes those who try to skirt the system.

However, the penalties and interest can be quite severe, even debilitating. Therefore, we must work to ensure that the penalty and interest system is understandable. Taxpayers cannot avoid what they do not understand. More importantly, we must minimize the number of taxpayers who are caught in the penalty system not because they were cheating, but because they were mistaken. We as representatives of the people must take pains to ensure that innocent taxpayers' lives are not ruined by a cascading imposition of penalties and interest due to honest mistakes.

So what I hope to accomplish is simple. I hope we can develop a consensus built upon the recommendations we receive today to achieve the objectives we outlined when we asked for these reports. To repeat: To encourage voluntary compliance, to enable the IRS to operate fairly, to deter undesired behavior, and to promote effective administration by the IRS.

Now I am pleased to yield to our ranking Democrat, Mr. Coyne.

Mr. COYNE. Thank you, Mr. Chairman. In 1989, the Ways and Means Oversight Subcommittee developed comprehensive proposals to reform the Tax Code's interest and penalty provisions. These provisions, known as the Improved Penalty Administration and Compliance Tax Act, or IMPACT, were enacted into law with the strong support of taxpayers and the professional tax community across the country. Now, more than 10 years later, it is appropriate that the subcommittee review the IRS's administration of tax penalties and interest.

I want to commend Chairman Houghton for providing the subcommittee with an opportunity to discuss the experts' suggestions for further legislative reforms. Also, I want to welcome representatives from the Department of the Treasury, the Joint Committee on Taxation, and the National IRS Taxpayer Advocate concerning their recent studies of the particular issue that we are addressing today.

In our continuing oversight of our tax system, it is critical that we understand how interest and penalty assessments are affecting taxpayers and how the system can be improved. The Taxpayer Bill of Rights legislation enacted over the past decade addressed some of the more compelling tax problems that taxpayers face. The Taxpayers' Bill of Rights 2 authorized the IRS to abate interest and penalties in certain situations and expanded the interest-free period for tax payment. Taxpayer Bill of Right number 3 required the IRS to provide taxpayers with detailed interest and penalty computations and delinquency notices, suspended interest, and certain penalties for audit delays, and reduced penalties for installment payment arrangements.

Even with these changes, however, more can be done. Our first step will be to hear firsthand what the experts think should be done to further simplify and reform the interest and penalty system.

I thank the witnesses for their testimony that they are about to give. Thank you.

Chairman HOUGHTON. Thanks very much. Mr. Hayworth, do you have a statement you would like to make?

Mr. HAYWORTH. Mr. Chairman, just to say to you and the ranking member, I am honored to be here with you this morning and happy that even the snow did not deter this important oversight hearing. We welcome those who are here to testify. Thank you, Mr. Chairman.

Chairman HOUGHTON. Thank you very much.

I guess the snow did not hurt anybody in Oklahoma, either. Would the distinguished gentleman like to make a statement?

Mr. WATKINS. I would, Mr. Chairman. First, a little informal, we did have a big snow in Oklahoma, but I just could not resist trying to get back here for this committee meeting, you know. It is a very important one. But we did have about a foot of snow to work through.

Mr. Chairman, I would like to ask you for your help. I think this is a very important hearing, and I commend you for having it. The Internal Revenue Service civil tax penalty and interest provisions are something that has been very much a part of my concern, and this subcommittee successfully led the effort 10 years ago to rationalize the civil tax penalties, and it is only appropriate that today we undertake to review those important reforms.

As you know, I have a particular concern about the present law, the interest rate situation. For far too long the IRS has been using interest rate differentials to extract excessive interest charges from the American taxpayer. Last year, we were victorious in having global interest netting enacted to equalize interest rates during those times when both the government owes the taxpayers some refunds and the taxpayer owes some additional taxes. Unfortunately for taxpayers, though, Mr. Chairman, the IRS has taken a very narrow view of the new statute and are denying taxpayers the full measure of the relief that this subcommittee intended to provide. I think it was our intention to make sure we leveled that playing field.

I look forward to working with you, Mr. Chairman, just as I would say in a kind of sidebar, you and I have a keen interest in international trade, the global opportunities that we have around the world. We are in a global competitive society. We need to be making it easier and there should be incentives to try to get out there and do more in the global arena, but by making such a narrow eye in that needle, it is very difficult for us to get things done.

So I look forward to working with you, and I ask for your help to correct this problem so that we can guarantee our taxpayers that they will not be charged interest rates by the IRS when they do not truly owe a debt to the government.

I would like to submit for the record a letter that many Members of this subcommittee signed last year supporting the need for this change. Mr. Chairman, thank you for being on that letter with me and working with us on this. I look forward to hearing the witnesses today on this. So I am delighted to be back with you today on the sunshiney face of this committee, ready to go.

Chairman HOUGHTON. Thank you, Mr. Watkins.

Well, we have our first panel. Mr. Joseph Mikrut, the Tax Legislative Counsel of the Department of the Treasury, is going to kick off here. Then Ms. Paull, who is head of the Joint Committee on Taxation; and Mr. Oveson of the Internal Revenue Service, the National Taxpayer Advocate, will talk, in that order.

So Mr. Mikrut, I understand that you need a few more minutes than the usual five. Please go ahead and take it, and you are on.

STATEMENT OF JOSEPH MIKRUT, TAX LEGISLATIVE COUNSEL, U.S. DEPARTMENT OF THE TREASURY

Mr. MIKRUT. Thank you, Mr. Chairman. Mr. Chairman, Mr. Coyne and distinguished members of the subcommittee, good morning. Thank you for the opportunity to discuss with you today the Treasury Department's study and recommendations with respect to the penalty and interest provisions of the Internal Revenue Code. It has been 11 years since the Congress has undertaken a comprehensive look at these important and fundamental pieces of our tax law and we commend the subcommittee for reopening this dialogue.

The study conducted by the Treasury and its report issued on October 25, 1999, copies of which have been made available to the members of the subcommittee, was mandated by the IRS Restructuring Reform Act of 1998. The study was to review the administration and implementation of the penalty and interest provisions and make appropriate legislative and administrative recommendations. In developing our report, we solicited, received and studied comments from the general public and consulted closely with the IRS.

In July 1999, we issued a white paper that made a number of recommendations, including those with respect to penalties on the issue of corporate tax shelters. Those recommendations were incorporated by reference into our October study and were the subject of a full committee hearing in November. I will not discuss these issues further today.

The staff of the Joint Committee and the National Taxpayer Advocate in his annual report to Congress also have conducted similar studies and have similarly made recommendations regarding the penalty and interest provisions of the code. Although there are differences amongst these recommendations, these differences are a matter of degree and there is general agreement on the importance of the role of penalties and interest in our system.

For the sake of brevity, I will not repeat all of the materials in the Treasury study. Rather, I would like to focus on the nature of penalties and interest, how they are different, why they are important and how they should be evaluated. I would like to sum up by pointing to some of the more important recommendations we make in our study.

With respect to penalties, in general, our income tax system is one of self-assessment that imposes three principal requirements on taxpayers: Timely-filed returns, to report the correct amount of tax owed, and to timely pay the amount due and owing. The penalty regime acts as an inducement for compliance with these requirements by providing sanctions for noncompliance.

There are over 100 civil and criminal penalty internal revenue codes. Our study focuses on certain principle penalties which account for the majority of assessments and abatements for which we receive the most comments and which affect the largest number of taxpayers. These penalties are the failure to file, the failure to pay the estimated tax penalties, the accuracy-related penalties, and the deposit penalties. In evaluating these and other penalties, we are mindful that achieving a fair and effective tax system of compliance requires striking a balance that fosters and maintains the current high degree of voluntary compliance amongst the vast majority of taxpayers, encourages taxpayers who are not compliant to quickly resolve their noncompliance problems with the IRS, and imposes an adequate system of sanctions that are fair to taxpayers whose noncompliance may be due to diverse causes that involve different degrees of culpability, but do not impose substantial additional burdens or complexities upon either taxpayers or the IRS.

Achieving such a balance is difficult because a system of sanctions that accounts for these differences may be complex, while a system that does not adequately make distinctions may be viewed as unfair. At the same time, compliant taxpayers, who make up the great majority of all taxpayers, deserve a tax system that recognizes their compliance. There is no perfect system for sanctions, and striking the appropriate balance involves trade-offs amongst competing concerns. We believe our study and the recommendations therein strike the proper balance among these competing concerns.

With respect to interest, we have examined the respective roles of interest and penalties in our tax system with a view toward manipulating an appropriate distinction between the two: Penalties or sanctions for noncompliant behavior, while interest is a charge for the use or forbearance of money. Treasury recognizes that taxpayers sometimes view interest as a penalty, and the Internal Revenue Code in certain sections blurs the distinction between the two. However, recognizing the difference between interest and penalties is an important element in crafting legislation and regulations that impose and abate interest and penalty charges.

Penalty provisions should be designed to influence compliant behavior. Interest provisions should be designed to make parties, both taxpayers and the government, whole with respect to overpayments and underpayments of tax. Penalties generally can be abated for reasonable cause and other statutorily-prescribed reasons that reflect their function as a sanction. By contrast, the grounds for abatement of interest are more properly narrowly drawn.

Even though one can easily distinguish between interest and penalties, determining the proper rate of interest is sometimes difficult. Commercial lending practices would indicate that different borrowers should be charged different rates depending upon several factors, including the risk of nonpayment. In addition, lenders typically lend at higher rates than they borrow. With respect to taxes, the Federal Government is maybe viewed as an involuntary lender and often a lender of last resort. The uniqueness of this role and the need for interest provisions that are administerial may lead one to craft interest provisions that deviate from the normal commercial lending practices.

With respect to our specific recommendations, I would like to highlight just a few. Under current law, the penalties for failure to file and failure to pay are coordinated and applied at a combined 5 percent per month charge for unpaid taxes over the first five months. Treasury recommends uncoupling these two provisions and restructuring them. The current front-loading of the failure-to-pay penalty under current law and the first five months delinquency does not provide a continuing incentive to correct filing failures and imposes additional financial hardships upon taxpayers. The failure-to-pay penalties should provide appropriate incentives for taxpayers to correct the payment delinquency and, if necessary, make arrangements for payments under various programs such as the installment program that the IRS makes available.

We believe that the estimated tax penalties should remain a penalty, but there are three principal simplification matters that we would propose. First, individuals should not be subject to estimated tax penalties if the balance due on the returns is less than $1,000; a reasonable cause waiver from penalties should be applied to first-time offenders; and penalty waivers should be provided automatically for certain de minimis amounts.

The backbone of our Federal income tax payment system has been the employer withholding and the deposit of FICA and income taxes from wages and salaries of employees. Penalties ranging from 2 to 10 percent apply to deposits made anywhere from one to 16 days late. Treasury recommends no immediate changes to these provisions. However, we do believe that the 10 percent penalty for failure to use the correct deposit method should be reduced. This type of error certainly does not deserve a 10 percent penalty.

We also recommend that in cases where depositors miss a deposit deadline by only one banking day, an interest charge rather than a 2 percent penalty be applied.

Finally, with respect to the interest provisions, we continue to believe that the underpayment interest rate should be a uniform rate determined by the appropriate market's rates of interest. The existing differentials applicable to corporations we believe have policy undertakings and should be retained.

Mr. Chairman, there are a lot of provisions contained in our report, many of which I have not gone through. But in conclusion, we strongly support a penalty and interest regime that fosters and maintains the current high level of compliance, provides appropriate costs and sanctions for noncompliance, and provides a reasonable and administrable degree of latitude for individual taxpayer circumstances and errors. We believe that the proposals made in our report strike this appropriate balance. We look forward to working with you, Mr. Chairman, and members of the subcommittee and full committee in further developing these and any other legislative proposals in this area.

I would be pleased to respond to any questions you may later have.

[The prepared statement follows:]

[An attachment is being retained in the Committee files:]

Statement of Joseph Mikrut, Tax Legislative Counsel, U.S. Department of the Treasury

Mr. Chairman, Ranking Member Coyne, and distinguished Members of the Subcommittee:

I appreciate the opportunity to discuss with you today the Department of Treasury's study and recommendations with respect to the penalty and interest provisions of the Internal Revenue Code of 1986.

The study conducted by Treasury and its report issued on October 25, 1999 were mandated by the Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA98). The study was to review the administration and implementation of those provisions and make appropriate legislative and administrative recommendations. On July 1, 1999, the Treasury Department issued The Problem of Corporate Tax Shelters: Discussion, Analysis, and Legislative Proposals, a white paper that made a number of recommendations, including with respect to certain penalties, to address the problem of corporate tax shelters. Those recommendations were incorporated by reference into the October penalty and interest report, and were the subject of a hearing in November in the full Committee.

IN GENERAL

As stated in its report, Treasury focused its penalty and interest study on the principal civil penalty provisions that affect large numbers of taxpayers and account for the majority of penalty assessments and abatements. In evaluating these penalties, Treasury was mindful that achieving a fair and effective system of compliance involves striking a balance that (i) fosters and maintains the high degree of voluntary compliance among the vast majority of taxpayers, (ii) encourages taxpayers who are not compliant to expeditiously resolve noncompliance problems with the IRS, and (iii) imposes an adequate system of sanctions that are fair to taxpayers whose noncompliance may be due to diverse causes that involve different degrees of culpability, but do not impose substantial additional complexity or burden. Achieving such a balance is inherently difficult because a system of sanctions that is calibrated to account for these differences may be complex, but a system that does not make adequate distinctions may be unfair. There is no perfect system of sanctions and striking the appropriate balance inherently involves tradeoffs among competing concerns. The issue of penalties is one that often strikes an emotional chord, particularly with respect to penalties with their attendant normative overtones. At the same time, compliant taxpayers -the vast majority of taxpayers—deserve a tax system that recognizes their compliance. Although a penalty regime should not be overly harsh to noncompliant taxpayers whose noncompliance may not reflect deliberate flouting of the tax laws, it is equally true that the currently high compliance level should not be discouraged. Treasury's study and recommendations reflect an effort to strike a reasonable balance, understanding that there is no single solution and different approaches can be formulated to achieve the same goals.

Treasury also examined the respective roles of penalties and interest in our tax system, with a view toward maintaining an appropriate distinction between penalties as sanctions for noncompliant conduct and interest as a charge for the use or forbearance of money. Treasury recognizes that current law does not always make a clear or consistent distinction between interest and penalties, but believes that this distinction is important both with respect to taxpayer perception of the amounts they are required to pay and the underlying reasons for the imposition, the desired deterrent effects, and the corollary consequences of the characterization of the payment. The distinction between penalties and interest has particular consequence for the statutory provisions that permit abatement of those impositions. Penalties generally can be abated for reasonable cause and other statutorily-prescribed reasons that reflect their function as a sanction, that is, as a deterrent to noncompliant conduct. By contrast, the grounds for abatement of interest traditionally have been more narrowly drawn because interest is a charge for the use or forbearance of money. To the extent that current-law penalties are converted to interest charges or interest becomes a more dominant mechanism for dealing with arrears in payment, important corollary consequences, such as interest deductibility or interest abatement provisions, must be considered. In general, Treasury's position is that interest should remain principally a charge for the use or forbearance of money and should be set at a rate that approximates market rates. Although there are penalties in the Code that have attributes of an interest charge and whose legislative origins support that characterization, these penalties also function as sanctions. Treasury is particularly concerned that conversion of certain penalties to interest, even if supportable on analytical grounds, may involve a correlative blurring of the distinctions that have been drawn in the Code between penalty and interest abatement provisions. If that distinction is blurred, it may cause further confusion among taxpayers regarding the distinction between penalties and interest.

Treasury also is mindful of the ongoing IRS reorganization and implementation aspects of the new taxpayer right provisions of RRA 1998. Considerable guidance has been issued by Treasury in the past year relating to a number of these new provisions and the IRS is engaged in a major overhaul of its structure and systems as directed by Congress. Time is required for the impact of these new provisions to be evaluated and certain of the new provisions affect IRS programs, such as the offer-in-compromise program, that provide avenues other than abatement for relief from monetary impositions.

Specific Recommendations

In its report, Treasury made a number of specific legislative recommendations, which are described below.

Penalties for Failure to File and Failure to Pay

Treasury recommends that the failure to file and failure to pay penalties be restructured to eliminate the frontloading of the failure to file penalty and to impose a higher failure to pay penalty than under current law. The frontloading of the failure to file penalty under current law in the first five months of a filing delinquency does not provide a continuing incentive to correct filing failures and imposes additional financial burden on taxpayers whose filing lapse may be coupled with payment difficulties so as to impede compliance. The filing obligation is of paramount importance to the tax system, but imposition of a severe penalty in the first five months of a filing delinquency appears incongruent with the availability of automatic extensions of time to file. Treasury proposes, accordingly, that the failure to file penalty be restructured to impose a lower penalty rate over a longer period of time, up to the current-law maximum amount. The current-law higher penalty for fraudulent failures to file, however, would be maintained. This proposal would maintain a failure to file penalty to encourage timely filing, but not impose as significant a financial burden as under current law for a filing lapse of short duration, while providing a continuing incentive for delinquent filers to correct a filing lapse of longer duration.

The failure to pay penalty should provide appropriate incentives to taxpayers to correct a payment delinquency and, if necessary, arrange for payment under various payment programs that the IRS makes available. A taxpayer who fails to make such arrangements in a timely manner should be subject to a higher penalty rate than that provided under current law. Treasury proposes, accordingly, that the failure to pay penalty be restructured to accomplish these purposes by imposing a penalty at the current rate of 0.5 percent per month for the first six months of a payment delinquency. The penalty rate would be raised to one percent per month for continuing payment delinquencies after the sixth month to provide an additional incentive to pay an outstanding tax liability. As under current law, the maximum penalty would be 25 percent. These penalty rates would be reduced if taxpayers make, and adhere to, arrangements with the IRS for payment. The failure to pay penalty would not be coordinated, as under current law, with the failure to file penalty to recognize that each form of delinquency is a separate act of noncompliance. More specifically, these recommendations would:

(1) Restructure the failure to file penalty to impose a penalty of 0.5 percent per month of the net amount due for the first six months of a delinquency in filing tax returns, which penalty rate will be increased to one percent per month thereafter, up to a maximum 25 percent. This restructured penalty would eliminate the current-law frontloading of the penalty into the first five months of a filing delinquency, providing a continuing incentive for delinquent filers to correct their filing delinquency over longer periods of time. The maximum penalty of 25 percent is the same as under current law. As under current law, fraudulent failures to file would be penalized at a higher penalty rate of 15 percent per month, up to a maximum of 75 percent.

(2) Restructure the failure to pay penalty to impose a penalty of 0.5 percent per month of the net amount due for the first six months of a payment delinquency, which rate would be increased to one percent per month thereafter, up to a maximum 25 percent. The penalty rate would be decreased from 0.5 percent to 0.25 percent per month if the taxpayer, within six months, enters into a payment arrangement with the IRS to which the taxpayer adheres. Likewise, the one-percent penalty rate would be reduced to 0.5 percent if the taxpayer, after the lapse of six months, enters into a payment arrangement with the IRS to which the taxpayer adheres.

Treasury also recommends that consideration be given to charging a fee, in the nature of a service charge, for late filing of "refund due" or "zero balance" returns. Presently, the failure to file penalty is imposed if a balance is due with the return but is not imposed if tax is not owed as a result, for example, of overwithholding. The importance of the filing obligation and the IRS administrative costs associated with nonfiling may warrant imposition of a fee for late-filed returns to encourage timely filing even if no balance is due with the return, at least after the IRS has contacted the nonfiling taxpayer.

Consideration also can be given to permitting the IRS to utilize a fixed interest rate for installment agreements to avoid the incurrence by a taxpayer who has made the required installment payments of a balloon payment at the end of the agreement.

Penalties for Failure to Pay Estimated Tax

Treasury recommends that the current-law addition to tax for failure to pay estimated tax remain treated as a penalty. Treasury recognizes that the current sanction has attributes of interest and of a penalty. The ancillary effects, however, of converting the sanction to an interest charge do not warrant such a change. Conversion to an interest charge may mean that existing statutory waiver provisions are inappropriate. Conversion to interest also would permit corporations to deduct the payment of such sanction.

In recognition, however, of the potentially cumbersome nature of complying with the estimated tax payment requirements, the following simplifying changes are recommended for consideration:

(1) Individuals should not be subject to estimated tax penalties if the balance due with their returns is less than $1,000. Thus, estimated tax payments should be included in the calculation of the $1,000 threshold, but Treasury recommends this change under a simplified averaging method that would preclude taxpayers from satisfying the threshold by concentrating estimated tax payments in later installments.

(2) A reasonable cause waiver from penalty should be permitted for individuals who are first-time estimated taxpayers, provided the balance due on the tax return is below a threshold amount and is paid with a timely filed return.

(3) Penalty waiver should be provided for individual estimated tax penalties below a de minimis amount, in the range of $10 to $20.

Penalty for Failure to Deposit

Treasury recommends that few immediate changes be made to the deposit rules or penalties at this time to provide a sufficient period of time for changes to the deposit rules enacted by RRA 1998 to take effect. However, the penalty for failure to use the correct deposit method should be reduced.. The current-law 10-percent penalty is too severe for this type of error.

Treasury also recommends that, in cases where depositors miss a deposit deadline by only one banking day, consideration be given to a reduction in the current penalty rate of two percent to a lower amount, but above an interest charge for a one-day delay.

Accuracy-Related and Preparer Penalties

The minimum accuracy standards, for disclosed and nondisclosed tax return positions, should be modified to impose the same standards on taxpayers and tax return preparers. A significant proportion of taxpayers rely on paid preparers. Such professionals have dual responsibilities to their client/taxpayers and to the integrity of the tax system and should be expected to be knowledgeable and diligent in applying the Federal tax laws.

The minimum accuracy standards should be raised to require a "realistic possibility of success on the merits" for a disclosed tax return position and "substantial authority" for an undisclosed return position. The standards for tax shelter items of noncorporate taxpayers should be higher. In the case of disclosed positions, substantial authority and a reasonable and good faith belief that the position had a "more likely than not" chance of success should be required. For undisclosed positions, substantial authority should be accompanied by a reasonable and good faith belief based upon a higher standard of accuracy than the "more likely than not" chance of success standard. The proposed changes in the accuracy standards would reduce the number of accuracy standards, impose minimum standards that are higher than current law litigating standards to discourage aggressive tax reporting, and eliminate divergence between the standards applicable to taxpayers and tax preparers.

Treasury further recommends consideration of better harmonization of the substantial understatement and negligence penalties. In many cases, the standards applicable to the substantial understatement penalty may subsume the negligence standards. It may be appropriate to consider whether the negligence penalty should relate only to understatements that do not satisfy the "substantiality" requirement.

In determining the amount of the preparer penalty, consideration should be given to a fee-based or other approach to more closely correlate the preparer penalty to the amount of the underlying understatement of tax, rather than the current-law flat dollar penalty amount.

Finally, Treasury also recommends enactment of the Administration's Budget proposals that would address penalties applicable to corporate tax shelters and the determination of "substantiality" for large corporate underpayments.

Penalty for Filing a Frivolous Return

The current-law penalty for filing a frivolous tax return should be raised from $500 to $1,500, but the IRS should abate the penalty for a first-time occurrence if a nonfrivolous return is filed within a reasonable period of time. This penalty amount was last raised in 1982 and significant numbers of such penalties are assessed. This approach will help bring taxpayers who file frivolous returns into better compliance.

Failures to File Certain Information Returns With Respect to Employee Benefit Plans

Several penalties currently apply to a qualified retirement plan's failure to file IRS Form 5500. These penalties should be consolidated into a single penalty not in excess of a monetary amount per day and not to exceed a monetary cap per return. This penalty would be waived upon a showing of reasonable cause. Welfare and fringe benefit plans should be subject to a similar single penalty.

Penalty and Interest Abatement

Interest Abatement

Abatement of interest in situations where taxpayers have reasonably relied on erroneous written advice of IRS personnel should be available. Treasury does not recommend further legislative expansion of the provisions permitting abatement of interest. A distinction exists between the imposition of interest as a charge for the use of money and penalties as sanctions for noncompliance. Because of this distinction, abatement of interest should be allowed in more limited circumstances than for penalties and generally restricted to circumstances where the IRS may be at fault or where serious circumstances outside the taxpayer's control result in payment delays. Current law provisions permitting abatement in circumstances of unreasonable IRS error or delay and in certain other prescribed circumstances provide sufficient scope for interest abatement at this time. In addition, taxpayers have recourse to other mechanisms for mitigation of interest and penalties, such as the offer-in-compromise program, which are in the early stages of implementing changes after enactment by RRA 1998.

Consideration of any modification of the current law monetary limitation on mandatory interest abatement in cases of erroneous refunds should be coupled with consideration of whether the IRS has adequate means under current law to recover erroneous refunds. Procedural impediments exist with regard to the recovery of erroneous refunds by assessment in all cases and litigation is required in some circumstances.

Penalty Abatement

Other than as described above, Treasury recommends that the IRS implement administrative improvements to ensure greater consistency in the application of penalty abatement criteria and enhanced quality review of penalty abatement decisions.

Interest Provisions

The underpayment interest rate (other than the "hot interest" rate) should be a uniform rate determined by appropriate market rates of interest. Treasury recognizes that no single rate is the appropriate market rate for all taxpayers but concludes that, for reasons of fairness and administrability, a single rate generally should apply to underpayments of tax. The appropriate rate should be in the range of the Applicable Federal Rate (AFR) plus two to five percentage points to reflect an average market rate for unsecured loans.

The existing rate differentials between the underpayment and overpayment rates for corporate underpayments and overpayments, including the "hot interest" rate on large corporate underpayments, should be retained. Because of the recent enactment of global interest netting rules, it is premature to eliminate existing rate differentials.

Treasury does not support an exclusion from income for overpayment interest paid to individuals. The legislative policy precluding deductions of consumer interest does not warrant such a change.

CONCLUSION

Treasury strongly supports a penalty and interest regime that fosters and maintains the current high level of compliance, provides appropriate costs and sanctions for noncompliance, and provides a reasonable and administrable degree of latitude for individual taxpayer circumstances and errors.

The proposals made in Treasury's report strike an appropriate balance among these objectives. The failure to file and failure to pay penalty would be restructured to provide appropriate sanctions without undue burden on taxpayers and with incentives for taxpayers to address payment difficulties with the IRS expeditiously. The proposals made with regard to estimated tax and deposit penalties are intended to address complexity and mitigate unintentional errors while recognizing the importance of the estimated tax and deposit rules to our "pay-as-you-go" tax system. The recommendations with respect to the accuracy and preparer penalties recognize the importance of our self-assessment system, the damage to taxpayer perceptions of fairness as a result of overly aggressive tax reporting by some taxpayers, and the importance of preparers and other practitioners in protecting the integrity of the tax system. Treasury's recommendations regarding penalty and interest abatement preserve the distinction between penalties and interest while providing latitude for mitigation in appropriate circumstances. Treasury's recommendation that current interest differentials be maintained with respect to corporate underpayments and overpayments is grounded in marketplace differences between borrowing and lending rates and reducing incentives for delayed payment of large corporate underpayments or incurrence of large corporate overpayments. The new global interest netting rules also are in the process of implementation and time is required to evaluate their efficacy.

Finally, consideration of any legislative change in the current penalty and interest regime must take into account: 1) behavioral impact of significant change cannot be predicted with precision; and 2) the ability of the IRS to administer the new rules in a timely and equitable manner.

This concludes my prepared remarks. We look forward to working with you, Mr. Chairman, and members of the Subcommittee and full Committee in further developing these and any other legislative proposals in this area. I would be pleased to respond to your questions.

[The attached report: "Report to the Congress on Penalty and Interest provisions of the Internal Revenue Code," Dated October 1999, is being retained in the Committee files. The Report can also be viewed electronically from the Treasury's website at "http: www.treas.gov/taxpolicy/library/intpenal.pdf".]

Chairman HOUGHTON. All right. Thank you very much, Mr. Mikrut.

Before we have the questions, I think we ought to hear everyone here.

Ms. Paull, would you like to testify?

STATEMENT OF LINDY PAULL, CHIEF OF STAFF, JOINT COMMITTEE ON TAXATION

Ms. PAULL. Thank you, Mr. Chairman and Mr. Coyne and members of the committee. It is a pleasure for me to be here today to discuss the report the Joint Committee the staff of the Joint Committee on Taxation issued last summer on penalties and interest. I have a statement, a written statement for the record, and I would just simply like to briefly summarize the major recommendations in our reports relating to penalties and interests that don't relate to corporate tax shelters. The committee held a corporate tax shelter hearing at the end of last session at which we presented those recommendations.

With respect to interest, we have an assortment of recommendations. The first recommendation that we would make is to have a single interest rate for underpayments, overpayments, for all taxpayers, and our recommendation, based on a balancing of a variety of factors, would be to set that interest rate at a short term applicable Federal rate, plus 5 percent.

We also recommended that interest paid by the Federal Government to individual taxpayers in the interest of fairness should not be includable in income. Under the present law, individual taxpayers do not get a tax deduction for interest paid to the Federal Government with respect to their tax liabilities.

In addition, we recommend that the IRS be given expanded authority to abate interest. Right now the authority to abate interest is very, very narrow. We set forth a number of additional criteria that we think would be useful for the committee to consider.

We would recommend that the authority to abate interest be expanded to cover any unreasonable error or delay caused by the IRS, not just administerial or managerial acts. We also would recommend that the authority to abate interest be expanded to cover any erroneous refund, so long as the taxpayer did not cause that erroneous refund to be issued, not just those refunds that are under $50,000 or less, as under current law.

We would also recommend that authority to abate interest be expanded when the taxpayer has reasonably relied on written IRS court statements, and those written IRS statements cause the underpayment of tax. We also have a recommendation with respect to somewhat of a catchall. Itis very difficult to foresee every circumstance that occurs, but there could be circumstances where the imposition of interest would cause a gross injustice.

In addition, we recommended that the estimated tax penalty be converted into an interest charge instead of a penalty, and also we made some specific recommendations on how to simplify the computation of the estimated tax payments, the interest charge on the estimated taxes that are underpaid.

We recommend the complete elimination of the failure to pay penalty for a number of reasons. If you were to get the interest charge correct or closer to maybe some prevailing rates would be, you would not need this penalty. It is somewhat of a duplication of interest. In addition, the penalty in the instance of when taxpayers have come forward and indicated how much they owe, but are unable to pay it and want to enter into an installment agreement, we would recommend some changes to encourage more quickly getting into those installment agreements. Therefore, in lieu of the failure-to-pay penalty, we recommend that a 50 percent annual late charge be put in place at the appropriate time. Our recommendation was four months from the filing of a return, or the assessment of a tax. That recommendation was based on the normal extensions for the automatic extensions for filing tax returns, but we are flexible on that period.

The final recommendation we have on the interest side is to recommend that the IRS establish some new dispute reserve account whereby a taxpayer can deposit money while in dispute with the IRS. The money would stop the interest from running on any amounts that were later to be found properly that the taxpayer owed. If the taxpayer was correct and did not, in fact,—the taxpayer's position was correct and did not, in fact, owe the interest— I mean the taxes, the taxpayer would receive the money back, with interest, which is a change from the provision under current law.

With respect to penalties, we did not make any recommendations to change the failure-to-file penalty because we believe it is really important to get tax returns filed as quickly as possible; the tax returns or the starting point for you to be able to figure your correct tax liability and all of the administrative procedures that go with that.

With respect to the accuracy-related penalties, our recommendation was to conform the standards for filing tax returns, conform the standards used to report items on the tax return for taxpayers and return preparers and, in some instances, we would recommend those standards be increased.

With respect to the failure to deposit payroll taxes, because the IRS Reform Act recently changed the rules, our recommendation was to not propose a new change this quickly after the IRS Reform Act, but to recommend monitoring of those rules. In particular, I think we pointed out that when a taxpayer moves from one time period to another, whether it is moving from quarterly deposits to monthly deposits to twice a week to the next business day, when you trip through those time frames or you go back and forth through those time frames, that can cause some difficulties. Certainly there is a—you know, the taxpayer can come forward with a reasonable cause to try to get out of the penalty, but that is the area that we thought needed to be monitored and some additional time being focused on over the next few years.

Finally, we have a few smaller proposals with respect to the returns that are filed by pension plans and tax-exempt organizations. With that, I will just end and say that we would be willing to work with the subcommittee to come up with whatever recommendations you feel is appropriate, and we welcome the opportunity to appear before you today.

[The prepared statement follows:]

Statement of Lindy Paull, Chief of Staff, Joint Committee on Taxation

My name is Lindy Paull. As Chief of Staff of the Joint Committee on Taxation, it is my pleasure to present the written testimony of the staff of the Joint Committee on Taxation (the "Joint Committee staff") at this hearing concerning tax penalties and interest before the Subcommittee on Oversight of the House Committee on Ways and Means.[1]

A. Background

Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (the "IRS Reform Act") directed the Joint Committee on Taxation and the Secretary of the Treasury to conduct separate studies of the present-law interest and penalty provisions of the Internal Revenue Code (the "Code") and to make any legislative or administrative recommendations they deem appropriate to simplify penalty and interest administration or reduce taxpayer burden. The studies were required to be submitted to the House Committee on Ways and Means and the Senate Committee on Finance by July 22, 1999.

In responding to this legislative mandate, the Joint Committee staff undertook an extensive study of the present-law system of penalties and interest. The Joint Committee staff reviewed each of the penalty and interest provisions in the Code. The Joint Committee staff economists analyzed the economic considerations that affect taxpayers' decisions with respect to compliance and the Federal government's decisions in setting enforcement parameters, including penalties. The Joint Committee staff met with representatives of the Department of the Treasury (the "Treasury") and the Internal Revenue Service (the "IRS"), requested the General Accounting Office to investigate IRS practices regarding penalties and interest and, with the assistance of the Library of Congress, reviewed penalty and interest regimes in other countries. The Joint Committee staff solicited comments from taxpayers, tax practitioners, tax clinics serving low-income individuals, and other interested parties, and met with representatives of major taxpayer groups and professional organizations to discuss their comments.

The Joint Committee staff study[2] includes a variety of recommendations to modify the present-law system of penalties and interest. These recommendations are designed to improve the overall administration of penalties and interest and to provide consistency in application with respect to similarly situated taxpayers.

B. Recommendations Relating to Interest

Equal treatment for all taxpayers

A single interest rate should be applied to all tax underpayments and overpayments for all taxpayers. The single interest rate should be set at the short-term applicable federal rate plus five percentage points ("AFR+5").

The Joint Committee staff recommendation is based on the concept that the Federal government and taxpayers, to the greatest extent possible, should be treated equally in the payment of interest. Equal treatment of interest would enhance perceptions of fairness and would simplify interest computations in situations involving overpayments and underpayments during overlapping periods of time. To achieve equal treatment, the same rate of interest should apply to payments by a taxpayer to the Federal government and to payments by the Federal government to a taxpayer, irrespective of whether the taxpayer is an individual or corporation, and without regard to the amount of the underpayment or overpayment of tax.

Present law does not embody this concept of equality. Corporations are required to pay higher interest rates on underpayments than the interest rates received on overpayments. Under certain circumstances, the rate of interest paid by a corporation on a large underpayment is four and one-half percentage points higher than

[1] This testimony may be cited as follows: Joint Committee on Taxation, *Testimony of the Staff of the Joint Committee on Taxation Before the Subcommittee on Oversight of the House Committee on Ways and Means, January 27, 2000* (JCX–2–00), January 26, 2000.

[2] Joint Committee on Taxation, Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (including Provisions Relating to Corporate Tax Shelters) (JCS–3–99), July 22, 1999 (the "Joint Committee staff study").

the interest rate that would be paid by the Federal government on a large overpayment.[3]

The IRS Reform Act moved toward equal treatment with respect to interest by requiring that the same rate of interest apply to underpayments and overpayments of individual taxpayers. The IRS Reform Act also provided a net interest rate of zero for interest payable by and allowable to a taxpayer on equivalent amounts of underpayments and overpayments for the same period. However, the implementation of the zero net interest rate is expected to be complicated. The legislative history to the 1998 Act recognizes that implementation of the zero net interest rate may be dependent on taxpayer initiative while the IRS develops procedures for the automatic application of the zero net interest rate. The Joint Committee staff recommendation to apply a single interest rate to underpayments and overpayments of all taxpayers would eliminate most of the implementation issues for taxpayers and the IRS.

Equal treatment of interest for an individual taxpayer should be accomplished by excluding from income interest paid to an individual taxpayer on an overpayment of tax.

Interest paid by the Federal government to a taxpayer should be treated for federal income tax purposes in the same manner as interest paid by a taxpayer to the Federal government. Under present law, individual taxpayers are required to include in gross income interest received from the Federal government, but they are not allowed to deduct interest paid to the Federal government.[4] This inequality in treatment may cause individual taxpayers to believe that the federal income tax laws are not fair.

Prior to 1987, interest paid by an individual was generally deductible so long as it was not incurred as a cost of carrying tax-exempt bonds. However, as part of an effort to eliminate the deduction of various personal expenses, the Tax Reform Act of 1986 made most types of personal interest nondeductible. Treasury regulations take the position that nondeductible personal interest includes interest paid on underpayments of federal income tax, regardless of the source of the income generating the tax liability.[5]

It is noteworthy that no deduction is allowed under the Treasury regulations even if the interest relates to a deficiency in tax on business activities. Other interest incurred in the course of operating a business generally is deductible. The Tax Court has held the regulation position to be unreasonable, and therefore invalid.[6] However, the U.S. Courts of Appeals have consistently upheld the validity of the regulation,[7] although these courts have expressed some reservations as to its wisdom.

The Joint Committee recommends excluding interest paid to an individual on an overpayment of tax to eliminate the inequality in treatment of individual taxpayers and the Federal government. Equal treatment of taxpayers and the IRS can be achieved so long as interest is either included and deductible, or excluded and nondeductible. Allowing individual taxpayers to exclude interest on overpayments, rather than deduct interest on underpayments, insures that individual taxpayers will be treated equally, whether or not they itemize deductions.

Abatement of interest

Under present law, the Secretary of the Treasury is authorized to abate interest in limited instances. Such circumstances include an unreasonable delay by the IRS in the performance of a managerial or ministerial act, a failure by the IRS to contact an individual taxpayer in a timely manner, an erroneous refund by the IRS of $50,000 or less, and during periods when the taxpayer is serving in a combat zone or is located in a designated disaster area.

Numerous situations arise in which the resolution of a taxpayer's case has been delayed as a result of events arising in their dealings with the IRS. By allowing for interest abatement only in specific situations that rarely occur, present law ties the hands of the IRS and prevents it from assisting taxpayers by abating the interest that accumulates during such delays. Thus, the circumstances in which the Sec-

[3] The current interest rate for a large corporate underpayment is 10 percent (so-called "hot" interest), compared with 5.5 percent paid by the Federal government on a large corporate overpayment (so-called "cold" interest). Rev. Rul. 99–53, 1999–50 I.R.B. 657 (December 13, 1999).

[4] This disparity in treatment does not exist for corporations. Under present law, corporations generally are allowed to deduct interest paid to the Federal government and interest received from the Federal government is included in gross income.

[5] Treas. Reg. sec. 1.163–9T(b)(2).

[6] *Redlark v. Commissioner,* 106 T.C. 31 (1996), rev'd 141 F. 3d 936 (9th Cir., 1998).

[7] The validity of the temporary regulation has been upheld in those Circuits that have considered the issue, including the Fourth, Sixth, Seventh, Eighth, and Ninth Circuits.

retary of the Treasury is authorized to abate interest should be expanded to cover additional situations where the collection of interest from the taxpayer is inappropriate.

The Secretary of the Treasury should be authorized to abate interest that is attributable to unreasonable IRS errors or delays, whether or not related to managerial or ministerial acts.

It is not appropriate to require taxpayers to pay interest for periods when the sole reason the taxpayer's case was not resolved in a timely manner relates to error or delay on the part of the IRS. The present-law rule prevents abatement in situations in which unreasonable delay on the part of the IRS is clearly present, but the reason for the delay does not meet the technical and limited definition of a managerial or ministerial act or the taxpayer cannot identify the specific act on the part of the IRS causing the delay. The present-law rule also serves as an excuse for IRS refusals to consider the abatement of interest. For example, a taxpayer's application for abatement would automatically be rejected under present law if the IRS spent excessive time due to obvious errors by a revenue agent in interpreting and applying the tax laws, the choice by an examining agent of which of his or her assigned cases to handle at a point in time, or the perceived need of the IRS to resolve other cases first.

The $50,000 limitation for abatement of interest on erroneous refunds should be removed.

Under present law, the Secretary is required to abate interest on erroneous refunds of $50,000 or less, provided the taxpayer has not in any way caused the erroneous refund. The Joint Committee staff recommends that the $50,000 limitation should be eliminated. If the taxpayer has done nothing to cause the erroneous refund, interest should not be charged until after the IRS requests the return of the money.

The Secretary should be allowed to abate interest on an underpayment if the underpayment is attributable to erroneous advice furnished to the taxpayer in writing by an officer or employee of the IRS acting in his or her official capacity.

Under present law, penalties and additions to tax (but not interest) must be abated if they are attributable to erroneous advice furnished to the taxpayer in writing by an officer or employee of the IRS acting in his or her official capacity. A taxpayer who follows the erroneous written advice of the IRS should not be charged interest for following that advice.

The Secretary should be granted the authority to abate interest if a gross injustice would result if interest is charged.

The Secretary should not be precluded from preventing a gross injustice solely because the particulars of a situation have not been provided for by law. It is anticipated that this authority would be used infrequently and only in situations in which the taxpayer has not materially contributed to the accrual of the interest.

Interest on disputed underpayments

Taxpayers should be allowed to establish interest-bearing accounts within the Treasury to stop the running of interest on taxes expected to be in dispute with the IRS.

Present law provides limited opportunities for a taxpayer to stop the accrual of interest prior to or during an IRS audit. A taxpayer may make a payment in the nature of a cash bond. However, such a cash bond does not earn interest and is ineffective to the extent the taxpayer recovers any portion of the deposit prior to final determination of the tax liability. Taxpayers and their representatives rarely consider this procedure for these reasons. As a result, taxpayers incur significant interest charges while waiting for their cases to be resolved.

The Joint Committee staff believes that tax administration would be benefitted by a mechanism that would allow taxpayers to manage exposure to underpayment interest without requiring the taxpayer to prepay tax on disputed items or to make a potentially indefinite-term investment in a non-interest bearing account. The Joint Committee recommends that taxpayers should be allowed to deposit amounts in a new "dispute reserve account." A dispute reserve account would be a special interest-bearing account within the U.S. Treasury that could be established by a taxpayer for any type of tax that is due for any period. Amounts could be withdrawn from a dispute reserve account at any time, and would earn interest from the date of deposit at a rate equal to the short term AFR. If an amount in the dispute reserve account is applied to pay an underpayment of tax, it is treated as a payment of tax on the original deposit date. The dispute reserve account could be especially helpful for lengthy audits with difficult issues or open audits of related passthrough entities.

C. Recommendations Relating to Accuracy-Related Return Standards for Taxpayers and Tax Preparers

The Joint Committee staff recommends (1) harmonizing the standards for taxpayers and tax preparers applicable under the accuracy-related penalties and (2) increasing the amount of the return preparer penalty. The Joint Committee staff believes that these recommendations will improve both the equity and administrability of the accuracy-related penalty system.

Undisclosed tax return positions

The minimum standard for each undisclosed position on a tax return should be that the taxpayer or tax preparer reasonably believes the return position is "more likely than not" the correct tax treatment under the Code.[8]

This standard, which would apply equally to taxpayers and tax preparers, would imply that, at the time the return was signed, there was a greater than 50 percent likelihood that all undisclosed positions would be sustained if challenged. The reasonable cause exception for the substantial understatement penalty would be eliminated.

Disclosed tax return positions

The minimum standard for each disclosed position taken or advised to be taken on a tax return should be that the taxpayer or tax preparer has "substantial authority" for such position.[9]

This standard, which would apply equally to taxpayers and tax preparers, would imply that, at the time the return was signed, there was a greater than 40 percent likelihood that all adequately disclosed positions would be sustained if challenged.

Revise tax preparer penalty amounts

The preparer penalty should be revised to better reflect the potential tax liabilities involved. The penalty for understatements due to unrealistic positions should be changed from a flat $250 to the greater of $250 or 50 percent of the tax preparer's fee. The penalty for willful or reckless conduct should be changed from a flat $1,000 to the greater of $1,000 or 100 percent of the preparer's fee.

The accuracy-related and tax preparer penalties are designed to delineate (1) when an erroneous position taken on a tax return should be considered innocent and not subject to penalty, (2) when taxpayers should specifically notify the IRS that they are adopting controversial positions, and (3) when taxpayers are taking unduly aggressive positions and should be penalized for any resulting tax deficiency regardless of disclosure. The flat $250 penalty of present law, for example, may have little deterrent effect if the tax preparer's fee is many times that amount.

Discussion of accuracy-related standards

Because federal tax law is complex and constantly evolving, it is unrealistic to expect taxpayers to file "perfect" returns, on which every position taken is unquestionably correct. Still, the U.S. Supreme Court has pointed out that "self assessment. . .is the basis of our American scheme of income taxation."[10] Self assessment requires a high degree of cooperation from the taxpayer to file an accurate tax return. A self-assessment system will work properly if taxpayers perceive the system to be fair and believe that the costs of noncompliance outweigh the benefits of such noncompliance.

Under present law, a taxpayer is not subject to an accuracy-related penalty for an *undisclosed* improper return position provided there is "substantial authority" for the position. The regulations describe substantial authority in terms of a spec-

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[8] Under the Joint Committee staff recommendations relating to corporate tax shelters, a higher standard would apply with respect to corporate tax shelter transactions.

[9] Under the Joint Committee staff recommendations relating to corporate tax shelters, a higher standard would apply with respect to corporate tax shelter transactions. For tax shelter transactions not involving corporations, the present-law standard of "more likely than not" would continue to apply as a means to avoid an understatement penalty with respect to disclosed positions.

[10] *Commissioner of Internal Revenue v. Lane Wells Co.*, 321 U.S. 219, 223 (1944).

trum,[11] with most practitioners assuming substantial authority implies a 40-percent chance of success if challenged by the IRS. In assessing whether a position is supported by substantial authority, certain specified sources of authority may be consulted.

Under present law, a taxpayer is not subject to the substantial understatement penalty for a *disclosed* improper return position provided there is a "reasonable basis" for the position. Most practitioners assume a reasonable basis exists for a position if there is at least a 20 percent likelihood of success if challenged by the IRS.

However, under present law, tax preparers are held to lower standards than taxpayers. For *nondisclosed* return positions, the tax preparer is not subject to the tax preparer penalty if the return position has a "realistic possibility of being sustained," which most practitioners believe falls between substantial authority and reasonable basis standards for taxpayers. If a return position is disclosed, a tax preparer need only ensure that the return position is "not frivolous." The "not frivolous" standard has been interpreted to mean there exists a five to ten percent chance of the return position being successful if challenged by the IRS.

The accuracy-related penalty generally is abated if the taxpayer can demonstrate there was a "reasonable cause" for the underpayment. Generally, if the taxpayer relies in good faith on the advice of a tax professional, the taxpayer would satisfy the reasonable cause requirement. Thus, the standards for taxpayers and tax preparers are interrelated and it is inappropriate for tax preparers to be held to a lower standard than taxpayers.

These present-law standards for imposition of accuracy-related penalties on taxpayers and return preparers arguably permit taxpayers to take positions on tax returns that have an inappropriately low chance of success if challenged by the IRS. These low standards have the effect of increasing perceptions of unfairness in our tax system because taxpayers who take aggressive positions on their returns and their advisors are unlikely to be penalized. If taxpayers and preparers are not held to standards which require them to believe information reported on tax returns is in fact correct, the IRS will have the impossible task of examining greater percentages of returns in order to maintain the fairness of our tax system.

D. Recommendations Relating to the Penalty for Failure to Pay Taxes

The failure to pay taxes penalty should be repealed. Interest would continue to apply to the underpaid amount, but at the single rate of AFR+5 discussed above. An annual late payment service charge would also apply to taxpayers who have not paid their taxes or have not entered into installment agreements in a timely manner.

Under the Joint Committee staff recommendation, the failure to pay taxes penalty would be repealed and taxpayers would be given four months after assessment [12] in which to pay their tax obligations and be charged interest only. At the end of that four-month period, if the taxpayer still has not fully paid the taxpayer's tax obligation, or entered into an installment agreement to pay such obligation, the taxpayer would be charged an annual 5-percent late payment service charge on the remaining outstanding balance. This service charge would be similar to late payment charges that are widely imposed in the private sector. Thus, taxpayers would easily understand the purpose of the charge—to encourage timely payment. To avoid the service charge, taxpayers would have a strong incentive to enter into an installment agreement in a timely fashion, rather than waiting for a long period of time and letting interest continue to mount without making further payments. The repeal of the penalty for failure to pay taxes and its replacement with the service charge would further a policy initiative to encourage the use of installment agreements that was begun by the IRS Reform Act, which reduced this penalty for taxpayers who enter into installment agreements.[13]

The late payment service charge would operate in the following way. If a taxpayer has not entered into an installment agreement by the fourth month after assessment, a 5-percent late payment service charge would be imposed on the balance remaining unpaid at the end of that four-month period. This 5-percent late payment service charge would also be imposed each year on the anniversary of its original imposition on the balance remaining unpaid at that anniversary date, unless the taxpayer has entered into an installment agreement with the IRS and has remained current on that agreement. For example, if an individual files an income tax return on April 15, but the full amount shown as due on that return is not paid with that

[11] Treas. Reg. sec. 1.6662–4(d)(2).

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

[13] Code sec. 6651(h).

return, the taxpayer must either pay the remaining taxes or enter into an installment agreement by August 15 to avoid paying the late payment service charge. A taxpayer could entirely avoid this service charge, however, by entering into an installment agreement with the IRS and remaining current on that agreement. Abrogation of the installment agreement by the taxpayer would result in the immediate imposition of the 5-percent late payment service charge.

Taxpayers who enter into installment agreements and who also agree to an automated withdrawal of each installment payment directly from their bank account would not be required to pay the present-law $43 fee for entering into an installment agreement.

The elimination of the $43 user fee for installment agreements for taxpayers who both enter into installment agreements and who agree to use automated mechanisms, such as automated debits from a bank account, to pay their installment payments is designed to increase the certainty of timely payment, simplify the payment process for taxpayers, decrease administrative costs of collection for the IRS, and eliminate what some taxpayers may view as a barrier to entering into an installment agreement.[14]

E. Recommendations Relating to Estimated Tax Penalties

The estimated tax penalty should be repealed and replaced with an interest charge using the single interest rate of AFR+5 discussed above. Many computational details also should be simplified. The threshold below which individuals are not subject to the estimated tax penalty (currently $1,000) should be increased to $2,000 and the calculation of this threshold would be modified to take into account certain estimated tax payments.[15]

Approximately 12 million individuals make estimated tax payments. Many of these individuals find that calculating the correct amount of estimated tax payments is complex and confusing. The Joint Committee staff recommendations would provide significant simplification for many of these individuals.

The Joint Committee staff recommends converting both the individual and the corporate estimated tax penalties into interest charges to more closely conform the titles and descriptions of those provisions with their effect. Because these penalties in fact are computed as an interest charge, conforming their title to the substance of their function may improve taxpayers' perceptions of the fairness of the tax system. The present-law penalties are essentially a time value of money computation which is not punitive in nature. The Joint Committee staff also recommends that no interest on underdeposits of estimated tax should be required for individual taxpayers if the balance due shown on the return is less than $2,000.[16] This would considerably simplify the computation of estimated tax payments and interest for many individuals, and eliminate the need for many of these individuals to calculate a penalty on underpayments of estimated tax altogether.

In addition to the recommendations to convert the present-law estimated tax penalty into an interest provision and to increase the threshold from $1,000 to $2,000, the Joint Committee staff recommends making several specific changes to the estimated tax rules that would significantly reduce complexity in calculating the penalty for failure to pay estimated tax.

The modified safe harbor should be repealed.

Under present law, taxpayers with an adjusted gross income over $150,000 ($75,000 for married taxpayers filing separate returns) who make estimated tax payments based on the prior

year's tax generally must do so based on 110 percent of the prior year's tax.[17] By repealing this rule, the same estimated tax safe harbor would apply to all individual taxpayers. Thus, to the extent that the special rule is eliminated, the estimated tax

[14] The cost to the IRS of administering these automated payment mechanisms is less than one dollar per payment. *See*, Tax Notes, "OIC, Third-Party Contact Guidance Imminent, *Ex Parte* Guidance Soon," June 14, 1999, at 1544.

[15] In calculating the $2,000 threshold, amounts withheld (such as income tax withholding from wages) would be taken into account as under present law.

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

[17] The applicable 110 percent is modified when the prior taxable year begins in 1998 through 2001. The applicable percentage is 105 when the prior taxable year begins in 1998, 108.6 when the prior taxable year begins in 1999, 110 when the prior taxable year begins in 2000, and 112 when the prior taxable year begins in 2001.

rules would be simplified, because all individual taxpayers would meet the estimated tax safe harbor if they made estimated payments equal to (1) 90 percent of the tax shown on the current year's return or (2) 100 percent of the prior year's tax.

Eliminate the need for numerous separate interest rate calculations.

Under present law, if interest rates change while an estimated tax underpayment is outstanding, taxpayers are required to make separate calculations of interest for the periods before and after the interest rate change. The Joint Committee staff recommends applying a single interest rate for any given estimated tax underpayment period. This would be the rate applicable to the first day of the quarter in which the pertinent estimated tax payment due date arises.

The definition of "underpayment" should be changed to allow existing underpayment balances to be used in underpayment calculations for succeeding estimated tax payment periods.

Under the current estimated tax rules, underpayment balances are not cumulative, and each underpayment must be tracked separately in determining the penalty for underpayment of estimated tax. Thus, each underpayment balance runs from its respective estimated payment due date through the earlier of the date it is paid or the following April 15th. This often requires multiple interest calculations for each underpayment. Under the Joint Committee staff recommendation, taxpayers would calculate the cumulative estimated tax underpayment for each period or quarter and apply the appropriate interest rate as of that date. Thus, only one calculation would be needed for each underpayment period. This change would reduce complexity in calculating a penalty for underpayment of estimated tax by significantly reducing the number of calculations required to compute the penalty.

A 365-day year should be used for all estimated tax penalty calculations.

Under current IRS procedures, taxpayers with underpayment balances that extend between a leap year and a non-leap year are required to make separate calculations solely to account for the difference in the number of days during each year. By requiring a 365-day year for all estimated tax calculations, this extra calculation would be eliminated.

F. OTHER RECOMMENDATIONS

Pension-related penalties

The number of potential penalties for failure to file the Form 5500 series annual return should be reduced from six to one. The IRS should have the sole responsibility for enforcement of the Code and ERISA reporting requirements.

This reduction in the number of potential penalties would result from the consolidation of the ERISA and Code penalties for failure to file an annual return, and the repeal of the separate Code penalties for failure to file the required schedules and plan status change notification. The IRS should be designated as the agency responsible for enforcement of the Code and ERISA reporting requirements applicable to pension and deferred compensation plans, thereby reducing from three to one the number of government agencies authorized to assess, waive, and reduce penalties for failure to file the Form 5500 series annual return.

Under present law, the Code and ERISA require a plan administrator of a pension or other funded plan of deferred compensation to file a Form 5500 series annual return with the Secretary of the Treasury, the Department of Labor, and, for some plans, the Pension Benefit Guaranty Corporation ("PBGC"). For failure to file a timely and complete annual return, the Code imposes on the plan administrator a penalty equal to $25 per day, not to exceed $15,000 per return. In addition, ERISA provides that both the Secretary of Labor and the PBGC may impose on the plan administrator a penalty of up to $1,100 per day. The Secretary of the Treasury, the Secretary of Labor, and the PBGC may waive their respective penalties if the plan administrator demonstrates that the failure to file is due to reasonable cause. Separate Code penalties also apply if administrators fail to file Schedules SSA, Schedule B, or plan status change notification.

The separate Code and ERISA penalty provisions, and the separate Code penalty provisions for Schedule SSA, Schedule B, and notification of a plan status change, complicate the Form 5500 series annual return penalty structure and create the possibility that a plan administrator may face multiple penalties for a failure to file one return. A plan administrator that fails to file an annual return may be required to pay six different penalties to three different government agencies. A plan administrator who seeks abatement of the penalties may be required to demonstrate the existence of reasonable cause to three different government agencies and may receive a different determination from each agency as to the sufficiency of the demonstration.

Penalty for failure to file annual information returns for charitable remainder trusts

The penalty for failure to file annual trust information returns should expressly apply to the failure of a split-interest trust to file Form 5227. The penalty imposed on trusts for failure to file Form 5227 should be set at amounts comparable to the penalties imposed on tax-exempt organizations for failure to file annual information returns.

Under present law, it is not clear that the statute imposing a penalty for failure to file annual trust information returns applies to a split-interest trust's failure to file Form 5227. Form 5227, however, is critical to the enforcement efforts of the IRS as it provides detailed information regarding the financial activities of split-interest trusts [18] and possible liabilities for private foundation excise taxes to which these trusts are subject. Increasing the penalty imposed on trusts that fail to file required information returns and ensuring that all relevant returns are subject to such penalty would encourage voluntary compliance by delinquent filers and would assist the IRS in obtaining information about the activities of such trusts.

G. Conclusion

The Joint Committee staff recommendations on penalties and interest are intended to increase compliance and enhance the fairness and administrability of the federal tax laws. In many cases, the recommendations build on the provisions of, and policies embodied in, the IRS Reform Act. As stated in our published study, the Joint Committee staff believes that any legislative changes regarding penalties and interest should be undertaken only after careful and deliberative review by the Congress and the opportunity for input from the public, the Treasury Department, and the IRS. This hearing is an important step in that review process.

I thank the Subcommittee for the opportunity to present the Joint Committee staff recommendations on penalties and interest and I welcome the opportunity to answer any questions you may have now or in the future.

[The attachment "Comparison of Joint Committee Staff and treasury Recommendations Relating to Penalty and Interest Provision of the Internal Revenue Code," JCX–79–99 is being retained in the Committee files.}

Chairman HOUGHTON. Well, thank you. We welcome it too.
Mr. Oveson.

STATEMENT OF W. VAL OVESON, NATIONAL TAXPAYER ADVOCATE, INTERNAL REVENUE SERVICE

Mr. OVESON. Mr. Chairman and Mr. Coyne, distinguished Members of the committee, thank you for inviting me here today. I am delighted to be with you to address this important topic. I congratulate you for commissioning these studies by the Joint Committee and the Treasury on the ongoing process of evaluating interest and penalty issues. It certainly is not a new issue, as pointed out in both of those reports.

Few tax administration topics generate the emotional response from taxpayers as do penalty and interest. While most taxpayers pay their taxes willingly, they chafe under the strict imposition of penalties and interest assessed on taxpayers who make mistakes on their returns, but are trying to comply with the law. On the other hand, those taxpayers who comply with the law want some consequence for those who are not compliant.

[18] Split-interest trusts are trusts in which some but not all of the interest is held for charitable purposes. Although these trusts are not private foundations, they are subject to some private foundation rules.

Penalties are imposed to punish noncompliant taxpayers and deter compliant taxpayers from being noncompliant, while interest is imposed to compensate either the taxpayer or the government for the time-value of money. Some incentives are necessary in our system, but the incentives have become way too complex, too burdensome, and even are contributing to noncompliance, in my opinion. We must reexamine these incentives.

Some research that I have seen suggests that compliance is more a function of citizens' respect for the institution of government and their confidence in those who are administering the laws and is not influenced as much by civil fines and penalties. Although more research should be done on this topic that I have just raised, I question the underlying assumption that compliance can be obtained through penalties alone. Indeed, as Treasury has just mentioned, we have had an increase in penalties from 10 to nearly over 100 in the last 10 years, and I do not think compliance has proportionately increased, so it has not solved the problem.

In my opinion, we are currently at the point of diminishing returns with our penalty and interest system. These laws have become so burdensome that they may be driving taxpayers away from compliance rather than toward. We see many cases where taxpayers want to comply or pay their tax and to come into full compliance, but they cannot pay the penalties and interest without going bankrupt or jeopardizing the funds needed to avoid hardships, including reasonable retirement savings.

An example of this situation that we are seeing with increasing frequency in the field involves individuals who are partners in tax shelters. Taxpayers, as early as the 1970s, as Chairman Houghton has already explained earlier, and up through the 1990s, have invested in partnerships whose major, if not only, purpose was to shelter income from tax. Litigation on these cases has been extensive and court proceedings have been extremely lengthy. Thus, for taxpayers who did not settle these cases, but awaited the results of litigation, final resolution can leave them without the ability to pay these liabilities dating back 10 years or more and penalty and interest accruals to match. The enormity of these liabilities has caused taxpayers to seek assistance from any source they can. They are coming to their congressional representatives and they are coming to my office to seek abatement of these penalties and interest and to have collection action suspended. Some taxpayers have filed for bankruptcy protection.

The tax liability has been established. That is not at issue here, and I am not talking about the underlying tax liability. We are dealing with the question of collectibility and fairness. We need to work to get these taxpayers back into full compliance, particularly where they are eager to do so.

I believe that the tax shelters are an abuse of our system, and that investors should be penalized, and that they owe interest for the time that they use the government's money. However, I question whether it is the function of government through the penalty and interest laws to punish these taxpayers to the point of insolvency when they are not able to even pay a fraction of the liabilities.

We frequently see requests for interest abatement because of service delays in taxpayer cases. I have raised this issue in the past and I would like to state again that I believe that the situations in which the Service may abate interest are too narrow under the current law. As the study explains, the Service may abate interest where an unreasonable delay results from managerial and ministerial acts. I believe limiting abatement of interest to these acts is unfair to taxpayers and should be expanded.

I believe that for reasons of fundamental fairness, the IRS should be permitted to abate interest whenever the Service causes unreasonable errors or delays and the taxpayer has not contributed significantly to those errors or delays. For example, the Commissioner directed the temporary reassignment of IRS examination personnel to customer service in order to provide our 24-hour a day phone service to taxpayers. Not unexpectedly, these personnel were taken away from their audits and other examination work, thus delaying resolution of the taxpayer cases. The Service may be unable to abate interest under current law because the delay resulted from a staffing decision. Such a decision may be a general administrative decision for which the statute does not permit abatement. I believe the Service should have the discretion to abate interest in such cases where taxpayers, through no fault of their own, bear additional financial burden because of the Service.

In my written testimony, which I would like to be made a part of the record, I have expressed my opinion on various issues from both Treasury and the Joint Committee studies. For example, I support the elimination of the failure to pay penalty but would not impose an annual surcharge, however. I believe the interest rate is the best vehicle to use to discourage taxpayers from using the Treasury Department as a bank. I agree with many of the recommendations in the study before you and believe that if they are used as a starting point, Congress will eventually alleviate a good deal of burden for taxpayers. The recommendations attempt to provide better incentives for taxpayers to comply with the law and to simplify the penalty and interest administration where possible. For the most part, they address the major issues that are causing taxpayers difficulty in creating undue burdens that we are seeing in the field.

Again, thank you for inviting me today. I am looking forward to answering questions and the rest of the hearing. Thank you.

[The prepared statement follows:]

Statement of W. Val Oveson, National Taxpayer Advocate, Internal Revenue Service

Mr. Chairman and Distinguished Members of the Subcommittee:

I am pleased to be here today to address the Subcommittee on the subject of the penalty and interest provisions of the Internal Revenue Code and the studies by the Joint Committee on Taxation and the Department of the Treasury on the implementation and administration of those provisions. I commend Congress for commissioning the studies in the Internal Revenue Service Restructuring and Reform Act of 1998. I would also like to congratulate both the Joint Committee and Treasury for such comprehensive reviews of areas in distinct need of this kind of evaluation. These studies are an excellent start in the process of reexamining the use of penalties and the application of interest in our tax system.

I agree with the Joint Committee and the Treasury Department when they caution that changes to the penalty and interest systems should be the result of deliberative review by Congress. Of course, all modifications to the tax laws deserve such review, but penalties and interest are designed to provide taxpayers with such basic incentives to comply with the law and are so fundamental to our system of taxation that changes to the current structure and the related consequences should be considered carefully.

I. *General Comments*

Few tax administration topics generate the emotional response from taxpayers as the imposition of penalties and the accrual of interest on tax liabilities. Most taxpayers pay their taxes willingly. They chafe, however, at the strict imposition of penalties and interest when they make small mistakes in their efforts to comply with the law. Many taxpayers who file and pay timely and comply with the laws, nevertheless, are concerned that there be some consequence for those who are late and do not comply.

Penalties are supposed to function in our tax system by punishing noncompliant taxpayers and deterring compliant taxpayers from noncompliant behavior; interest is supposed to compensate either taxpayers or the government for the use of money. These incentives are necessary in our system, but there is risk that the incentives may become too complex and the burdens too great, which may even contribute to noncompliance.

In the penalty and interest regimes, the questions focus for the most part on the severity of the penalties, the applicable interest rate and how much leniency there should be in waiving penalties or abating interest. I believe, however, that we must re-examine what incentives our systems provide. In fact, some research recently suggested that compliance is more a function of the citizens' respect for the institution of government and their confidence in those who are administering the laws and is not influenced by civil fines and penalties as much as we traditionally believe.[1] Although more research should be done on this topic, I think we need to question the underlying assumption that compliance can be attained through imposing penalties.

In my opinion, we are currently at the point of diminishing returns with our penalty and interest regimes. In other words, these systems have become so burdensome that they may be driving taxpayers toward noncompliance rather than toward compliance. In the Taxpayer Advocate Service, we see many cases in which a taxpayer understands why penalties and interest have been assessed and would like to come into full compliance. In a large number of those cases, however, the taxpayer cannot reasonably expect to pay off their liabilities over time with the amount of the penalties assessed and with further penalties and interest continuing to accrue.

One of the problems taxpayers are bringing to the Taxpayer Advocate Service with increasing frequency involves TEFRA partnerships determined to be tax shelters. Taxpayers, as early as the 1970s and up through the 1990s, invested in a number of partnerships whose major, if not only, purpose was to shelter income from tax liability. For a number of reasons, audits of shelter cases can be quite extensive and Tax Court proceedings fairly lengthy. Thus, for taxpayers who do not settle these cases, but await the results of litigation, final resolution can leave them with liabilities dating back 10 years or more with penalty and interest accruals to match.

The enormity of these liabilities has caused taxpayers to seek assistance from a number of sources, including their Congressional representatives and various functional areas within the Service, including my office, to abate all or part of the accumulated liabilities or to suspend collection action. Some taxpayers have filed for bankruptcy protection. More than most, shelter cases can reflect the burden associated with the past and current penalty and interest structures. Very few taxpayers are prepared to pay or can pay penalty and interest accumulations that may date back to the 1970s.

Some say that these taxpayers should have known that the results of their investments were too good to be true. Nevertheless, I believe we should not focus on blame at this point. We need to work to get these taxpayers back into full compliance, possibly through installment agreements or the expanded offer-in-compromise criteria. I believe that tax shelters are an abuse of our system and the investors should be penalized. I also concede that the investors owe interest for the time they had the use of the government's money. I question, however, whether it is the function of the government and our penalty and interest regimes to punish these taxpayers to the point that they become insolvent and unable to pay even a fraction of these liabilities.

[1] Tom R. Tyler, Beyond Self-Interest: Why People Obey Laws and Accept Decisions, *The Responsive Community,* Fall 1998, at 44.

Of course, we also see other issues regarding penalty and interest accruals in other areas, such as installment agreements. For example, when entering into an installment agreement, the taxpayer agrees to pay a certain dollar amount (biweekly, monthly, quarterly) until the tax liability is paid in full. General computations of how long a taxpayer will have to pay on the agreement are based on the amounts accrued as of the date the agreement is accepted. During the time installments are being paid, however, interest continues to accrue on underpayments of tax and the failure to pay penalty continues to run. At the end of the payment term, the taxpayer receives a bill for amounts of penalty and interest that accrued during the course of the agreement. This is an unpleasant surprise to many installment agreement taxpayers, who generally believe that they have met their obligations by keeping up with their payments.

On a related note, the Taxpayer Advocate Service frequently sees other issues regarding requests for interest abatement because of Service delays in a taxpayer's case. I have raised this issue in the past and would like to state again that I believe that the situations in which the Service may abate interest are too narrow under current law. As the studies explain, the Service may abate interest where an unreasonable error or delay results from managerial or ministerial acts. I believe limiting abatement of interest to these situations is unfair to taxpayers.

In my FY 1998 Annual Report to Congress and when I came before you this past February, I informed you that I had issued the first-ever Taxpayer Advocate Directive ("TAD") regarding waiving penalties and abating interest in innocent spouse cases. While considering the TAD, it became apparent that, because of the effective date of the managerial exception, I could not direct abatement of interest caused by managerial delays for tax years beginning before 1997. Moreover, it was clear that the law in this area is quite restrictive. Section 6404(e) permits abatement only where the assessment of interest is attributable to unreasonable error or delay by the Service in performing a ministerial or managerial act. I believe that, for reasons of fundamental fairness, the Service should be permitted to abate interest *whenever* the Service causes unreasonable error or delay and the taxpayer has not contributed significantly to that error or delay.

For example, the Commissioner directed the temporary reassignment of IRS Examination personnel to work in Customer Service offices in order to provide 24-hour phone assistance to taxpayers. Not unexpectedly, these personnel were taken away from audits and other examination work, thus delaying resolution of taxpayer cases. Under current law, the Service may be unable to abate interest attributable to that delay. Depending on the facts and circumstances, such a decision may be a "general administrative decision" for which the statute does not permit abatement. I believe that the Service should have the discretion to abate interest in such cases where taxpayers, through no fault of their own, bear an additional financial burden because of the actions of the Service.

II. *National Taxpayer Advocate's Report to Congress for FY 1999*

In the National Taxpayer Advocate's Report to Congress for FY 1999, we reported again this year on the significant compliance burden penalties and interest cause for taxpayers. For the second year in my tenure as National Taxpayer Advocate, we determined that penalties remained one of the most litigated issues for individual and self-employed taxpayers and penalty administration one of the most serious problems facing taxpayers.

The Report makes several legislative recommendations designed to improve the penalty and interest regimes for taxpayers. With regard to penalties, we proposed that Congress eliminate the failure to pay penalty. Absent elimination, however, we proposed further mitigation or waiver of the failure to pay penalty for taxpayers in installment agreements. We also proposed the simplification or elimination of the estimated tax penalty and the creation of a reasonable cause exception for the frivolous return penalty. With regard to interest, we proposed that Congress expand interest abatement authority to all taxes, instead of limiting it to income, estate, gift, generation skipping and certain excise taxes, expand interest abatement authority in any circumstance in which there is unreasonable error or delay, allow the Service to use a fixed interest rate on installment agreements, restrict compounding of interest to the underlying tax only and not to penalties and additions to tax, limit interest on a tax liability to 200 percent of the liability and allow the IRS to abate interest where the taxpayer is experiencing a significant hardship. We hope that Congress will consider these proposals that we believe will alleviate taxpayer burden and improve the fairness and equity of the tax system for taxpayers.

III. *Reactions to Specific Recommendations in Penalty and Interest Studies*

I agree with many of the recommendations in the studies before you and believe that, if they are used as a starting point, Congress will eventually alleviate a good deal of burden for taxpayers. The recommendations attempt to provide better incentives for taxpayers to comply with the law and to simplify the penalty and interest systems. For the most part, they address the major issues that are causing taxpayers difficulties and creating undue burdens. In addressing my comments on the specific recommendations, I have focused on those issues affecting individual taxpayers.

A. Recommendations regarding Interest Provisions

1. Interest Rate

I believe you should consider the concept of using one interest rate for taxpayers and applying that rate to both underpayments and overpayments. Applying one interest rate will increase fairness and reduce complexity and will preclude the government making money from taxpayers. Linking the rate to the market should prevent taxpayers from treating the government as a preferred lender or borrower. In determining an applicable interest rate, however, I would suggest a range along the lines of the Treasury Department recommendation of AFR plus 2 to 5 percent. Such a rate should reasonably compensate the government and provide sufficient incentive for taxpayers to comply with the law.

Should you consider this proposal, I believe you also should evaluate the possible complexity caused by quarterly adjustments to the applicable interest rate. Because the Service changes the rate every quarter, it is more difficult to administer. If the Service changes it too infrequently, however, the link to the market rate will diminish. To strike a balance between the two extremes and to more closely reflect private industry practice, I recommend that the rate change yearly.

2. Interest Paid by the IRS to Individual Taxpayers

I believe that interest paid by the IRS should be treated differently than other types of interest and be excludable from income. The present system, which denies individual taxpayers a deduction for interest paid on taxes, treats those taxpayers less advantageously than corporate taxpayers and creates a mismatch for individuals between overpayment and underpayment interest. I believe the Joint Committee's proposal to exclude interest paid by the IRS from the income of individual taxpayers should make the system fairer than it is currently, especially when considered in conjunction with the first proposal of a single interest rate that applies to all taxpayers.

3. Abatement of Interest

Over the last several years, Congress has been concerned with the authority of the Service to abate interest. In 1996, Congress expanded the Service's authority to abate interest to include instances in which managerial acts caused unreasonable error or delay. In 1998, Congress enacted a provision requiring suspension of interest where the Service has taken longer than a specified period of time to issue a deficiency notice to a taxpayer. I agreed with both of those changes, but I also believe that we need to go farther to be fair to taxpayers.

I support the Joint Committee's proposals regarding abatement of interest. If Congress chooses to enact these proposals, however, I believe the intent of the law must be clear in order to minimize any difficulties in interpreting the provision.

4. Dispute Reserve Accounts

The Joint Committee's recommendation to provide taxpayers with "dispute reserve accounts" to stop the running of interest is certainly an idea that has merit. However, I raise two issues for your consideration. First, as you know, it is already difficult for the Service to keep track of taxpayer accounts. Over the last two years, we have heard about many problems that are caused, at least in part, by the Service's computer systems. Allowing taxpayers to set up such accounts before new systems are put in place would create an administrative burden for the Service, which could lead to greater difficulties for taxpayers.

Second, current law provides two methods by which taxpayers may pay disputed amounts, stop the running of interest and preserve the right to petition the Tax Court. As the Joint Committee points out, a taxpayer may submit a cash bond to stop the running of interest on the amount of proposed tax and preserve the right to petition the Tax Court prior to the mailing of a notice of deficiency. Payments designated as a cash bond do not earn interest, however, but do stop the running of interest.

After receiving the notice of deficiency or initiating Tax Court litigation, the taxpayer also may make payments on the liability that will stop the running of interest and will not preclude further proceedings in the Tax Court. These payments will be applied to the tax liability. If the taxpayer ultimately prevails in Tax Court, any amount the court determines is an overpayment will be refunded with interest to the taxpayer.

Rather than establishing dispute reserve accounts at this point, I recommend that the Service publicize the current options for payment and how these options affect the taxpayer's ability to seek a judicial determination from the Tax Court.

B. Recommendations regarding Penalty Provisions

1. Penalty for Failure to Pay Tax

As I have testified to you before, I support the complete repeal of the failure to pay penalty. We do not need to replace the penalty with some alternative system, such as a five percent late payment charge. By setting the interest rate slightly above the market rate, we compensate the government for the use of the money and provide taxpayers with the incentive to pay. In my experience, few taxpayers are aware of the failure to pay penalty and, thus, it does not effectively motivate taxpayers to comply. In fact, when a taxpayer is in financial trouble or has not filed returns for several years, the failure to pay penalty becomes a barrier to compliance rather than an inducement.

I also support Treasury's proposal to fix the interest rate on installment agreements. With a fixed rate, the Service could work with the taxpayer to include interest accruals over the life of the agreement in the payment schedule. This would permit taxpayers to avoid the balloon-type payment due at the end of the agreement. A fixed interest rate would also permit taxpayers to better understand the agreements, which would become more like other consumer payment agreements, such as mortgages.

2. Penalty for Failure to File

I agree with the Treasury Department that Congress should restructure the application of the failure to file penalty. Treasury's recommendation, if enacted, would both provide a continuing incentive to correct filing failures and make the application of the penalty more consistent with the four-month automatic extension to file.

I think it is premature to assess a "fee" or "service charge" for taxpayers who file late, but do not owe money with the return. Before Congress enhances penalties in this area, I believe we should publicize the issue and reinforce to taxpayers and preparers the importance of filing, whether or not a balance is due with the return.

Finally, I believe that Congress should permit the Service to waive outright the failure to file penalty and possibly the failure to pay penalty for first-time filers and for first-time offenders, similar to the Treasury proposals for first-time estimated taxpayers. In my experience, taxpayers who have either not been in the system or who have always been compliant may not even understand that, in addition to an interest charge, there are penalties for failing to file or pay. We should strive to identify these taxpayers and to encourage them to remain compliant, rather than penalize them immediately.

3. Estimated Tax Penalties

I agree with the Joint Committee's recommendations concerning the estimated tax penalties. The penalty has always operated as an interest charge on money that should have been paid to the government. Properly calling this interest is more honest than continuing to refer to the scheme as a penalty. I raise the same concern that Treasury raised regarding waiving this penalty for reasonable cause. I feel it is essential that the Service have this authority regardless of what it is called.

I also agree with Treasury's suggestion that Congress consider some sort of reasonable cause waiver from this penalty for first-time estimated taxpayers, but I would encourage the waiver to apply regardless of the amount due. As I said above with regard to penalties for failing to file and pay, identifying these taxpayers and working with them will prevent future mistakes and help keep them in compliance.

I also urge you to consider a more meaningful change to the underpayment threshold for the estimated tax penalty, such as $5,000. The higher threshold would help eliminate the burden of this provision for many taxpayers who are starting small businesses or who receive supplemental income from such a business. As an alternative to simply raising the threshold for application of a penalty or interest charge, I suggest that Congress consider indexing the threshold. While it might add back some complexity, it would be fairer in the future.

4. Accuracy-Related Penalties

I believe that individual taxpayers do not have an appreciation for the legalistic standards of "substantial authority" and "reasonable basis," along with their attendant percentage of success calculations. I feel that most taxpayers are filling out their returns to the best of their ability and are not aware of these rules.

If Congress undertakes a review of this area, however, simplification is in order. The "sliding-scale" nature of the current standards is confusing. Taxpayers and preparers need a brighter line so that understanding obligations is easier. I also support making the standards consistent for tax preparers and taxpayers.

Regarding the level of the preparer penalties, I believe Congress should consider not only raising the amounts of the penalties, but also how these penalties relate to Circular 230 standards for tax practitioners. Effective enforcement of the standards of practice can go a long way toward ensuring practitioner accountability.

5. Frivolous Return Penalty

I support Treasury's recommendation to raise the frivolous return penalty and provide for a reasonable cause exception. Currently, the Service cannot waive this penalty for reasonable cause. The Taxpayer Advocate Service has seen several cases in which taxpayers were misled or even duped into filing a frivolous return. After intervention and education from the Service, these taxpayers have understood their mistakes and would like to correct the error. Particularly where the taxpayer has a good compliance history, it seems unfair not to waive the penalty. Additionally and as Treasury points out, permitting a reasonable cause waiver would provide an incentive for taxpayers to file correctly.

Essentially, frivolous filers would be given a second chance with regard to this penalty after the IRS educates them as to their obligations. I would like to suggest that Congress consider treating all taxpayers in this manner, particularly those who fail to comply in less egregious ways.

C. General Administrative Provisions

Overall, I agree with the administrative recommendations the studies make. I believe that the results of the changes could be good for taxpayers, as long as the Service can reasonably and effectively accomplish the changes. For example, I believe that developing better information systems to track data will yield positive results, but note with caution that the current capacity of the Service to create this type of system is limited. With the implementation of the new computer systems currently under design, however, the ability of the Service to respond to this type of recommendation will be much greater and, therefore, of greater benefit to taxpayers.

From a practical point of view, I would like to add a caveat to the recommendation regarding improved supervisory review of penalty and interest administration and application. Although uniformity and consistency are important goals in any tax system, where multiple reviews of employee decisions are required, employees can feel disenfranchised and may, in an attempt to guard against making mistakes, simply avoid making any decisions. While abatement decisions are inherently a judgment call, it is impossible, if not inadvisable, to force so much consistency that the process is paralyzed. I have seen this happen in other tax agencies with penalty and interest abatement programs with disastrous results. In my opinion, the Service should train employees well and then let them do their work. Review is necessary for the purpose of adjusting the training and correcting misunderstandings.

Finally, I would like to address the Joint Committee's recommendation requiring the IRS to consider using alternative means, such as email or fax, to communicate with taxpayers. I believe this is a reasonable recommendation. There are many new ways to communicate with the taxpayers that could speed processes and improve the system. In fact, I believe the Service is ready and willing to embrace these new technologies. However, because of issues with the confidentiality of tax information and the security of the Internet and the Service's systems in general, Congress may need to reconcile any competing interests by reexamining the restrictions on confidentiality and security.

IV. *Conclusion*

Thank you for allowing me to testify before you today on this important topic. I am delighted that you now have in front of you two studies making recommendations to improve the administration of the penalty and interest provisions of the Internal Revenue Code. There is a great need to simplify this area. Taxpayers are overburdened by the number and complexity of the provisions for penalty and interest.

I urge you to carefully consider these recommendations and enact laws that will make compliance easier and less burdensome for taxpayers.

Thank you.

Chairman HOUGHTON. Thanks very much, Mr. Oveson.

I would like to ask a quick question and then I will pass it along to Mr. Coyne and the other Members of the panel.

Obviously, we want—this is really directed to you, Mr. Mikrut. Obviously, we want to have a disciplined system. Obviously we want to have people be fair and honest with our system. Yet, at the same time, there seems to me sort of a dichotomy between what the Treasury wants to do and what the Joint Committee on Taxation and also Mr. Oveson has suggested that they have made, I think the Joint Committee made some 11 different suggestions, really sort of taxpayer-friendly, and I don't think there has been any response at all from the Treasury.

I mean, for example, the Joint Committee talks about abating interest attributable to unreasonable IRS errors; nothing from the Treasury. Payment of interest on erroneous refunds should be removed; nothing from Treasury. Abating interest on underpayment; nothing. Abating interest that causes injustice; nothing.

So maybe you could explain this. Because at the end of the day, we have to be on the same page here. Because I mean the most important things are our constituents. So maybe you could help me on that.

Mr. MIKRUT. Surely, Mr. Chairman.

With respect to abatements of interest, we have made a recommendation that to the extent that a taxpayer relies on written advice from the IRS, interest should be abated; that we should expand present law that deals with managerial-administerial acts, which Congress has somewhat limited our abilities to include that case, in addition.

However, in looking again at the nature of interest versus the nature of a penalty, we think that it is more appropriate that abatements for interest be more narrowly drawn, simply to reflect the time value money of interest. However, we certainly recognize that whatever provisions are adopted by Congress, we would propose that there be very objective standards for purposes of determining when interest or penalties can be abated so that we are not in a position where it is unclear amongst taxpayers and the IRS when they can and cannot abate interest, and we are looking primarily for guidance in that area from the direction of Congress.

Chairman HOUGHTON. Yes. I guess it is not only an objective test, but it is a human test, and I think that this has to be part and parcel of our thinking here. Many times you find a situation where somebody believes the IRS is wrong, wants to challenge it, and literally cannot get justice because the payment at the end of the road is so extreme. That is one of the things that concerns me. You may have other answers to that.

What I would like to do, however, is to go through the rest of the panel and let them ask questions.

Mr. Coyne, would you like to ask questions?

Mr. COYNE. Thank you, Mr. Chairman.

Mr. Mikrut, Treasury does not agree with the Joint Committee on recommendations to, number one, equalize the interest rate charged to taxpayers and paid by the IRS; number two, to make interest paid to taxpayers on overpayments excludable from income; or three, allow abatement of interest to prevent gross injustice and for all unreasonable delays caused by the IRS.

I wonder if you could explain why does Treasury object to these suggestions, or could you expand on why Treasury objects to these suggestions?

Mr. MIKRUT. Certainly, Mr. Coyne. With respect to equalization of interest rates, as you know, in 1998, Congress equalized the rates for individuals, so what we are dealing with then is the rates that apply to corporations. Congress, in 1989 and again in 1994, created a divergence of rates between overpayments and underpayments with respect to corporations to address certain specific concerns. Those concerns were, one, that corporations perhaps may have been playing the audit lottery and were relying on a relatively low interest rate to the extent they were eventually—deficiencies were later determined, so they put in the AFR plus 5 rate in the late 1980s.

In 1994, the concern was that the corporations could be, in effect, investing with the Federal Government and getting an AFR plus 2 return, when a normal investor with the U.S. Treasury gets a point AFR return. So they reduce the rate on large overpayments of AFR plus a half of a percentage point. We think the policy underlying those two decisions was solid and should be respected.

In addition, Congress has put in global interest netting so that to the extent that there is an overpayment and underpayment running from a corporation at the same time, those two amounts can be netted together if the 4-1/2 percent potential differential is eliminated. And we are working on regulations to further implement global interest netting on a broader basis.

Finally, your last question with respect to the excludability of interest overpayments again relates to the fact that if an individual or a corporation buys a T-bill and earns interest on the T-bill, those amounts are includable in income. However, if they simply invest in the Federal Government by overpaying their taxes, we would think you should get the same result in either case. So the excludability and includability of interest should follow the normal operating rules whether those overpayments, underpayments or the interest thereon relate to taxes or some other form of investment.

Mr. COYNE. I wonder if you could tell me how many times the IRS in fact has abated interest during the calendar year 1994. Do you have any information about that?

Mr. MIKRUT. I don't believe we have the 1999 data yet, Mr. Coyne, but we can supply that to your office as soon as it becomes available.

Mr. COYNE. Would you supply that to us?

Mr. MIKRUT. Yes.

[The following was subseqently received:]

In fiscal year 1999, there were 837,557 abatements of interest with respect to individual taxpayers (totaling $179 million) and 306,326 abatements of interest with respect to business taxpayers (totaling $801 million).

Mr. COYNE. If Congress was to pass legislation in the area of interest and penalty reform this year, in 2000, what changes would be your priorities; that is, Treasury's priorities, and why?

Mr. MIKRUT. I think you should look at again the provisions that affect the most number of taxpayers and where there is this perception of the greatest amount of injustice. We think the failure to file and failure to pay penalties should be restructured, separated, and a lower rate apply. We think doing this would create greater compliance with respect to those provisions and would promote equity.

We also think that there should be some minor tweaks to the deposit penalties, because in those cases, a 10 percent penalty may apply solely because the taxpayer made an error in determining which method to which deposit of payroll taxes, so we think there should be some tweaks there. We think those are the major provisions.

We also believe that in consideration of these legislative changes, we have to take into account again how the IRS can administer them and, again, that really relates to when these provisions should become effective.

Mr. COYNE. Well, both Treasury and the Joint Committee recommend increases in the tax preparer personalities. What are some of the examples of how tax preparers are abusing the tax system?

Mr. MIKRUT. Ms. Paull can also talk to the Joint Committee's recommendations, but what we have observed is that the standards for avoiding the penalty for tax preparers are very much lower than the same standards that we apply to taxpayers. To the extent that taxpayers, particularly individuals, rely upon paid preparers to interpret the law and help with their compliance needs, we think the standards should be the same between taxpayers and their advisors, paid preparers. So we would elevate both standards to be exactly the same.

We also suggest that perhaps in order to be a more effective sanction, the penalty on preparers should be similar to the penalty on taxpayers, the taxpayers as a percentage of the underpayment with the preparers be a percentage of the underpayment or perhaps a percentage of the fees that they generate in that regard.

So I think with respect to paid preparers, the views of the Joint Committee and Treasury are consistent with the goals; it is just the execution of those goals where we may have slight differences.

Ms. PAULL. I would agree.

Mr. COYNE. Thank you.

Chairman HOUGHTON. Mr. Hayworth.

Mr. HAYWORTH. Mr. Chairman, I thank you, and again to our witnesses, welcome.

Mr. Mikrut, I want to follow up on an observation made by the chairman that I think necessitates some amplification and clarification. As I examine the comparison of what the Joint Committee staff and Treasury are recommending, I was struck not only by your testimony, but also by just taking a look, on no fewer than 13 occasions, by my count, I read, "retain present law, no recommendation. Retain present law, no recommendation," again, a baker's dozen times from Treasury. The Taxpayer Advocate recommends 11 changes to the penalty and interest regime.

I would just like to know for the record, did Treasury adopt any of the Taxpayer Advocate's recommendations?

Mr. MIKRUT. The Taxpayer Advocate's recommendations came out after ours, but I think there is some consistency between the two, yes.

Mr. HAYWORTH. The question is, did you adopt any of the recommendations? You put out your report before the Taxpayer Advocate's report?

Mr. MIKRUT. Yes.

Mr. HAYWORTH. So the answer would be no?

Mr. MIKRUT. Well, I think yes, if possible—.

Mr. HAYWORTH. Are you prepared to issue an addendum to formally accept any of the Taxpayer Advocate's recommendations, or is Treasury happy with the status quo?

Mr. MIKRUT. I think we have made several recommendations, Mr. Hayworth, so we are not happy with the status quo. We think with respect to the penalty and interest provisions of the Code a certain amount of caution is warranted for two reasons. One, we have currently a very high degree of compliance and we want to maintain that high degree of compliance. It is often very difficult when you talk to the economists and when you look at the economic literature to determine exactly what the behavioral effects of any interest and penalty change may be, so that is one reason to go slowly.

Second, as I indicated to Mr. Coyne, one of the things you have to take into account is how the IRS can implement these provisions. The IRS is currently going through a major restructuring as mandated by the 1998 act. There were several changes in the Taxpayer Bill of Rights that required reevaluation of some of the provisions that affect taxpayers, particularly with respect to interest and penalties. It may be prudent to see how exactly those programs work before changing them once again. So again although you may think that our recommendations were modest, we think that in a large extent, the compliance program is not necessarily broken, and so caution might be warranted in this case.

Mr. HAYWORTH. You mentioned in your answer behavioral effects. Let me revisit one area. You are recommending, Treasury is recommending, that taxpayers who do not owe taxes or are owed a refund should be charged a service fee for filing a late return. Again, for amplification, how large a fee do you folks at Treasury envision charging these taxpayers?

Mr. MIKRUT. Well, we wouldn't charge anything, Mr. Hayworth. This is something that Congress would have to adopt. But what we are considering—.

Mr. HAYWORTH. Well, let me—what would you recommend that Congress adopt? How would you like to see these folks that owe taxes be penalized? Do you have a fee in mind?

Mr. MIKRUT. Yes. I think the fee would be relatively modest, in the nature of about $50, which would approximate the cost of the IRS to contact the taxpayer for the IRS to prepare a substitute return which is required in these cases. The fee would not apply for first-time offenders, necessarily. It would have to only apply if the taxpayer had a history of not filing tax returns. So it would be more in the nature of we believe a service charge as opposed to a penalty, just reflect the additional cost of the service.

Mr. HAYWORTH. I see. So the citizen—I have it. So you guys aren't really in the service business. The citizen should be held accountable for your extra paperwork. Under current law, is it not true there is no sanction for filing a late return if a taxpayer does not owe taxes or is owed a refund?

Mr. MIKRUT. That is true, Mr. Hayworth.

Mr. HAYWORTH. Here is the fundamental difference in philosophy, Mr. Mikrut, and I thank you for your candor. The Internal Revenue Service should be a service. What you are doing is completely, in the buzz words of the 21st century, reversing the paradigm. You are saying for folks who don't owe anything, by golly, you are going to pay up because you made us spend some time on this case. I would respectfully suggest that in terms of behavioral effects, I believe that is the wrong course of action to take. I thank the Chairman, and I thank you for your answer.

Chairman HOUGHTON. Mr. Watkins.

Mr. WATKINS. Thank you, Mr. Chairman.

You know, I mentioned earlier, and I would like to get back to a letter I sent to Chairman Archer, Chairman Houghton and also the distinguished—I started to say Senator, but House Member from Arizona, J.D. Hayworth and myself sent a letter about global netting, and it looks like to me the Treasury is taking again the most narrow view in dealing with the application and implementation of the global interest netting rules. Let me say that the IRS has come forward in a very narrow way in denying the taxpayer the full measure of relief intended under global netting. The IRS, in the letter I pointed out, is arguing that no interest literally is allowable under subchapter B during the 45-day interest-free period. However, we believe that these interest-free periods, it is just common sense, clearly should be excluded from the interest netting computation there. To do otherwise, it would introduce unnecessary complexity there and also the process would contravene the underlying rationale of our connecting global interest rate equalization.

Why are they taking such a narrow view? Why are they taking such a narrow scope? It is like they totally want to slap the Congress in the face and take the pharaoh's view on this whole situation. And that is not the intent, I can assure you, of those of us up here.

Can you answer that for me?

Mr. MIKRUT. Yes, Mr. Watkins. In looking at the provision that Congress enacted in 1998, we used certain terms, underpayment, overpayment, and the netting of interest. We believe that the use of those terms has to dovetail with the current provisions of the Code so that if interest is not allowable because the IRS would act within 45 days or to the extent that a taxpayer would credit his overpayment to estimated tax payments and therefore does not get any interest, the provision is not applicable, simply by the definition of the terms that Congress used.

If I could use an analogy, for instance, if one taxpayer had an overpayment and petitioned the government for the refund of that, he would automatically get it, without any interest.

So it would seem that the intent of Congress would be to treat that taxpayer the same as a taxpayer that also had at the same time an underpayment running. So that in effect, if you allowed the netting of the two, the taxpayer then who had the underpayment would in effect be getting interest at the AFR plus 2 rate or potentially even the AFR plus 5 rate, which would be against the intent of Congress in not applying or not granting any interest to the first taxpayer. So we try to reconcile those two cases.

Mr. WATKINS. It seems like to me you are making it a lot more complex in the understanding of what you are doing. That is not unusual. We all know if you read a lot of the regulations and all of the other things and some of these revisions and approximations you have made and all. But trying to find that level playing field and making sure we are not penalizing unnecessarily, and if you are not allowing the interest-free periods, that is one area even I think where it is very clear that they are trying to get as much revenue as they can.

I just think, Mr. Chairman, and I would like to—I just want to say thank you for having these hearings today. But I think in some way we are going to have to try to deal into the meat of the coconut and see what we can do about getting down to some of the details. Because it seems very obvious that, as our friend from Arizona has pointed out, not taking any of the recommendations that we have made and trying to work through them, and as a result, we are not getting anywhere, and it is a shame that we have to go to in-depth statutory provisions to try to get something done.

So let me say I look forward to kind of proceeding on this in even greater detail as we go forth. Thank you, Mr. Chairman.

Chairman HOUGHTON. Thank you, Mr. Watkins.

Mr. Portman.

Mr. PORTMAN. Thank you, Mr. Chairman.

I want to commend you for having this important hearing and for directing the subcommittee to try to make sense of the various reports we have before us. I hope we can come up with some recommendations that we can either enact or promote Treasury taking action under its existing authority to relieve some of the taxpayer issues that Mr. Oveson talked about.

I particularly want to thank the Joint Committee on Taxation and Treasury for their reports and then for Mr. Oveson, you getting into it in the Taxpayer Advocate's report that recently came out. This is a tough issue and it is one that there is going to have to be a balance on. It is also a big picture issue in the sense that we have to understand better whether the current provisions of law are increasing or decreasing compliance. I tend to take the point of view expressed this morning, at least indirectly, by Mr. Oveson, which is that the "service" in IRS should mean that taxpayers can get their problems resolved more quickly and with less frustration with the government and that will lead to better compliance. That was really the theory behind so many of the changes that came in 1998, some of which are still not being implemented.

I would just have to take this moment to say that these are the "big picture" kinds of issues that the IRS Oversight Board was meant to look at. Not micromanaging, not specific enforcement matters, but these are the big picture issues that we still are not grappling with at the IRS. I, for one, am extremely frustrated that with all of the changes at the IRS and this continued discussion on this particular issue, and I do have some specific questions for Treasury on this, that we do not have the benefit of the Oversight Board in place. Here we are a year-and-a-half since enactment of the law; one year and, what is today, the 27th, one year and five days after the Administration was required under law to send the names to the U.S. Senate and we still do not have all the names up. I am told every day the final names are going to be up this week or next week. It is an outrage.

Again, I would just say, Mr. Chairman, with all due respect, these are the kinds of issues this subcommittee should be grappling with, but we should also have the benefit of this overview from the IRS Oversight Board which would be private and public members who could look at some of these bigger picture questions.

Mr. Oveson got into this notion that in many cases, taxpayers want to comply but they cannot pay the penalties and interest, and you mentioned, Mr. Oveson, some of the specific cases you are grappling with every day, for instance partnerships and tax shelter litigation. I will agree that the intention of the Treasury with the RRA, the IRS Restructuring Reform Act, that was passed in 1998, does deal with this issue, particularly in the area of offers and compromises, and it deals with the abatement issue. I am disappointed that the Treasury has not been more aggressive in following the direction of the RRA. It specifically directed the IRS to prescribe guidelines to determine when an offer and compromise should be accepted. I refer you to the report language of the conference report that says that in formulating these rules, the IRS should take into account such factors as equity, hardship and public policy where a compromise of an individual taxpayer's income tax liability would promote effective tax administration.

That is in the report. The legislative history also specified that IRS should utilize its new authority "to resolve long-standing cases by foregoing penalties and interest which have accumulated as a result of delay in determining the taxpayer's liability." Per Mr. Oveson's comments, here is a guy who has to deal with this all the time because he has said these taxpayers are calling his office, they are calling his taxpayer advocates in districts around the country. I know in July of 1999, July 21st, the IRS issued proposed regulations, but they failed to incorporate this goal of using the offer and compromise to abate accumulated interest charges in these long-standing cases Mr. Oveson talked about. The preamble to the proposed regulations actually acknowledges this failure and asks for public comment.

My question to you this morning, Mr. Mikrut, if I might, is can you explain what Treasury's position is on this and whether you expect to incorporate, this what I think is clear congressional intent, more fully in your final regulations?

Mr. MIKRUT. Sure, Mr. Portman.

As you mentioned, the conference report says that it is the anticipation that the IRS would put into the regulations, in consideration of the offer and compromise program, factors of equity, hardship and public policy which we interpret to promote effective tax administration. Our goal in putting out the regulations last year was for the need for immediate guidance. We believe that the rationale for amending section 7122, the offer and compromise program, was a perception that there was inconsistent treatment perhaps amongst different taxpayers in different parts of the country under the existing standards. So what we wanted to do was provide immediate guidance to the field on how the program should be used. We wanted to use as many objective standards to promote such consistency as possible, recognizing that we could not cover all cases immediately. For that reason, we went out as temporary and proposed regulations, so that the temporary nature would obviate the cases that we knew we had a handle on, cases of hardship and equity, and to try to ask for comments on the more difficult cases, and delay is admittedly one of those cases. Because there may, in fact, be somewhat of a tension between delay and equity, two things that the conference report tries to get at.

For instance, it is often unclear when delay is caused by the taxpayer as opposed to delay caused by the IRS, and how to you unscramble the eggs in that case. To the extent that delay is caused by the taxpayer, equity would seem to say that you should not abate interest, or to the extent that delay is caused by a taxpayer, which would seem to indicate that you should not abate the interest. On the other hand, the regulations do provide, though, that even if delay is caused by the taxpayer, if charging the taxpayer interest would create a hardship, the abatement is still possible in the offer and compromise program.

So what we propose to do is put out the three standards that we currently put out. We are closely monitoring the program. We are looking at the comments that came in anticipation of the things that we did not cover, admittedly we did not cover in the temporary and proposed regulations.

Mr. PORTMAN. Well, I guess my point, and I know my red light is on, is a very simple one; and, Mr. Oveson, perhaps you can comment on this later, which is that I think you have the authority under current law to be much more aggressive in resolving these cases, particularly with regard to delay. I am disappointed you haven't already come out with those regulations. I understand the need for consistency. I think that was not inconsistent in also dealing with some of the other issues. I would just hope that Mr. Oveson will continue to push internally and perhaps we need additional direction from Congress, although I don't think it is necessary. In response to the Chairman earlier, you indicated that you were looking for some more legislative direction with regard to abatement. I think in this area of offer and compromise you have it, and I would hope the Treasury would take advantage of that.

Thank you, Mr. Chairman.

Chairman HOUGHTON. Thank you very much, Mr. Portman. Mr. McInnis.

Mr. MCINNIS. I have a couple of questions here I would like to ask and then have you answer them after I conclude my questions.

First of all, there are some very, what you would probably consider minor penalties that are extremely aggravating to taxpayers out there, that I am not sure are being addressed in your notes. Maybe I missed those notes. One of them, for example, if a payment falls below a certain amount; for example, one penny, the tax is short one penny, your computer banking kicks out an automatic penalty letter which is entirely unproportionate to the one penny of tax not paid. That letter contains within it certain threats to garnish accounts and so on.

I asked the IRS and did not receive a satisfactory—I got a response, it seemed to be satisfactory, but no satisfactory action, in which why couldn't the IRS put into their computer program that any underpayment say of $20 or use some percentage that before an automatic action is kicked out by the computer, that a supervisor would have to approve it, so you are not sending out threatening letters which only put a black eye on the IRS, which is exactly what they did for one penny in a couple or two or three different cases that I have, number one.

Number two, another penalty, I have a rancher in my area, he hired, had some hired help, had he sent in the payroll tax, apparently the IRS sent you a payment book with coupons after you have had the employee for a year. So he is accustomed to sending in the payment, he made his tax payment on time, after the year he got his coupon book, he failed to send in the coupon. He sent in the payment, but anyway, he sends in the payment, doesn't have the coupon with it, so they nail him with a 10 percent tax, only because of the fact that the coupon itself, not the payment, but the coupon itself was not in the envelope. I mean those kinds of things that don't make any sense.

The other thing that I would ask you to respond to and that is that the Taxpayer Advocate, I would like to know your official response that the IRS should have the discretion to abate interest in such cases where taxpayers, through no fault of their own, bear additional financial burden because of actions of the Service. For example, if a taxpayer is trying to get you on a phone or if a taxpayer is trying to schedule an audit or sit down with the IRS because they are so busy, cannot schedule for a period of time or cannot get back to these people, it would seem to me that in fact, it was a good faith effort on behalf of the taxpayer and it was truly the fault of the IRS that they should have the authority to abate the interest that is accumulating between the period of time that they should have been able to meet with the client and the period of time that due to their own fault they were able to meet with the client. So those are the three areas, the two you could probably put into one class, and then the third. If you could comment on those, I would appreciate it.

Mr. MIKRUT. Mr. McInnis, let me respond to at least your first two hypotheticals, or perhaps real cases.

Mr. MCINNIS. Let me just say they are not hypotheticals, first of all. They are factual cases. Thank you.

Mr. MIKRUT. Again, the thing to keep in mind in proposing legislation and when we propose regulations with respect to the penalty and interest provisions is what exactly can the IRS administer at this time, and we try to work closely with the IRS with respect to all of these proposals. I would agree that it would seem very strange that computer-generated deficiency for a penny would go out with everything that is normally intended to these sorts of things. On the other hand, without automation and requiring each notification to taxpayers be reviewed by someone, we create even further delay, which somewhat gets into your last case of what is unreasonable delay and what is not.

With respect to your issue on the rancher, we have proposed, to the extent that a deposit payment was made in the wrong form or in the wrong manner that we would not impose the 10 percent penalty and that if the payment is there on time, we would only look to the lateness of the payment and then perhaps only charge an interest-like fee to the extent that the payment was one day or less late. So to that extent we have addressed that case.

Finally, we have had a discussion earlier today on the unreasonable delay for interest abatement, and again, I think the difficulty there is trying to promulgate objective standards so both taxpayers and the Service know who has the burden for delay and how do you rationalize between who has the responsibility for moving the case forward. Those are my answers to your three questions.

Mr. MCINNIS. Thank you.

Chairman HOUGHTON. Thanks very much.

Mr. Weller.

Mr. WELLER. Thank you, Mr. Chairman. I would just begin by wishing you a happy new year. It is good to be here for the first subcommittee hearing of the year. I also want to congratulate you for the new technology I see we are using for the light out there. No longer have those little bulbs, now modern and concise in green, yellow and red, but still right where it should be.

I have a question for the gentleman from Treasury, actually a couple of questions, and they built really on what Mr. McInnis was referring to. The gentleman from Treasury referred to the example of someone underpaying by a penalty and the gentleman from Treasury referred to that as hypothetical. Well, I happen to have one of those hypothetical examples right here. I am going to, of course, put this letter into the record. But Dr. Bruce Smith, who operates a foot and ankle clinic in Frankfurt, Illinois in the south suburbs of Chicago that I have the privilege of representing, has a computer-generated form here dated, it looks like March 22, 1999. It is a request for payment. It says, “Our records show you owe 1 penny on your return for the above tax period.”.

The letter goes on to say, “To avoid additional failure to pay penalty and interest, please allow enough mailing time so that we receive your payment by a certain date. Make your check or money order payment to the United States Treasury, including the taxpayer identification number” and so forth. It says, “If you feel we have made a mistake, please call us,” and of course points out on the tax statement that the underpayment was one penny, one cent, and of course they were penalized $100 for being one cent short in paying their taxes. Since you are the representative of the Treasury, I would just like to ask you to explain that and justify it.

Mr. MIKRUT. Well, that is both difficult to explain, since I am—other than your letter, I don’t know the facts and what the penalty relates to.

Mr. WELLER. It is on your letterhead, the Department of the Treasury, IRS.

Mr. MIKRUT. And it is even harder to justify. Just as saying that it is hard to justify why Visa sends my dog a request to get a credit card. I think computerization both facilitates tax administration and will create some anomalous results, and I think without knowing more about the facts in your case, it sounds like this is one of those anomalous results.

Mr. WELLER. Do you have a certain threshold if, in this case someone owes one cent in which somehow a program you have developed to kick them out so you reconsider? I imagine the cost of generating this letter was far more than 1 cent, and the amount of time that was invested in it, as well as computer time and paper and so forth. Do you have some sort of program in place where you watch for these things?

Mr. MIKRUT. I am probably not the right person to respond to exactly what current computer capabilities of the IRS are, Mr. Weller, but I can get back to you with respect to that.

In our report to Congress on the interest and penalty provisions, we had made recommendations that in cases where the amounts are de minimis, particularly with respect to the estimated taxes where some very de minimis amounts generate automatic penalties, that those penalties be waived. So we agree with the spirit of what you are—the case you are pointing out. There are certain instances where it may be appropriate that even though an amount is due and owing, that it is not worth the effort to generate the correspondence between the taxpayer and the IRS.

Mr. WELLER. Have you ever figured out what the actual cost of generating this letter and sending it to the taxpayer would be?

Mr. MIKRUT. I don't have that with me either, Mr. Weller.

[The following was subsequently received:]

The cost of generating notices to taxpayers depends in part on whether the notice is systemically generated or manually prepared by IRS personnel. A systemically-generated notice costs, on average, $1.05 (including postage, paper and direct labor costs).

Department of the Treasury
Internal Revenue Service
KANSAS CITY, MO 64999

Date of this notice: MAR. 22, 1999
Taxpayer Identifying Number
Form: 9 1 Tax Period: DEC. 31, 1998

For assistance you may call us at:

1-800-829-8815

FRANKFORT IL

REQUEST FOR PAYMENT

FEDERAL EMPLOYMENT TAX

OUR RECORDS SHOW YOU OWE $100.01 ON YOUR RETURN FOR THE ABOVE TAX PERIOD.

TO AVOID ADDITIONAL FAILURE TO PAY PENALTY AND INTEREST, PLEASE ALLOW ENOUGH MAILING TIME SO THAT WE RECEIVE YOUR PAYMENT BY APR. 12, 1999. MAKE YOUR CHECK OR MONEY ORDER PAYABLE TO THE UNITED STATES TREASURY. SHOW YOUR TAXPAYER IDENTIFICATION NUMBER OR YOUR IDENTIFYING NUMBER ON YOUR PAYMENT AND MAIL IT WITH THE STUB PORTION OF THIS NOTICE.

IF YOU THINK WE MADE A MISTAKE, PLEASE CALL US AT THE NUMBER LISTED ABOVE. WHEN YOU CALL, PLEASE HAVE YOUR PAYMENT INFORMATION AND A COPY OF YOUR TAX RETURN AVAILABLE. THIS INFORMATION WILL HELP US FIND ANY PAYMENT YOU MADE THAT WE HAVEN'T APPLIED.

TAX STATEMENT

TAX ON RETURN	$8,296.17
TOTAL CREDITS	$8,296.16
AMOUNT PREVIOUSLY REFUNDED TO YOU	$.00
UNDERPAYMENT	$.01
*PENALTY	100.00
*INTEREST	.00
AMOUNT YOU OWE	$100.01

THE FOLLOWING IS A LIST OF PAYMENTS WE HAVE CREDITED TO YOUR ACCOUNT FOR THE ABOVE TAX AND TAX PERIOD.

DATE OF PAYMENT	AMOUNT	DATE OF PAYMENT	AMOUNT	DATE OF PAYMENT	AMOUNT
NOV. 7, 1998	743.76	DEC. 8, 1998	735.20	JAN. 6, 1999	757.20
JAN. 15, 1999	5,060.00	FEB. 3, 1999	1,000.00		

Mr. WELLER. Okay. That would be an interesting number to know, particularly if that cost you $100 to send this form letter out and timewise, staffwise and so forth. But I would very much like to—I look forward to hearing your response, if you can get us the information.

The other issue I want to ask you about is something a number of us on this committee were greatly concerned about as we worked to move the legislation to reform the IRS, and it was an issue where we really met great resistance from your department, and that was the issue of dealing with the unlucky, innocent spouse, in many cases where you had in most cases a divorced single mom with the kids, in many cases the struggling, working mom not always responsible for having the kids, but found out that her former spouse was a deadbeat in paying child support and then later on discovered that thanks to being contacted by the IRS, that there is a problem with the taxes. And in many of those cases, that unlucky, innocent spouse had no responsibility, no involvement, but because the IRS could find her, they sent her the bill and of course were trying to hold her accountable.

One of the key reforms that we were successful in doing and we were able to change around your department, because you resisted us during this process, and I really wanted to get a report from you on what the status of our reforms to help those unlucky, innocent spouses, what kind of information you can provide me on how many have qualified for the provisions that we included in the IRS reforms and of course how your department has been responding to those requests to be qualified as an unlucky and innocent spouse.

Mr. MIKRUT. Again, I can get you that information. The program is ongoing. We have recently just this last month issued additional guidance with respect to when an innocent spouse would qualify for relief. We have directed the field that there are certain cases where relief would be automatic. We also gave a list of facts and circumstances that should be taken into account. The guidance we released I believe greatly liberalizes the areas. It piggybacks quite extensively with the offers and compromise guidance we put out earlier in the year to look at when there would be hardship with respect to trying to collect amounts due and owing from the innocent spouse. Again, it will take some time before this guidance trickles down to the district level and is actually applied on a case-by-case basis, but I will try to get you the preliminary numbers.

[The following was subsequently received:]

As of March 1999, the IRS implemented an administrative tracking system to monitor the number of innocent spouse claims received and the processing of such claims. Based on information provided by the IRS from its new tracking system, approximately 56,000 innocent spouse claims were received since inception of the tracking system through December 31, 1999. The IRS estimates an additional 7,000 claims were received and addressed prior to implementation of the tracking system. Of the 63,000 claims received, as of December 31, 1999, approximately 34,000 claims were awaiting consideration or in the process of review. The remainder either were resolved on the merits, were in various stages of post-determination administrative or judicial review, or did not satisfy the minimum criteria for consideration (for example, no liability remained). The IRS is taking steps, where resources permit, to shorten the processing time and reduce its inventory of unresolved claims to ensure that innocent spouse claims receive timely and careful review. Treasury's Office of Tax Policy is working with the IRS to issue timely guidance with respect to these new provisions.

Mr. WELLER. Mr. Chairman, I see my red light, if I could just have one follow-up question on this.

This issue, of course, has brought the attention of my constituents. I have about a dozen unlucky spouses a year contact my office throwing up their hands in frustration because of their circumstances and of course having the IRS showing up at their door, so this was an important reform.

Let me ask this. Obviously, you are implementing this now, and I look forward to getting the information from you if you would send it to me in answer to my questions.

Do you have any idea what the timetable is, the amount of time it takes you to process that claim and respond, when someone makes that, from a penalty and interest standpoint, how do you treat that individual that is applying to be qualified as an unlucky, innocent spouse.

Mr. MIKRUT. I will try to get you that information as well, Mr. Weller.

[The information was not available at the time of printing.]

Mr. WELLER. Okay. Thank you, Mr. Chairman.

Chairman HOUGHTON. Mr. Coyne.

Mr. COYNE. Thank you, Mr. Chairman.

Ms. Paull, your committee recommends making interest paid to taxpayers by the IRS excludable from income.

Ms. PAULL. To individual taxpayers, that is correct, Mr. Coyne.

Mr. COYNE. How would you suggest that this helps the IRS and how does it help the individual taxpayer?

Ms. PAULL. Well, right now I think the individual taxpayer perceives the tax system as somewhat unfair because even if their interest relates to an underpayment from their business activities where most interest is deductible, they do not get to deduct the interest paid to the IRS.

In our looking at the data, there is not a lot of interest paid to individual taxpayers by the IRS. Most people try to kind of get their taxes as close to their liability as they can and pay them in, you know, through withholding or estimated tax payments. But to the extent you overpay your taxes, we felt there was a perception that the Tax Code was unfair in the sense that if you underpay, you pay interest on it, you don't get a tax deduction. Also, of course, if you—and then if you overpay, the interest is taxed to you.

So rather than revisiting the decision that was hard-thought, I think, during the 1986 act, that interest paid to the IRS on an underpayment is not deductible, we thought it would be useful to recommend, really for fairness reasons, to exclude the interest that is paid to individual taxpayers. Our recommendation specifically did not go to corporate taxpayers who do get a tax deduction for interest paid to the IRS, and therefore, the interest, any interest that would be paid by the IRS or the Federal Government to the corporate taxpayer should be includable income. There would be equality of treatment of those payments.

Mr. COYNE. I would like to ask both you and Mr. Oveson the same question I asked Mr. Mikrut. If Congress was to pass legislation in the area of interest and penalty reform this year, what changes would be each of your priorities and why would you make those recommendations?

Ms. PAULL. Well, I would have to say that the overhaul of the interest provisions would be a very high priority. I guess we think—we like all of our recommendations, so we would hope that you would seriously consider them all, because we spent a lot of time and effort working both with the administration and outside groups on them. But I would say that there is—we had kind of a global interest set of proposals and I would hope that would be given the highest priority, because as you probably know, many people do complain a lot about the interest provisions in the Tax Code and they are very complicated.

Mr. COYNE. So each of them carries about the same priority? Each recommendation that you have made carries about the same priority?

Ms. PAULL. Well, all of the recommendations we hope you will consider, but I would also hope that you would give the highest priority to the interest recommendations, especially for a single interest rate and that would reduce a lot of complexity, and also converting the estimated tax payments into interest payments and also allowing taxpayers to place money on deposit that are in dispute to stop the running of interest. All of those really do work together, and we would hope you would give some serious consideration to that.

Mr. COYNE. Mr. Oveson.

Mr. OVESON. Mr. Coyne, I would agree with Ms. Paull that abatement of interest would be my top priority. I think I have made that pretty clear over the last year-and-a-half, of having more ability and authority to deal with the abatement of interest. The reconciling of the rates to a single interest rate, I think that is really important. And the whole interest netting issue would basically go away if you were to equalize those interest rates. The interest netting provisions and the interest netting issue is phenomenally complicated and extremely difficult for the IRS to deal with, as well as industry to deal with. It is a big deal.

The failure to pay issue, I think that affects a lot of taxpayers, and it is a complicating issue to the Code. I would put it number 3.

Mr. COYNE. On the issue of the IRS charging taxpayers interest due and it is due, in part, because the IRS caused the delay for which the taxpayers have no control, could you give us some examples of that?

Mr. OVESON. I gave you one example in my testimony where an examination is in process and the examiner is called away to go to customer service phone lines. If the exam were finished earlier, that interest would stop sooner, because then the taxpayer would know there was an assessment. Because the examiner went away, they did not know they owed anything, and therefore, I think that is a problem that is caused by the IRS.

Mr. COYNE. Is there any other?

Mr. OVESON. Oh, there are all kinds of them. Where—I am drawing a blank right now in thinking of them, but maybe I can think of something later.

Mr. COYNE. Well, maybe you can make some available to us. Thank you.

[The following was subsequently received:]

All of the following examples assume that the taxpayer did not significantly contribute to the delay.

• A taxpayer received a notice from IRS involving a complicated situation. The taxpayer frequently asked the IRS to transfer the case to a field office so the taxpayer could meet face to face with IRS. The request was consistently ignored but eventually, the case was transferred to the field and settled. Once the decision to transfer the case was made, the transfer was accomplished timely. Interest could not be abated.

• A taxpayer was audited and disagreed with the adjustments. The taxpayer went to Appeals, but the case was delayed and there was no activity for over one year. The taxpayer presented letters to the Appeals Officer to have the case transferred to another office due to the length of time it was taking to work the case. The Appeals Officer did not work on the case, due to his workload, and the transfer was denied. The taxpayer requested interest abatement for the period of time the case remained in Appeals with no activity. The request was denied.

• An account is restricted from generating penalty and interest and a manual computation must be done whenever tax changes or payments post. A notice is generated in the service center for a re-computation. This is low priority work and it can be a long time before the taxpayer gets a bill with the recomputed amount. During this time, interest continues to accrue.

• An IRS employee advised a taxpayer of the wrong balance due. The taxpayer paid that balance believing he/she was paid in full. However, the employee computed penalty and/or interest incorrectly.

• An IRS employee provided an incorrect payoff amount to a taxpayer. The taxpayer's account had an "interest computation hold" indicator on the module. The employee who gave the payoff amount neglected to take the "interest computation hold" on the account into consideration. The taxpayer borrowed money and took a second mortgage to full pay the account. The taxpayer later received a bill for the Interest.

A taxpayer liquidated assets to pay the balance due as computed by IRS. The Revenue Officer entered the incorrect year when calculating penalties and interest and the taxpayer still owes a years worth of interest.

• A Corporation was audited and the Revenue Agent gave the taxpayer a payoff amount. The Revenue Agent used the wrong calculation in computing the interest. The Corporation paid the entire pay off amount to the Revenue Agent. Then the Corporation received a notice for the correct amount of interest.

• A deceased taxpayer's 1995 return was filed reflecting estimated tax payments of $58,986.00. The Center input this amount as withholding and refunded the amount to the taxpayer on March 20, 1998. The check was voided and returned to the IRS. IRS again released the overpayment and refunded it to the taxpayer. Again the check was voided and returned to the IRS. Then the IRS manually refunded the money on July 10, 1998. This time the taxpayer's representative deposited the money until the error could be cleared up. IRC 6404(e)(2) allows us to abate interest that accrued on the refund from the refund date to the date of demand for repayment, (regardless of how long the taxpayer had use of the refund) as long as the taxpayer did not cause the erroneous refund and the erroneous refund is less than $50,000. In this case, the interest could not be abated.

• A taxpayer was one of four partners and the other partners were involved in fraud. When the taxpayer was made aware of the fraud, he assisted IRS in securing the information for conviction. He had no fraud involvement. In November 1990, the taxpayer asked IRS for a pay-off amount. He was advised that the information could not be provided at that time and not to worry until he got a bill. The taxpayer was informed of the proposed tax liability of $113,767 in December 1997. The taxpayer full paid this liability in February 1998, which was before the actual assessment date in March 1998. The taxpayer then received a bill for $115,667.89 in interest, covering the full eight years of the investigation. The taxpayer appealed and it was denied.

Taxpayers invested in TEFRA shelters. The cases are suspended in the TEFRA Unit while a key case is worked. When a case is ready for final closure, the 120 percent interest rate frequently makes it impossible for the taxpayer to pay.

• A taxpayer was not notified of a balance due because the amount of tax owed was so small. The taxpayer paid the balance due immediately upon notification and now asks for abatement/refund stating he had not received statements advising him that interest was owed.

Chairman HOUGHTON. Thank you very much. We are going to close off this panel and we thank Mr. Oveson and Mr. Mikrut and Ms. Paull.

Mr. WATKINS. Mr. Chairman, could I have one quick question.

Chairman HOUGHTON. Okay. Shoot.

Mr. WATKINS. Maybe to each of you quickly, it will not require a long answer, and, Ms. Paull, we will start with you.

Do you have any question at all that the intent of this subcommittee was to provide that interest rates be equalized, so that neither the government or the taxpayer was financially disadvantaged by the interest rate differential during all periods of overlapping mutual indebtedness? Do you have any question that was our intent at that time?

Ms. PAULL. Are you referring to the 1998 change that affected the global netting?

Mr. WATKINS. Yes.

Ms. PAULL. I would have to say, although I do not know what this committee's intent was, but I was working for the Senate Finance Committee, and we were aware, to be perfectly frank with you, Mr. Watkins, that there were complicating issues like the 45-day period for which interest did not—the taxpayer was not entitled to interest on an overpayment during those 45-day periods. We were aware that, and I believe, I am pretty sure the revenue estimate did not take into account giving interest netting during that period. I would say that we, in doing this report, we took a hard look at the interest netting rules and decided it would be more—it would be a—a better approach would be to have a single interest rate rather than to have to go through a lot of complicating—this is a very complicated proposal.

So unfortunately, it was not in connection with this committee.

Mr. WATKINS. I think the intent was very clear. That is the point I want to try to make of our actions here, Mr. Chairman. That is what I am trying to get across. I think it is very clear and I think we need to see that Treasury takes some action to meet the intent of this subcommittee. Thank you.

Chairman HOUGHTON. Okay. Thanks, Mr. Watkins. Well, thank you very much, Ms. Paull, Mr. Mikrut, Mr. Oveson. We certainly appreciate you being here.

Now I will introduce our second panel. Ms. Judith Akin, who is an Enrolled Agent in Gaithersburg, Maryland and a member of the National Association of Enrolled Agents. We have Mr. Ronald Pearlman, Chairman of the Task Force on Corporate Tax Shelters of the American Bar Association Section of Taxation, and a professor at Georgetown University Law Center; Mr. Mark H. Ely, on behalf of the Tax Division of the American Institute of Certified Public Accountants; and Mr. Charles W. Shewbridge, Chief Tax Executive of the BellSouth Corporation in Atlanta, Georgia, and President of Tax Executives Institute, Incorporated.

Thank you very much for being here. We look forward to hearing your testimony. We are going to try to move this thing along so that we are through here at 12 o'clock. I am sorry it has taken so long. So if you would take your place, we would appreciate moving along.

Ms. Akin, would you like to start your testimony, or Mr. Watkins, would you like to introduce Ms. Akin?

Mr. WATKINS. Well, I am glad she arrived. I told her I would see her here.

Chairman HOUGHTON. All right, great. Ms. Akin, please start your testimony.

STATEMENT OF JUDITH AKIN, ENROLLED AGENT, JAA ENTERPRISE, L.L.C., OKLAHOMA CITY, OKLAHOMA, AND MEMBER, BOARD OF DIRECTORS, NATIONAL ASSOCIATION OF ENROLLED AGENTS, GAITHERSBURG, MARYLAND

Ms. AKIN. Mr. Chairman, members of the subcommittee, I am Judy Akin, an Enrolled Agent, and I am the immediate past chair of the IRS Information Reporting Program Advisory Committee and an officer and member of the board of directors of the National Association of Enrolled Agents. I have been an Enrolled Agent for more than 25 years and maintain a private practice in Oklahoma City, where I work with individual and small business taxpayers.

Today, I am representing the National Association of Enrolled Agents whose more than 10,000 members are tax professionals licensed by the Department of the Treasury to represent taxpayers before all administrative levels of the Internal Revenue Service.

I am pleased to have this opportunity to testify before you on the subject of interest and penalty reform. I would like to summarize my testimony, and without objection, submit my written testimony for the record.

We appreciate that these hearings are being held today and hope that penalty oversight will become a regular part of this subcommittee's schedule. We do applaud the IRS's recent steps to improve the administration of penalties. These include permitting taxpayers to designate the application of tax deposits to minimize tax deposit penalties, the resolution of crediting payroll and self-employment taxes in certain nonfiling situations, and the continuation of problem-solving days. We would also like to mention that the IRS has decided to expand the ability for both individuals and Businesses to warehouse tax payments under the Electronic Federal Tax Payment System (EFTPS). While the system will not be up and running until after July 1, we believe this will go a long ways towards remedying problems some taxpayers have in meeting Federal payroll deposit rules and estimated tax payments. We have found continual problems with the assessment of penalties on small businesses, individual taxpayers, particularly the elderly, and small nonprofit organizations.

This is, indeed, a difficult area of administration perhaps exemplified in a recent article in Tax Notes which uses the following phrase in describing Treasury as having trouble figuring out where one liability ends and punishment begins. It is an extremely apt phrase capturing in a nutshell the effect of the provisions requiring moderate income taxpayers to pay approximately 110 percent of the prior year's tax in order to avoid penalties. In addition, it penalizes the taxpayer for having to pay extra tax advisory fees to see their practitioner to help avoid the penalty. Our list of suggested changes includes simplifying and streamlining the assessment of tax penalties. We believe the IRS has the right to collect interest for time value of money used, but we also believe that penalties which are predetermined as harsh provide a counterproductive effect that does not encourage taxpayers to come forward.

We believe the IRS is doing an excellent job of outreach to the small business community. However, even more needs to be done. With respect to small community-based nonprofits, we find understanding of their tax responsibilities to be a perennial problem. Often, these organizations have volunteer leadership which changes from year to year and frequently we find there is no permanent staff or records or if they have them, they are very incomplete and spotty. We are looking at the new tax-exempt government entities division of the Internal Revenue Service to provide leadership in this area.

We have also received many comments about taxpayers, particularly senior citizens, being caught up in penalties where they are caught unaware. Steps need to be taken immediately to lessen the impact of penalties on these taxpayers. As our society moves toward more self-managed retirement plans such as IRAs and 401(k)s with required distributions, there are many opportunities for senior citizens to run afoul and have these savings taxed away.

In our testimony we have provided many examples of what is happening to small businesses as well as individual taxpayers. These are real problems; these are problems that we are facing every day.

At this time I would like to thank you for the opportunity to present our views and I would be happy to answer any questions.

[The prepared statement follows:]

Statement of Judith Akin, Enrolled Agent, JAA Enterprise, L.L.C., Oklahoma City, Oklahoma, and Member, Board of Directors, National Association of Enrolled Agents, Gaithersburg, Maryland

Mr. Chairman and members of the subcommittee, I am Judith Akin, Enrolled Agent. I am the immediate past chair of the IRS Information Reporting Program Advisory Committee and I am an officer and member of the Board of Directors of the National Association of Enrolled Agents. I have been an EA for more than 25 years and maintain a private practice in Oklahoma City, Oklahoma where I work with individual and small business taxpayers.

Today I am representing NAEA whose more than 10,000 members are tax professionals licensed by the U.S. Department of the Treasury to represent taxpayers before all administrative levels of the Internal Revenue Service. I am pleased to have this opportunity to testify before you on the subject of penalty reform.

As you know, Enrolled Agents were created in 1884 to ensure ethical and professional representation of claims brought to the Treasury Department. Members of NAEA ascribe to a Code of Ethics and Rules of Professional Conduct and adhere to annual Continuing Professional Education standards, which exceed IRS requirements. Like attorneys and Certified Public

Accountants, we are governed by Treasury Circular 230 in our practice before the Internal Revenue Service. We are the only tax professionals who are tested by the IRS on our knowledge of tax law. Since we collectively work with millions of taxpayers and small businesses each year, Enrolled Agents are uniquely positioned to observe and comment on the average American taxpayer's experience with our system of tax administration.

THE NEED FOR PENALTY REFORM

Since our testimony before the Commission on Restructuring the IRS in 1997, NAEA members have frequently spoken out on the need for penalty reform. We were pleased to see this issue addressed by the Joint Committee on Taxation and the Treasury in recent reports to Congress. Portions of the National Taxpayer Advocate's Report add to the discourse. However, we would not wish you to think that reforms are not already underway. We are pleased to note that a major "fairness" issue has been resolved. Full credit is now being given for Social Security and self-employment taxes paid in. In the past, if a taxpayer failed to file a tax return for more than three years, even if there was a refund due and all taxes were paid in timely, the taxpayer was not credited by the Social Security Administration for the FICA and SE taxes paid in. Yet the IRS insisted on collecting these same taxes. The procedure is now that, if the government is paid the taxes, it credits the taxpayer's account. We are very pleased that the procedure has changed.

IRS problem solving days continue to provide a safety valve for resolution of some long-standing cases. We applaud IRS' consistent effort in this area. At the end of the day, we believe they are doing the right thing in making their best people available to help get cases resolved and closed, thus reducing penalties and interest imposed on taxpayers.

CORPORATE TAX SHELTERS

We realize that the issue of corporate tax shelters is not before us today and was addressed at a hearing in November. We would respectfully urge the members of this subcommittee to understand the impact of these devices on the compliance of average taxpayers. Our tax system is based on voluntary assessment. If average taxpayers believe that those who faithfully pay their taxes are foolish, then you will see a commensurate increase in noncompliance.

You may recall that one impetus for the Tax Reform Act of 1986 was that large corporations were "zeroing out" on their taxes. Middle class taxpayers realized they were paying more in taxes than major corporations. Were the tax breaks of the time legal? Yes, but they undermined our tax system. Its perceived fairness is critical to its success. Speaking as someone from the heartland, I urge you to maintain taxpayer confidence in the integrity of our tax system.

RESPONSE TO THE NATIONAL TAXPAYER ADVOCATE'S REPORT

While the National Taxpayer Advocate's Report covers a variety of topics, I would like to comment on several that concern penalty issues.

Problem #5: Penalty Administration

Consistency in imposing penalties and consistency in abating them is an issue that needs the continued attention of appropriate IRS personnel. We would agree with our colleagues at the Tax Executives Institute that this is a problem needing prompt attention in order to maintain confidence in the fairness of the system. The coordinated review recommended by TEI is one we would endorse.

Problem #8: Innocent Spouse

We are pleased that on January 18, 2000 IRS issued final guidance for taxpayers seeking equitable relief from federal tax liaiblity under IRC Sections 6015(f) and 66(c) pursuant to the Tax Restructuring and Reform Act of 1998. These claims for innocent spouse relief are among the most difficult and time-consuming for practitioners to deal with and we welcome IRS guidance in resolving them.

Problem #10: Misapplication of Payments

NAEA concurs with the National Taxpayer Advocate that this is a continuing problem but not a severe one based on our considerable experience with the Electronic Federal Tax Payment System. Our direct experience is that mistakes are few and that they are, for the most part, quickly corrected. We remain optimistic that as IRS personnel, taxpayers and practitioners become more accustomed to this and other new methods of payment, errors will be even fewer than they are now and will be quickly resolved.

Problem #15: Compliance Burden on Small Business

We would agree that the IRS has made significant strides in terms of reaching out to the small business community to help educate and thereby reduce the compliance burden on this sector of the taxpaying public. The Small Business CD-ROM developed by the Office of Public Liaison and Small Business Affairs is an excellent tool that can help small business owners maximize the assistance available through the IRS. Another excellent program is the Federal Tax Deposit School that is run much like "traffic school" which a business owner must attend when he/she has run afoul of the deposit rules. It is being replicated around the country with Enrolled

Agents working with IRS employees to ensure that small business gets the information early, understands the importance of tax withholding, and has the opportunity to get back into compliance and remain there.

We are also very pleased with IRS' recent decision to permit taxpayers to designate the payment of federal tax deposits so as to minimize penalties. Taken together, these are very positive steps leading to greater fairness in the system.

Problem #18: Understanding Federal Tax Deposit Problems

NAEA concurs with the National Taxpayer Advocate that this area is in need of revision. At present, many of the rules are overly complex and subject to change which the small business community, in particular, is unable to keep up with. We are also concerned about the impact of frequent changes upon the newest and smallest businesses, those that do not yet have the resources to hire professional assistance for tax and accounting work.

Dispute Mitigation

NAEA concurs with the National Taxpayer Advocate that penalty administration contributes to significant problems facing taxpayers. It would be extremely helpful if penalty abatement could be consistently available, particularly in those areas where taxpayers have made innocent mistakes. The cases NAEA has brought to the subcommittee should provide some understanding of the dimensions of this problem in that affects not only small businesses but also elderly taxpayers and small, community-based nonprofit organizations.

CASE STUDIES

More than half of NAEA's members are online. As a result, NAEA regularly surveys its members for their views and experience on various issues. The survey on penalty reform generated scores of replies. They break down into several areas: those affecting small business, those affecting senior citizens, and those affecting small nonprofits. We examined these reports from our Members through the prism of 1) voluntary compliance; 2) fairness in operation; 3) whether a deterrent to undesirable behavior; and 4) whether the penalties were capable of effective and efficient administration by the IRS.

A. *Small Business*

It is a frequent assertion that small business is the least compliant part of the taxpayer community. However, as frontline tax practitioners, we find that noncompliance is often due to a lack of information and understanding of the tax code. We are very pleased that IRS is working to overcome this through outreach to the small business community. However, there remains much work to be done as the following anecdotes from our members indicate.

*A retail store owner in New Hampshire with an impeccable record of making timely—even early—deposits of payroll taxes stretching back 20 years, was not aware that effective 1/1/99 he would be required to make semi-weekly deposits. By the time the error was caught, the penalty due was $2,000, even though he was still making timely deposits each month.

*A young businessman in Virginia was advised to set up his small company, in which he was the sole person involved, as an'S Corporation but did not know he was supposed to pay himself a salary. A couple of years went by and this individual did not withhold taxes on the amounts he withdrew from the corporation. An accountant, upon finding this error, went back through the records and grossed up his pay, filed the necessary payroll tax reports, and told the client how much in tax he had to pay. The client agreed this was reasonable and began paying the back taxes in installments and kept current with the reporting. The IRS came in and assessed the 100% penalty on the back taxes, refusing to abate any of the penalties and interest. The young man was forced into bankruptcy. This was a clear example of a person who was trying to do the right thing and was not trying to "beat the government." A reasonable penalty and interest charge in this situation would have been warranted but not the 100% penalty.

*In 1983, a small businessman in Texas, faced with his wife leaving him and his son being sent to prison for murder, became a non-filer. He had had his tax return prepared but in the midst of the family tragedy, neglected to sign and send it in. When contacted by the IRS in 1990, he filed his returns from 1986 forward but, wanting to be completely honest, he volunteered to file for 1983, 1984 and 1985. The years he volunteered to file were then chosen for audit. He was assessed $19,000 in additional income and self-employment taxes and $75,000 in penalties and interest. IRS refused to accept an offer in compromise. He was forced into bankruptcy.

When he sold his business he owed $31,000 in income tax. The funds from selling the business were put into bankruptcy and the court would not release the funds to pay the tax. When the funds were finally released, IRS assessed him penalties and interest for not paying his taxes on time.

*A cabinetmaker in California tried to get back in business after declaring bankruptcy in the early 1990s. Faced with cash flow problems, he made payroll deposits late. Penalties and interest on his account now total 52.6% of his tax liability, although he has made every effort to get current. When asked about penalty abatement, IRS declined, even though the taxpayer has kept his account current and recently made a $3,000 lump sum payment.

*A client who did her own payroll did not do the "look back" on tax deposit frequency. The four-quarter deposits in that "look back" totaled $50,005, $5 over the amount that required her to pay semi-monthly. IRS has discontinued sending notices and thus she continued her monthly deposits in 1999. The penalty for first quarter was in excess of $500, with the same true for the second quarter. She sought professional help and the penalties were finally abated but the process was quite time consuming and required assistance from a tax professional.

*Taxpayer died last December 25 after a lengthy illness. His wife was unable to get the 941 (payroll tax deposit) taxes paid on time. IRS said she would have to pay the penalties and interest first, in order to be considered for the abatement. If she could pay the penalties and interest, she would, obviously, not have to request any assistance. Because of the penalties, she cannot pay the taxes owed and it keeps growing faster than she can pay.

B. *Small Nonprofits*

Understanding of the tax laws as they apply to nonprofits is a perennial issue for those of us who work with small nonprofit organizations. Often, community-based organizations have volunteer leadership, which changes from year to year. Frequently we find they have no permanent staff, no records, or if they have them, they are very spotty and incomplete. Sometimes the leader is a visionary who is focused upon the mission of the organization and fails to think about taxes at all. There is a widely held view at the grassroots level that nonprofits are exempt from all taxes. Imagine the surprise when a tax notice is received.

*A social club in Alabama was penalized $440 for late filing of the Form 990EZ. It was due May 15, 1998 and was filed 22 days late.

*A small nonprofit received a penalty for late filing totaling $1,640 when the administrator, in attempting to obtain an extension to file the return, used the guidelines for the individual extension. He sent in the request but neglected to give a "reason" for the request. When IRS notified the nonprofit that the extension was not accepted, the nonprofit quickly sent in the return so that it was only 2 weeks late. However the penalty was assessed anyway.

*Two payroll tax checks were inadvertently buried on the desk of the pastor of a small church. The payments were mailed in but, of course, were late. IRS assessed a penalty. Abatement was requested on the grounds that payroll tax deposits had not been late in over 5 years and that although the circumstances may not be "reasonable cause" in nature they were certainly not a case of "willful neglect." Penalty abatement denied.

*The pastor of a small church in Florida applied for and received recognition as a not for profit more than a dozen years ago. The pastor believed the organization did not need to file any tax returns because of its nonprofit status. IRS wiped the client from its records because a return has never been filed. When the church sought an EA to put together financial records for a bank loan, they were asked for copies of their tax return. In the words of the EA, they hadn't a clue. The pastor decided to file all returns that had never been filed. Meanwhile, IRS could find no record of their being approved as a not for profit but fortunately, the taxpayer had held onto that document so it was sent to IRS. Information is being reconstructed for tax years 1995–1998. IRS has assessed a penalty of $5,000 for 1995 but has yet to bill for the other years. True, the client was negligent but it could be argued that so was the IRS for not following up when the nonprofit did not file originally.

C. *Individual Taxpayers*

We received many comments about taxpayers—particularly senior citizens—being caught up in penalties where they truly did not understand the situation and were caught unaware. Steps need to be taken immediately to lessen the impact on taxpayers who are completely in the dark about the penalties and interest they face if they try to come back into compliance after an innocent mistake.

Furthermore, as our society moves toward self-managed retirement plans such as IRAs and 401(k)s, there will be many more opportunities for individuals to inadvertently run afoul of the system with disastrous consequences. Some examples of the problems senior citizens face are cited below:

*A senior citizen was drawing out his IRA, using the minimum distribution. Last November his wife was sick with pneumonia and she was hospitalized for 9 days. With his stress, he forgot, and the bank neglected to remind him, to take out his minimum distribution of $1,692. When he realized his mistake, he withdrew it on February 1, 1999. When he did the return on March 6th, the EA had to prepare a Form 5329 and he paid the $846 (50%) penalty. Without the penalty, he owed $15. As directed in Publication 590, a letter was included explaining the situation but apparently it was never read. Nothing was heard from the IRS for 6 months. About 3 weeks ago his EA followed up with a Power of Attorney, letter and copies of all documents. The most aggravating thing about this is he is a retired person who is trying to comply with the tax law and gets hit with a 50% penalty. If he had committed civil fraud and willfully understated his taxes by the same $1,692, his penalty would have been 25% or $423.

*Taxpayer is a widow in her late seventies who is still working as a secretary in a federal agency. She has a small IRA in the agency's credit union. In August, the credit union sent her a form stating that because she was past 70 l/2 years of age, she must withdraw a certain amount. If she agreed to the withdrawal, she merely had to check a box and return the form. She suffered a heart attack and was hospitalized for several weeks. Consequently she failed to return the form. The penalty for failing to make the required withdrawals is 50%. A request that penalty be waived has been made, but this is an example of the type of circumstance affecting potentially millions of taxpayers of ordinary means.

*Taxpayers, age 78 and 76 years old, have an outstanding tax liability from 1967 and 1968. Thirty years later, it's still open as the IRS has threatened action on these retired people and had repeated statute extensions signed. For tax year 1967, original debt was assessed at $27,015.25 in 1975. Current debt is now at $236,255.26 after more than $40,000 has already been paid on the debt. For 1968, liability was assessed at $9,813.28 as of 1975; $14,000 was paid in 1975 with a current balance due of $13,130.07. Both the 1967 and 1968 returns were filed timely. They are paying off the debt at the rate of $150 to $300 per month with no hope of ever paying it off. Each payment made shows an equal amount of interest assessed each month so no progress is ever made and then the additional interest that they couldn't pay is incurred. This couple has few assets: a 1987 Chevy, a little life insurance. They owe $15,000 in credit card bills; they pay $900 per month for medical care and are in very poor health. They have lived with this situation hanging over their heads all these years.

Increasingly complicated estimated tax rules are making it difficult, if not impossible, for taxpayers to stay in compliance. Just one example of several that were sent in:

*Taxpayer's liability for the 1998 1040 was $9,000 which was satisfied with estimated payments of $5,800 made before the submission of the return and $3,200 paid with the submission of the return. IRS null and voided her Form 4868 Request for Automatic Extension of Time to File, charging a penalty of $676. The interest tab was $106.99. The taxpayer managed to find herself in this situation despite having overpaid (paid in advance) her estimated tax, even through the 4th quarter.

We are finding that once taxpayers fall behind, they may never be able to catch up. A typical example:

*In 1989, a low wage individual went to work for a company. He did not realize taxes were not being withheld. He was given a 1099-MISC at year-end but had no money to pay taxes. His 1989 tax debt is now $17,262 of which $1,598 is penalty and $9,079—one-third more than the tax owed—is interest. Given his spotty work history, he owes from 1990 and also 1997 and 1998. Most low-income taxpayers do not question employers. They want the work and just don't understand when employers hand them a 1099-MISC instead of a W–2 at the end of the year. This is particularly true for low-income workers who are often very naive about employment taxes and who are not in a position of strength to bargain with a prospective employer.

NAEA Recommendations

1. *Review of Penalty Administration*

As we have previously testified, the problem with penalties often originates here in Congress.

We are very pleased that these hearings are being held and hope that they will be done on a regular basis in the future, much as the IRS budget and filing season readiness hearings are. The reports by the Joint Committee on Taxation and Treasury, along with portions of the National Taxpayer Advocate's Report provide very useful guidance on areas in need of attention.

2. *Tax Penalties Should Not be Used for Revenue Raising*

There are too many penalties for too many infractions and no one could reasonably expect taxpayers to comprehend their applicability. We think the current code's proliferation of penalties has accomplished nothing but create taxpayer perceptions of a system run amok which acts like a hidden tax rate. This feeling is reinforced by the fact that, in the past, various committees scored penalties for revenue raising purposes. Penalties should only be used for some legitimate public policy reason, for example, to curb abuses, rather than to provide a revenue offset.

3. *Payment and Abatement Should Be Separate Considerations*

As some of our earlier examples indicate, we believe that insisting that tax and interest be paid before a request to abate a penalty for reasonable cause can be considered should be eliminated. Payment of tax and abatement of penalties should be separate considerations and the facts and circumstances of each case should be weighed.

4. *Trust Fund Recovery Penalty*

This penalty should be assessed against officers, rather than against just those who were responsible. Once the actual outstanding taxes have been paid to protect the employees benefits, the penalties and interest should be stopped or limited to a maximum amount. In addition, IRS needs to ensure that proper procedures are in place. To prevent future loss of taxes, interest and penalties by IRS, a new law should be considered which would allow the IRS and State Agency be notified of ALL bankruptcies in which an outstanding IRS account is on file.

5. *Eliminate or Restrict the Failure to Pay Penalty*

Too often Enrolled Agents are called upon to seek abatement of this penalty. It should only be imposed in cases of egregious fraud or negligence. Again, facts and circumstances of each case should be taken into consideration.

6. *Simplify the FTD deposit rules and the Related Penalties*

Too often we are called upon to straighten out problems when common sense should prevail. The facts and circumstances of each case should be considered. We are heartened by IRS' recent decision on application of federal tax deposit payments. It's a step in the right direction.

7. *Offer to Eliminate or Reduce Penalties*

Enrolled Agents, as a rule, strive to return taxpayers to compliance and search for ways to enable them to stay that way. It would be very helpful if IRS would look to the facts and circumstances of cases and offer to eliminate or reduce penalties. Several comments from our Members noted that rather than encouraging taxpayers to come into compliance, the severity of penalties can force a taxpayer to continue to not file and/or pay his or her taxes.

Perhaps a two-tier system could be implemented so that if the taxpayer comes forward and files his/her return voluntarily, the penalty would be waived or at least greatly reduced. If the IRS must come to the taxpayer, then the penalty would be higher.

In addition, it would be helpful if no penalties, only interest, were charged for a taxpayer or paid preparer who makes an honest mistake. Given the complexity of our tax laws, penalties should only be applied where there is a clear and deliberate effort on the part of the taxpayer or paid preparer to cheat the government.

8. *Standardize the Forms 1099*

The current system frequently hammers individuals who make a simple mistake such as overlooking an interest or dividend payment. This is particularly true for the elderly who have great difficulty following the law and keeping track of these payments. This confusion could be dramatically reduced if there were standard Forms 1099, which would be required to be used by every information reporter with no substitutions allowed. We are seeing an ever-increasing number of interest and dividend statements that look much more like a letter than a reporting document. There is no reason why, with today's modern computer systems, all information reporters cannot have and use identical forms. This is also true for W–2s.

9. *Eliminate Frivolous Penalties*

Many clients are being affected by the Failure to File the Information Return, Form 1065, when there are fewer than 10 partners. Practitioners in the know use PL 95–600 to get the penalty abated but the mere fact that this Public Law exists and IRS continues to ignore the Committee's directives causes clients grief and worry. IRS employees need to recognize that there is no "assessable penalty" on a partnership with fewer than 10 partners and all partners reporting their distributive share on their individual tax returns.

The $100 minimum penalty for returns filed more than 60 days late is sometimes excessive. For example, taxpayer had a 1998 tax liability of $197. He had withholding of $88 and a payment of $109 was filed when the return was submitted in early August. IRS assessed a late filing penalty of $100, late payment penalty of $2.72 and interest. Combining the late filing and late payment penalties would make things simpler, fairer and easier for the taxpayer to comprehend.

10. *Eliminate the Daily Compounding of Interest on Penalties*

The compounding factor does not help collect the taxes any faster and creates just that much more that the taxpayer cannot pay. Again, perhaps a facts and circumstances approach could be used to eliminate daily compounding of interest on penalties when taxpayers have made an innocent mistake.

11. *Continue Education Outreach to Taxpayers*

It is important that IRS continue its outreach to taxpayers. We believe IRS is doing an excellent job with respect to individual and small business taxpayers. We are very concerned about the lack of information for small nonprofits. This area needs immediate attention.

12. *Provide Adequate Training for IRS Employees*

There is always tension between having a consistent national standard and having the ability to make judgments on a case by case basis. NAEA does not wish to make a recommendation which would be impossible for IRS personnel to carry out. However, the hardship cases we have described necessitate IRS personnel having the ability to mitigate penalties where there is no intent to cheat the government. Perhaps a well-defined national standard coupled with adequate training as well as the ability to exercise judgment in difficult cases would benefit both the IRS and taxpayers.

CONCLUSION

I would like to thank you, Mr. Chairman and the members of the Oversight Subcommittee, for the invitation to share our members' views with you today. I will be happy to respond to your questions and comments about our recommendations.

[The attached report: "Report to the Congress on Penalty and Interest provisions of the Internal Revenue Code," Dated October 1999, is being retained in the Committee files. The Report can also be viewed electronically from the Treasury's website at "http: www.treas.gov/taxpolicy/library/intpenal.pdf".]

Chairman HOUGHTON. Thanks very much, Ms. Akin.

Now I would like to introduce Mr. Pearlman, who, of course, as you remember, used to be the head of the Joint Committee on Taxation. Chairman, great to have you here today.

STATEMENT OF RONALD A. PEARLMAN, CHAIR, TASK FORCE ON CORPORATE TAX SHELTERS, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION

Mr. PEARLMAN. Good morning, Mr. Chairman, Mr. Coyne, Members of this distinguished committee, it is a pleasure to be here. Today I am here on behalf of the Tax Section of the American Bar Association. The Section appreciates the opportunity to appear before the subcommittee. We believe that both the Joint Committee and the Treasury penalty and interest studies address important issues and we take our hats off to them for the preparation of their studies and to you, Mr. Chairman, for scheduling this hearing.

In the interest of time, I am going to limit my remarks to just two items relating to penalties that we believe are particularly important. Our written statement and our previous submissions to the Joint Committee and Treasury staffs provide much more detail on the views of the Tax Section on the penalty and interest provisions of the Code.

Let me say these two issues, the two items I am going to address, relate broadly to the topics of level of rates, level of penalty rates, and the flexibility which the tax collector has regarding the administration of the penalty system.

The first matter I would like to address is the Joint Committee's proposal, which I think has not been discussed this morning, to eliminate the present law reasonable cause exception to the substantial understatement penalty of section 6662. As you know, under existing law, the courts and the IRS are given discretion to waive a penalty based on a standard of reasonable cause. This discretion permits the Service and the courts to take into consideration the particular circumstances underlying the position the taxpayer took on his or her return in determining whether the penalty should be sustained. We oppose repeal of the reasonable cause exception. In our view, it would create a rigid, inflexible penalty structure and would preclude the application of discretion by the IRS or a court that we think is very important to a properly functioning penalty system.

I would say as a broader matter, it seems to me as you review the penalty provisions of the Code, an appropriate question continually asked is what kind of degree of flexibility are you giving the tax collector to address instances where penalties should be abated. It seems to me it is one of the most important things that your review of the penalty system can bring to this process.

Some might think the repeal of the reasonable cause exception will have the effect of making it more difficult for unsympathetic taxpayers to avoid application of a penalty, and it may. But the subcommittee should understand that two other results also are likely. First, if the IRS has no discretion to waive a penalty, it is likely that fewer penalties will be asserted in cases where they should be. Second, if the reasonable cause exception were to be repealed, I suspect that in the future this subcommittee will be forced to hold hearings to listen to stories of taxpayers who had sympathetic cases for penalty waivers based on reasonable cause, but whose cases could not be favorably disposed of by the IRS because the standard was no longer in the statute.

The second item I want to discuss is the item of size of penalties. Review of the history of penalty rates will reveal that this is not a new issue. It is always a dilemma. If the penalty rate is too low, it will not have the desired deterrent effect. If the rate is too high and is considered too harsh, the IRS will anticipate adverse taxpayer reactions and will be less inclined to assert penalties even in cases where the penalty is appropriate. The accuracy-related penalty rates now range from a low of 20 percent to a high of 40 percent in the so-called gross misvaluation statements.

Now, we do not mean to suggest that the gross misvaluation statements are not appropriate cases for the imposition of a penalty, but we do suggest that 40 percent is too high. Anecdotally, we think the penalty is very rarely imposed. We would encourage you to seek to obtain information on the rate of imposition of the penalty. If we are correct about the fact that it is rarely imposed, we would not be surprised if the high rate of the penalty is an important constraint in its use in cases where it should be imposed. Reduction of the penalty rate to a more realistic number may make the penalty a more useful tool in trying to discourage valuation misstatements.

We also, as the staffs indicated this morning, think that the failure-to-deposit penalties are too large. It is interesting that if you assume a $10,000 failure to deposit payment is one day late, a $200 penalty is imposed. And if it is two weeks late, at a 10 percent penalty, the penalty approximates an interest rate of 260 percent. We think these cases in which taxpayers are trying to comply with the law by paying their taxes and yet are subjected to relatively large penalties are inappropriate. The Treasury Department report contains recommendations for reducing the failure to deposit penalty. We think those recommendations are constructive and we encourage the subcommittee to seriously consider them.

That concludes my remarks. I am pleased to try to answer any questions.

[The prepared statement follows:]

Statement of Ronald A. Pearlman, Chair, Task Force on Corporate Tax Shelters, Section of Taxation, American Bar Association

My name is Ronald A. Pearlman. I appear before you today in my capacity as Chair, Task Force on Corporate Tax Shelters of the American Bar Association Section of Taxation. This testimony is presented on behalf of the Section of Taxation. It has not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, accordingly, should not be construed as representing the policy of the Association.

The Section of Taxation appreciates the opportunity to appear before the Committee today. We believe the recommendations in the penalty and interest studies by the Joint Committee on Taxation [1] (hereafter "JCT Study") and Department of the Treasury's Office of Tax Policy [2] (hereafter "Treasury Report") address very important issues. Our testimony today will not include comments on each and every item in the studies. Individual members of the Tax Section would be pleased, however, to provide assistance and comments to members of the House Ways and Means Committee's Oversight Subcommittee and your Staff on any recommendations you might identify.

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

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

[2] Department of the Treasury, Office of Tax Policy, *Report to The Congress on Penalty and Interest Provisions of the Internal Revenue Code*, October 1999.

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

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

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

ACCURACY-RELATED AND PREPARER PENALTIES

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

Reporting Standards for Taxpayers and Preparers.[3] At present, the two penalties are not completely coordinated, since what is expectated of preparers is somewhat less than what is expected of taxpayers. Both the JCT Study and the Treasury Report recommend conforming the reporting standards for taxpayers and preparers. However, the JCT Study would set standards for taxpayers and preparers much higher than the standards of current law, while the Treasury Report would set standards at levels nearer those of current law.

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

The Joint Committee Staff recommended changing the standard for undisclosed positions from substantial authority to a reasonable belief that the position taken is "more likely than not" correct. We do not believe that this proposal is an improvement on the "substantial authority" standard; it would be less objective, would en-

[3] We do not address tax shelter penalties, whether corporate or non-corporate, here; we will address them in separate tax shelter comments.

courage difficult factual inquiries into the state of mind of the taxpayer and preparer, could encourage excessive disclosure, and would fail to give adequate weight to the complexity and uncertainty of existing tax law.

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

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

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

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

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

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

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

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

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

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

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

INTEREST AND PAYMENT PENALTIES

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

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

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

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

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

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

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

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

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

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

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

CONCLUSION

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

Chairman HOUGHTON. Thank you, Mr. Pearlman. Mr. Ely.

STATEMENT OF MARK H. ELY, CHAIR, PENALTY AND INTEREST TASK FORCE, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. ELY. Thank you, Mr. Chairman and Members of this distinguished subcommittee. Thank you for inviting the American Institute of Certified Public Accountants to testify before you today. I am Mark Ely and I am representing the AICPA as chair of its Penalty and Interest Task Force. The AICPA is a national professional organization of certified public accountants comprised of more than 330,000 members, many of whom advise clients on tax matters and prepare income and other tax returns. It is from this broad base of experience that we offer our comments.

The AICPA worked with Congress, the IRS, other tax practitioners and business groups in 1989 on the last major reform of the Federal tax penalty provisions. We believe that there once again is a need to take a comprehensive look at the interest and penalty regime and make needed reforms to ensure the provisions are appropriately and fairly applied and are designed to accomplish their true purpose. We offer you and your staff our assistance with such undertaking.

Because of the limited time, we will comment today on only a few items. We have, however, submitted written testimony for the record which contains our detailed comments on the penalty and interest reform proposals contained in Treasury and the Joint Committee's 1999 studies and the Taxpayer Advocate's 1999 annual report to Congress.

We appreciate that those studies contain many proposals to simplify the penalty and interest provisions and their administration. Consistent therewith, we have included in our comments recommendations for the use of safe harbors to simplify penalty administration. We also compliment the Advocate on the interest he has shown for reforms in the penalty and interest area. Our comments are based on our continued belief in the philosophy that the purpose of penalties is to encourage compliance, not to raise revenue; in addition, the philosophy that interest is not imposed as a penalty, but rather is solely compensation for the use of money. We urge Congress to adhere to these philosophies.

I will now comment on a few of the reform proposals; specifically, the standards applicable to taxpayers, tax return preparers and IRS employees regarding tax return filing positions and fundamental changes to the interest regime. Both Joint Committee staff and Treasury recommend that the same standard should apply for tax return positions to taxpayers and tax return preparers. We do not object to that recommendation, but request that in making such a change, Congress clarify that the imposition of the penalty against a taxpayer and an imposition of the penalty against a tax return preparer must be based on separate determinations.

For disclosed positions, the Joint Committee staff recommends that the minimum standard for both taxpayers and return preparers be substantial authority. Treasury recommends that the standard be a realistic possibility of being sustained on the merits. We have serious concerns about raising the standard for disclosed positions above the reasonable basis standard which is currently applicable to taxpayers. The Federal tax law is forever changing. As a result, there may be virtually no authority with respect to the tax treatment of an item at the time the return is filed. Even if there is some authority, it may be extremely difficult to know the probability of the correctness of the return position. Under the proposed higher standards, taxpayers may be forced to avoid taking otherwise meritorious provisions on their returns.

For undisclosed positions, the Joint Committee staff recommends that the taxpayer and the return preparer must reasonably believe that the tax treatment is more likely than not the correct treatment. Treasury believes the standard should be substantial authority.

We agree with Treasury that the substantial authority standard is more appropriate. The Joint Committee approach would require taxpayers to assume the responsibility of judges who must weigh the merits of competing valid positions to determine the best "position." such an approach would be unduly burdensome for taxpayers, particularly those with limited resources. Moreover, a more likely than not standard could require taxpayers to disclose in their returns even though the position comports with applicable authorities. This would unnecessarily increase compliance costs for taxpayers and burden on the IRS, and would literally inundate the IRS with countless, inconsequential disclosures, weakening the overall effectiveness of the disclosure regime. Thus, we believe the standard for the disclosed positions should be substantial authority.

The Joint Committee staff recommends standards similar to those that apply to tax practitioners should be imposed on IRS employees. We agree. IRS employees should be held to the same standards of responsibility as others in the tax system and sanctions should be specified to encourage enforcement. Finally, with respect to the interest regime, which is a very high priority for the AICPA, we are pleased that there are several proposals for fundamental changes for which we have persistently advocated, such as the Joint Committee staff's proposal to eliminate interest rate differentials by establishing a single rate applicable to both understatements and overpayments. We strongly believe that adopting a single rate for overpayments and underpayments for all taxpayers will substantially reduce the administrative difficulties and financial inequities associated with numerous interest rate differentials contained in the current regime. We have other comments in our written testimony as to the interest regime.

We would be happy to meet with you and your staff at a later date to discuss reform proposals, and I am happy to answer any questions. Thank you.

[The prepared statement follows:]

Statement of Mark H. Ely, Chair, Penalty and Interest Taskforce, American Institute of Certified Public Accountants

Mr. Chairman and members of this distinguished Subcommittee:

The American Institute of Certified Public Accountants ("AICPA") offers you these comments on the penalty and interest provisions in the Internal Revenue Code ("Code"). The AICPA is the national, professional organization of certified public accountants comprised of more than 330,000 members. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. They provide services to individuals, not-for-profit organizations, small and medium-size businesses, as well as America's major businesses, including multi-national corporations. Many serve businesses as employees. It is from this broad base of experience that we offer our comments.

INTRODUCTION

The AICPA worked with Members of Congress, the Internal Revenue Service, and other tax practitioners and business groups in 1989 in connection with the last major reform of the federal tax penalty provisions. The result of those efforts was the Improved Penalty Administration and Compliance Tax Act of 1989 ("IMPACT"). Since then, questions have been raised regarding the appropriate administration of the interest and penalty provisions, such as the use of penalties as a bargaining tool by the IRS. Also since that time, a number of revisions to the interest and penalty provisions have been made or proposed. We believe there once again is a need to take a comprehensive look at the interest and penalty provisions and make needed reforms to ensure the provisions are appropriately and fairly applied and are designed to accomplish their purpose. We encourage you to do so.

We offer you our assistance with such an undertaking, and, as an initial step, provide you with our comments on: the Joint Committee on Taxation's Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (Including Provisions Relating to Corporate Tax Shelters) (JCS–3–99), July 22, 1999; the Department of the Treasury's study, entitled Penalty and Interest Provisions of the Internal Revenue Code, released October 25, 1999; and the penalty and interest reform provisions in the National Taxpayer Advocate's 1999 Annual Report to Congress, released January 4, 2000.

Our comments regarding penalties are based on our continued belief in the philosophy embraced by IMPACT, that the purpose of penalties is to encourage compliance, not to raise revenue. We urge Congress not to alter that philosophy. We also urge Congress to adhere to the philosophy that interest is not to be imposed as a penalty, but rather is solely compensation for the use of money.

Our comments are based on considering the penalty and interest regime in its entirety. Individual comments and suggestions should not be accepted or rejected in a piecemeal fashion since the appropriateness of one provision often depends on the status of another.

PENALTY PROVISIONS

1. Accuracy-Related and Preparer Penalties

Note: The following discussion relates only to non-tax shelter items.

Standards for Taxpayers and Preparers

Both the JCT staff and Treasury propose modifications to the standards that must be satisfied with respect to a tax return position in order to avoid the accuracy-related penalty applicable to taxpayers under section 6662 for the substantial understatement of tax and the preparer penalty under section 6694(a) for understatement of a taxpayer's liability due to an unrealistic position. Under present law, to avoid the substantial understatement penalty, a taxpayer must have "substantial authority" for an undisclosed position and a "reasonable basis" for a disclosed position; for a tax return preparer to avoid the preparer penalty, an undisclosed position must have a "realistic possibility of being sustained on the merits" and a disclosed position must not be "frivolous."

Both the JCT staff and Treasury recommend that the same standards apply to taxpayers and tax return preparers. We do not object to that recommendation, but request that in making such a change, Congress clarify in the statutory language that the imposition of a penalty against a taxpayer and the imposition of a penalty against the taxpayer's return preparer must be based on separate determinations. The imposition of a penalty against one is not evidence that the imposition of a penalty against the other is appropriate. For example, a taxpayer may pay a penalty for personal reasons, such as to avoid expending additional time and money to contest the issue even though the taxpayer might have been successful if the matter had been pursued; an automatic imposition of a penalty against the return preparer in such a case clearly would be inappropriate. An independent review of the applicable authorities and of the facts, including who had knowledge of specific facts, must be considered in determining whether the imposition of a penalty against a particular party is appropriate.

Standards for Disclosed Positions

Under current law, to avoid a substantial understatement penalty with respect to a disclosed position, a taxpayer must have a "reasonable basis" for a return position; for a tax return preparer to avoid a preparer penalty with respect to a disclosed position, the position must not have been "frivolous." The JCT staff recommends raising the minimum standard for taxpayers and tax return preparers regarding disclosed positions such that, to avoid a penalty for a disclosed position, there must be at least "substantial authority." Treasury recommends raising the minimum standards for taxpayers and tax return preparers regarding disclosed positions such that, to avoid a penalty for a disclosed position, there must be at least a "realistic possibility of being sustained on the merits."

We have serious concerns about raising the standard for taxpayers and tax return preparers above the "reasonable basis" standard currently applicable to taxpayers. We are particularly troubled by the JCT staff's proposal to establish "substantial authority" as the minimum standard for disclosed positions. Such a high standard may be unworkable. While taxpayers and tax return preparers may be able to ascertain whether "substantial authority" exists with regard to some issues, that is not true in all cases. The Federal tax law is forever changing, and, as a result, there may be virtually no guidance issued at the time a return is filed, and, therefore, virtually no authority with respect to the proper tax treatment of an item. Further, even if there is some authority, given the exceedingly complex nature of the tax law, it may nevertheless be extremely difficult for taxpayers and preparers to know the probable correctness of many return positions. It is not only unrealistic, in many cases it is impossible, to ensure such a high degree of accuracy as is required by a "substantial authority" standard or even the "realistic possibility of being sustained on the merits" standard without forcing taxpayers to avoid otherwise meritorious positions on the return.

While taxpayers may be able to ascertain whether "substantial authority" or "realistic possibility of being sustained on the merits" exists with regard to some issues, that certainly is not true in all cases. This problem is compounded by the fact that the IRS has failed to adhere to a provision added to the Internal Revenue Code in 1989 to assist taxpayers and preparers in determining whether "substantial authority" is present for a position. IMPACT created section 6662(d)(2)(D) of the Code, requiring the IRS to publish, not less frequently than annually, a list of positions for which the IRS believes there is no "substantial authority" and which affect a significant number of taxpayers. To date, the IRS has never issued any such list for any year. If the IRS is unable itself to determine which positions lack "substantial authority," it is unreasonable to adopt this threshold as the minimum reporting standard for return positions by taxpayers and tax return preparers.

In its 1989 civil tax penalty study, the IRS acknowledged the practical limits on the probable correctness of returns. In the Commissioner's Study of Civil Penalties, 1989, at VIII–11, the IRS noted:

While not in and of themselves determinative of the correct standard of behavior, a variety of factors limit the ability of taxpayers to report positions disclosing a liability that is probably correct. Perhaps the most significant limitation is the ambiguity inherent in applying a complex and changing set of tax rules to an infinite variety of factual situations, which may themselves be of ambiguous import. These complexities may result in failure to recognize issues, incorrect conclusions as to the probability that a particular position will prevail, and differences of opinion regarding probability that are not resolvable short of the courthouse. The complexity of modern financial affairs, when coupled with the legal requirement to file a return by a statutory deadline and the costs of making the best possible assessment of each individual issue may also provide practical limits on the pursuit of a theoretically perfect return.

For these reasons, we believe the standard for disclosed positions should be the "reasonable basis" standard currently applicable to taxpayers.

Standards for Undisclosed Positions

Under current law, to avoid the substantial understatement penalty with respect to an undisclosed position, a taxpayer must have "substantial authority;" for a tax return preparer to avoid a preparer penalty with respect to an undisclosed position, the position must have a "realistic possibility of being sustained on the merits." The JCT staff recommends that, for an undisclosed position, the taxpayer and the tax return preparer must reasonably believe that the tax treatment is "more likely than not" the correct tax treatment under the Code. In contrast, Treasury does not propose raising the standard for undisclosed positions above the "substantial authority" standard that currently applies to taxpayers; it would apply that standard to both taxpayers and tax return preparers.

We agree with Treasury that the "substantial authority" standard is the more appropriate threshold standard for undisclosed positions, rather than the higher "more likely than not" standard recommended by the JCT staff. Currently, the only authorities that can be relied upon to constitute "substantial authority" are those issued by the government itself or the judiciary. Acceptable authorities include: the Internal Revenue Code and other statutory provisions, regulations, court decisions, and administrative pronouncements (e.g. revenue rulings, revenue procedures, proposed regulations, private letter rulings, technical advice memoranda, actions on decisions, information releases, notices, and other similar documents published by Treasury or the IRS). In addition, the list of authorities includes General Explanations of tax legislation prepared by the Joint Committee on Taxation (the "Blue Book"). Conclusions in treatises, legal periodicals, legal opinions or opinions of other tax professionals do not qualify under present IRS rules.

Taxpayers and preparers who take positions relying on the government's own rules and pronouncements should be able to feel comfortable that their positions are sufficiently accurate so as to free them from the possibility of penalties. A "more likely than not" standard for undisclosed positions would mean disclosure would be required even though the "substantial authority" threshold is satisfied with respect to a position. Having taxpayers disclose items on their returns which comport with the government's own list of authorities would unnecessarily increase compliance costs for taxpayers and burden for the IRS. Further, such an approach would literally inundate the IRS with countless inconsequential disclosures, weakening the overall effectiveness of the disclosure regime. Thus, we believe the standard for undisclosed positions should be "substantial authority."

Reasonable Cause Exception

The JCT staff recommends repeal of the reasonable cause exception to the substantial understatement penalty. We disagree, believing that the exception is necessary to provide flexibility needed to waive the penalty in appropriate situations.

Amount of Preparer Penalty

The JCT staff recommends increasing the amount of tax return preparer penalties. For first-tier violations, i.e., preparation of a return with a position that does not meet the minimum preparer standards, the JCT staff recommends changing the preparer penalty from a flat $250 per occurrence to the greater of $250 or 50% of the tax preparer's fee. For second-tier violations, i.e., understatements that result from willful or reckless disregard of the rules or regulations, the JCT staff recommends increasing the amount from a flat $1,000 per occurrence to the greater of $1,000 or 100% of the preparer's fee.

Treasury also recommends increasing the tax return preparer penalties. Treasury recommends that consideration be given to a fee-based or other approach that more closely correlates the preparer penalty to the amount of the underlying understatement of tax rather than the flat dollar penalty amount under current law.

We support retaining the two-tier flat dollar penalty under current law. We base our recommendation on the lack of empirical evidence indicating that the flat dollar amount is not effective. In our opinion, deterrence for preparers results not from a dollar penalty, but rather from the possible adverse impact on the preparer's ability to practice and on his/her reputation for integrity and ethical behavior.

2. Failure to File Penalty

Rate

The current law contains a failure to file penalty of 5% of the net tax due, for each month (or portion thereof) the return remains unfiled, up to a maximum of 25%. The JCT staff proposes no change to the current provision. Treasury recommends that the penalty be restructured to eliminate front-loading; it proposes doing this by lowering the penalty rate in the initial months and providing for the increase in the rate, up to the 25% maximum, over a longer period of time. The example Treasury presented was charging a rate of 0.5% per month for the first 6 months and 1% per month thereafter, up to the 25% maximum. Treasury recommends retaining the current rule for fraudulent failure to file.

We agree with Treasury's reasoning that the front-loading of the failure to file penalty in the first five months of a filing delinquency does not provide a continuing incentive to correct filing failures and imposes additional financial burdens on taxpayers whose filing lapse may be coupled with payment difficulties, thus, possibly impeding prompt compliance. We also agree with Treasury that the current structure seems especially harsh given the fact, by merely requesting one, a taxpayer is entitled to an automatic extension for most or all of those five months. (An individual taxpayer is entitled to an automatic four-month extension; a corporate taxpayer is entitled to an automatic six-month extension.)

Given the significance to the tax system of taxpayers fulfilling their filing obligations, the failure to file penalty should be structured to provide a strong incentive for timely compliance, and a continuing incentive to promptly correct any failure to file.

Service Charge

Under current law, since the late filing penalty is a percentage of the net tax due, no penalty applies with respect to a late-filed return if the return reflects a refund due or no tax due. Treasury recommends imposing a new de minimis service charge for late returns that have a refund or no tax due, at least in situations where the IRS has already contacted the taxpayer regarding the failure to file the return.

We do not support this recommendation. We view such an approach as unjustified. Such an approach is particularly inequitable in situations where the taxpayer has a refund due, since the IRS has had interest-free use of the taxpayer's money.

Safe Harbor

Treasury recommends adoption of a provision that would permit the IRS to take into account a taxpayer's compliance history in determining if there is reasonable cause for abatement of the failure to file penalty. Treasury does not support providing automatic relief from the failure to file penalty based on safe harbor rules, however.

Although we agree with Treasury that a taxpayer's compliance history should be considered in determining the appropriateness of a penalty, we recommend a more expansive simplification of the penalty abatement provisions.

To reduce the burden on both taxpayers and the Service resulting from the imposition of many inappropriate penalties, we recommend that safe harbor provisions be established for a variety of penalties (particularly those that are mechanical in nature, such as the failure to file, failure to pay and failure to deposit penalties) that would be deemed to represent reasonable cause. The object of these safe harbors would be to minimize the assessment and subsequent abatement of many penalties. Safe harbor provisions could take the form of:

- No penalty assessment for an initial occurrence; however, the taxpayer should receive a notice that a subsequent error would result in a penalty;
- Automatic non-assertion of a penalty based upon a record of a certain number of periods of compliance; and/or
- Voluntary attendance at an educational seminar on the issue in question, as the basis for non-assertion or abatement.

Such safe harbors would encourage and create vested interests in compliance, since a history of compliance would result in relief. Additionally, the likelihood of future abatements would diminish if the taxpayer has a history of non-compliance. Furthermore, a system of automatic abatement would reduce the time spent by both the Service and taxpayers on proposing an assessment, initiating and responding to correspondence, and on the subsequent abatement. The ability to abate a penalty for a reasonable cause other than those used for automatic abatements would continue; however, reasonable cause abatements requiring independent evaluation should be reduced.

3. Failure to Pay Penalty

Retention or Repeal

Current law contains a failure to pay penalty equal to 0.5% per month (or fraction thereof), up to a maximum of 25%. This penalty was created in 1969 to respond to the belief that the then-applicable interest rate (a flat 6%) on underpayments was not sufficient to encourage timely payment of tax and to discourage the use of the government as a low-cost lender.

The JCT staff recommends repealing the penalty for failure to pay taxes, noting the repeal would be consistent with a policy initiative begun by RRA'98, in which the rate of the penalty for failure to pay was reduced. The National Taxpayer Advocate also recommends a repeal of the penalty. Treasury acknowledges that the initial intent of the penalty was to address the fact that the interest rate on underpayments did not take into account the then market rate; nevertheless, it recommends retaining the failure to pay penalty, but with a restructured rate, as noted below.

We believe that, since the rate of interest on underpayments is now tied to the market rate of interest, this penalty, as a substitute for interest, should be repealed. If the penalty is not repealed, we recommend adoption of the mitigation and waiver provisions noted below.

Expansion of Mitigation of Penalty for Months During Period of Installment Agreement

Under current law, the failure to pay penalty for individuals with respect to a timely filed return is reduced from .5% to .25% for any month in which an installment agreement is in effect. This mitigation provision does not apply to halve the penalty in any case in which a final notice has been issued (at which time the penalty increases to 1% per month).

The National Taxpayer Advocate recommends that this mitigation provision be expanded to include reducing the penalty rate from 1% to .5% in situations (1) when a final notice is issued in error or as the result of an administrative practice and (2) when a final notice has been issued, for any month in which an installment agreement is in effect. We agree with the recommendation.

Waiver of Penalty When an Installment Agreement is in Effect

The National Taxpayer Advocate also recommends that the failure to pay penalty be waived for any month in which an approved installment agreement is in effect, even if the 1% per month penalty rate otherwise applies. Under the recommendation, however, the failure to pay penalty would be reinstated for the entire period if the taxpayer defaulted prior to completing the agreement. We agree with that recommendation.

Rate

Treasury recommends restructuring the calculation of the failure to pay penalty. The penalty would equal 0.5% per month for the first 6 months and 1% per month thereafter, up to the maximum of 25%. The penalty would be reduced to 0.25% per month during the first 6 months and 0.5% per month thereafter if the taxpayer makes and adheres to a payment agreement. As under current law, a higher rate would apply once the IRS takes action to enforce collection.

As noted above, we recommend repealing the failure to pay penalty rather than revising the rate.

Service Charge

The JCT staff recommends imposing an annual 5% late payment service charge on taxpayers that do not enter into an installment agreement within 4 months after assessment. The service charge would be imposed on the balance remaining unpaid at the end of the 4-month period.

We do not support establishment of a service charge for failure to enter into an installment agreement. We believe that such a service charge will penalize taxpayers who already are struggling to pay their tax obligations.

Related Installment Agreement Issues

Waiver of Fee. The JCT staff recommends waiving the installment agreement fee for taxpayers that agree to the automated withdrawal of each installment payment.

We support the JCT staff's recommendation. We believe that waiving the fee for taxpayers that enter into agreements to pay tax via an automated system of withdrawal will provide an incentive to enter into these agreements and better ensure payment of taxes. We have heard that some states that offer automated withdrawal payment plans have shown high rates of adherence to installment agreements. We believe that adoption of this provision will similarly facilitate a higher rate of adherence to installment agreements for the Federal government.

Installment Agreement Interest Rate. Treasury recommends providing the IRS with the authority to use a fixed rather that a floating interest rate on installment agreements in order to facilitate adherence to such agreements and to avoid possible balloon payments.

We support Treasury's recommendation to simplify the installment interest rate calculation.

4. Estimated Tax Penalty

Status as Penalty or Interest

The JCT staff recommends repealing the individual and corporate estimated tax penalties and replacing them with interest charges. The National Taxpayer Advocate also recommends eliminating the penalty and allowing interest to be automatically asserted, or as an alternative, he calls for simplification of the estimated tax penalty computations. Treasury recommends retaining the individual and corporate estimated tax penalties as penalties.

We support the recommendation of the JCT staff and the National Taxpayer Advocate for converting the estimated tax penalties for individuals and corporations into interest provisions. The conversion of the estimated tax penalties into interest charges would result in a more accurate characterization since the penalties are essentially fees for the use of money.

Deductibility of Interest

The JCT staff recommends that interest on underpayments of estimated tax by individual taxpayers be nondeductible personal interest, whereas interest paid on underpayments of estimated tax by corporate taxpayers be deductible. We recommend that deficiency interest be deductible by individual taxpayers to the extent the deficiency to which the interest relates is attributable to the taxpayer's trade or business or investment activities.

$1,000 Threshold for Individuals

The JCT staff recommends increasing to $2,000 the threshold below which individuals are not subject to the estimated tax penalty. Currently the threshold amount is $1,000 after reduction for withheld taxes. The JCT staff also recommends that the calculation of the threshold be modified to take into account certain estimated tax payments, i.e., estimated taxes paid in four equal installments on or before their due date. Accordingly, for qualifying individual taxpayers, no interest on underdeposits of estimated tax would be imposed if the tax shown on the tax return, reduced by withholding and certain estimated tax payments, is less than $2,000.

Treasury recommends retaining the current $1,000 threshold, but allowing estimated tax payments to be considered under a proposed simplified averaging method in determining whether the threshold is satisfied.

We support increasing to $2,000 the threshold below which individuals are not subject to the estimated tax penalty. We also support allowing estimated tax payments to be considered under a simplified averaging method in determining if the threshold is satisfied. Both recommendations should simplify the computations required to calculate estimated tax payments and the interest (JCT) or penalty (Treasury) on underpayments.

Safe Harbors

The JCT staff recommends repealing the modified safe harbor that is applicable to individual taxpayers whose adjusted gross income for the preceding taxable year exceeded $150,000. Under the JCT staff's proposal, all taxpayers making estimated payments based on the prior year's tax would do so based on 100% of the prior year's tax.

We support this JCT staff recommendation for simplification of the safe harbor provisions.

Rate

The JCT staff recommends applying only one interest rate per underpayment period -the rate applicable on the first day of the quarter in which the payment is due. Currently, if interest rates change while an underpayment is outstanding, separate calculations are required for the periods before and after the interest rate change. Having only one interest rate apply per underpayment period would end the potential for multiple interest calculations occurring within one estimated tax underpayment period.

We support this JCT staff recommendation for simplification of the computations.

Underpayment Balances

The JCT staff recommends changing the definition of "underpayment" to allow existing underpayment balances to be used in underpayment calculations for succeeding estimated payment periods, i.e., making underpayment balances cumulative. Under the proposal, taxpayers would no longer be required to track each outstanding underpayment balance until the earlier of the date paid or the following April 15th.

We support this JCT staff recommendation for simplification of the computations.

Leap Year Issue

The JCT staff recommends establishment of a 365-day year for estimated tax penalty calculation purposes. Current IRS procedures require separate calculations when outstanding underpayment balances extend from a leap year through a non-leap year.

We support this JCT staff recommendation for simplification of the computations.

First-Time Offender

Treasury recommends providing a reasonable cause waiver of the estimated tax penalty for individuals that are first-time payers of estimated tax. The proposed waiver would be available only if the balance due is below a certain amount and is paid with a timely-filed return. Current law does not provide a general reasonable cause waiver for failure to pay estimated tax for individuals.

Although we do not support Treasury's position on retaining the estimated tax penalty, if the penalty is continued, we do support the recommendation for a reasonable cause waiver of the penalty for individuals that are first-time offenders.

Penalty Waiver

Treasury recommends waiving the estimated tax penalty if the penalty is below a certain de minimis amount -e.g., $10 to $20. There is no current statutory authority permitting the IRS to waive estimated tax penalties below a de minimis amount.

Although we do not support Treasury's position on retaining the estimated tax penalty, if the penalty is continued, we support the recommendation for establishing a de minimis waiver, but recommend a higher de minimis amount.

Safe Harbor for Corporations

We recommend increasing the taxable income cut off point from $1 million to $10 million for defining a "large corporation" for purposes of the Section 6655(d)(1)(B)(ii) safe harbor.

5. Failure to Deposit Penalty

Recently Enacted Provisions

Both the JCT staff and Treasury recommend that no major changes be made to the failure to deposit penalty provisions, to allow time for recent changes in these rules to be implemented and evaluated.

We support the recommendations that no major changes be made to the new rules until the provisions have been in effect long enough to be evaluated, but we encourage the introduction of any minor changes that add to the simplification of the failure to deposit penalty.

Deposit Schedule

The JCT staff recommends that Treasury consider revisions to the deposit regulations, particularly the change in deposit schedule, to change in a later calendar quarter.

We support the JCT staff's recommendation as a simplification of the failure to deposit provisions.

Penalty for Wrong Method of Deposit

Treasury recommends that it be provided with the authority to reduce the penalty for use of the wrong deposit method from 10% to 2%. Currently, taxpayers who use the wrong deposit method may be subject to the penalty rate of 10% and, thus, may be treated as harshly as if they did not make the deposit at all.

We support Treasury's recommendation; the lower rate would not be unduly harsh and would accomplish the same objective of encouraging payment by the proper method.

Systemic Problems of Payroll Services

The JCT staff and Treasury recommend that the IRS work with payroll services to resolve systemic errors, rather that deal with individual employers on a case by case basis.

We support the JCT staff and Treasury's recommendations. Such an approach could greatly simplify the resolution of such problems.

6. Pension Benefit Penalties

The JCT staff recommends consolidating the IRS and ERISA penalties for failure to file timely and complete Form 5500, and reducing from three to one the number of governmental agencies authorized to assess, waive, and reduce penalties for failure to file Form 5500. The JCT staff recommends designating the IRS as the agency responsible for enforcement of reporting. The JCT staff also recommends repealing the separate penalties for failure to file Schedules SSA and B and for failure to provide notification of changes in plan status. The JCT staff recommends treating these situations as a failure to file a complete Form 5500.

Treasury recommends consolidating the penalty for failure to file Form 5500 into a single penalty that will not exceed a specified dollar amount per day or a monetary cap per return. Treasury proposes that the single penalty would be waived upon a showing of reasonable cause. Welfare and fringe benefit plans would be subject to a similar single penalty under Treasury's proposal. Treasury recommends designating the Department of Labor as the agency responsible for enforcement of reporting. The Department of Labor's DFVC voluntary compliance program would continue to provide relief from late filing or failure to file penalties for Form 5500 under the proposed single penalty.

Although we do not have comments on the specific recommendations, we do encourage proposals such as these that promote simplification.

7. Uniformity of Administration

Statistical Information

The JCT staff and Treasury recommend that the IRS improve its method of providing statistical information on abatements and the reasons and criteria for abatements. We support this recommendation.

Supervisory Review

The JCT staff and Treasury recommend improving the supervisory review of the imposition and abatement of penalties. We support this recommendation on the theory that such improved review would promote equitable treatment of taxpayers.

Abatement

The JCT staff recommends consideration by the IRS of establishing a penalty oversight committee similar to the Transfer Pricing Penalty Oversight Committee.

We support the JCT staff's recommendation as a means to promote equitable treatment of taxpayers. Previously, the AICPA has recommended the creation of a database regarding the imposition and abatement of penalties and the establishment of a coordinator of penalty administration to promote consistent application.

INTEREST PROVISIONS

Determining the amount of interest owed to or by taxpayers in connection with their Federal tax liabilities is governed by a rather complicated set of interest and procedural provisions in the Internal Revenue Code. We believe simplification of the interest regime is in order and commend the JCT staff for proposing the establishment of a single interest rate applicable to both underpayments and overpayments of all taxpayers and the abatement of interest in various instances. We agree that these proposals will greatly simplify interest computations and are disappointed that Treasury essentially recommends maintaining the current interest regime, including interest rate differentials for corporate taxpayers. We think the recommendations made by the JCT staff, coupled with our proposed modifications, will result in a fairer, simpler, more administrable interest regime. We also believe that the JCT staff's interest simplification recommendations, with our modifications, should be adopted in their entirety because the benefits of each component necessarily depends upon the enactment of the others.

Like both the JCT staff and Treasury, we believe the Internal Revenue Code's interest provisions should provide for compensation to the government for the time that the taxpayer has use of the government's tax dollars and to the taxpayer for the time the government has use of the taxpayer's money. Interest is fundamentally a charge or compensation for the use or forbearance of another's money -it is not a penalty. The interest provisions should not be used to financially punish taxpayers.

1. Interest Rate

The JCT staff recommends providing one interest rate for overpayments and underpayments for both individuals and corporations, equal to the short-term applicable federal rate ("AFR") plus 5 percentage points. Treasury recommends a uniform interest rate in the range of AFR plus 2 to 5 percentage points except in the case of large corporate overpayments or underpayments, for which Treasury recommends retaining the current rate differential, including "hot interest."

We strongly believe that adopting a single rate for underpayments and overpayments of all taxpayers will substantially reduce the administrative difficulties and financial inequities associated with the numerous differentials contained in the current regime. We, therefore, support the JCT staff's single rate recommendation.

Establishing one rate for every taxpayer necessarily entails blending the various market rates applicable to all taxpayers; however, we are concerned that the JCT staff's proposal may establish an excessively high interest rate. At current market rates, raising the overpayment and underpayment rates to AFR+5 percentage points would result in a 10 percent rate; that would be the highest rate of interest for ordinary underpayments in more than a decade. Individual taxpayers would see their underpayment rate jump from 8% to 10% and the minimum rate that would apply to corporate taxpayers would be equal to the current "hot interest" rate. We concur with Treasury that the appropriate rate should be in the range of the AFR plus 2 to 5 percentage points and should reflect typical market rates.

2. Interest Abatement

Additional Causes for Abatement

The JCT staff recommends that the IRS be granted the authority to abate interest: (1) where necessary to avoid gross injustice; (2) for periods attributable to any unreasonable IRS error or delay, whether or not related to managerial or ministerial acts; (3) in situations where the taxpayer is repaying an excessive refund based on IRS calculations, without regard to the size of the refund; and, (4) to the extent the interest is attributable to taxpayer reliance on a written statement of the IRS.

Treasury agrees to abatement of interest when the taxpayer has reasonably relied on erroneous written advice from the IRS, but does not recommend further legislative expansion of abatement of interest, arguing that current law provides sufficient relief. The National Taxpayer Advocate recommends abatement when the taxpayer is experiencing significant hardship.

We support the recommendations of the JCT staff and the National Taxpayer Advocate and strongly encourage their adoption. Further, because the IRS has been reluctant in the past to grant relief in this area, we request that the terms "gross injustice," "unreasonable" and "significant hardship" be adequately defined to provide the IRS with clear standards for implementation.

Application of Abatement Attributable to Errors and Delays to Nondeficiency Federal Taxes

The current law provision allowing abatement based on errors or delays by the IRS is limited to interest on income, estate, gift, generation skipping, and certain excise taxes. The National Taxpayer Advocate recommends that the abatement provision be expanded to apply to interest on employment taxes, the remainder of excise taxes, and certain other taxes. We agree with that recommendation.

3. Suspension of Interest Where IRS Fails to Contact Taxpayer

Neither Treasury nor the JCT staff make any recommendations with regard to the interest suspension provision, enacted as part of the Internal Revenue Service Restructuring and Reform Act of 1998, that suspends the accrual of deficiency interest for individual taxpayers in all cases where the IRS fails to notify the taxpayer within 18 months (1 year beginning in 2004), specifically stating the taxpayer's liability and the basis for that liability. Under use of money principles, interest is charged solely as compensation for the use of another's money. While there may be some situations in which use of money principles should give way to more compelling objectives, such as in the abatement context, we believe such an automatic suspension provision is an unnecessary feature for a single-rate interest regime with broad interest abatement authorities. An expanded interest abatement provision should provide adequate relief for those taxpayers subjected to excessive interest charges. We, therefore, recommend that this provision be repealed and that any resulting savings to the government be applied to lowering the proposed single-rate amount.

4. Interest Netting

Treasury argues that, given the recent enactment of global interest netting, it is premature to adjust interest rates to eliminate all interest differentials. On the other hand, the JCT staff notes that establishing a single rate of interest will simplify tax administration and "limit" the need for interest netting on a going-forward basis. We believe that restoring interest rate harmony will mitigate (but not eliminate) the need for interest netting in most cases, because the rate at which interest is paid by a taxpayer to the IRS with respect to any underpayment of tax will be the same rate paid by the IRS to a taxpayer who overpays a tax liability. Unfortunately, the Internal Revenue Code contains several special rules providing for interest-free periods whereby taxpayers and the government are given grace periods to take certain actions without accruing additional interest charges. For example, the government is given 45 days to process refund claims and taxpayers are afforded 21 calendar days to pay demand notices (10 business days if the amount exceeds $100,000). Thus, even with the single-rate interest regime advocated by JCT staff, there would continue to be some situations where taxpayers could be charged interest on periods of underpayment that run concurrently with a non-interest bearing overpayment period for the taxpayer.

We support JCT's proposed single rate regime but believe that interest netting still would be appropriate in some circumstances, to ensure that taxpayers are not charged interest on amounts where no true liability actually exists. Extending interest netting to interest-free periods would be consistent with use of money principles and would not harm the government since during these periods of time, neither the taxpayer nor the government are actually indebted to one another. In our judgment, taxpayers do not object to interest-free periods; they recognize the importance of administrative convenience, to allow the government sufficient time to process claims for refund. Taxpayers, however, do resent the imposition of interest on equivalent outstanding amounts under the pretext that a true liability exists where none does. Absent netting, the problem will become more acute if the interest rates are equalized at a higher level, as the JCT staff is proposing.

The JCT report states that limiting the availability of netting to situations in which the taxpayer both owes and is owed interest for the same period preserves the integrity of the rule requiring the suspension of interest where the IRS fails to contact an individual taxpayer. The JCT staff seems to be saying that taxpayers should be required to pay interest during some periods of mutual indebtedness when they clearly are not indebted to their government in order to preserve the concept of suspending interest for taxpayers who have admittedly underpaid their taxes. Logic dictates that taxpayers who owe tax should pay interest and those who owe no tax should not pay interest.

In summary, we believe that a new single-rate interest regime should contain an interest netting component whereby taxpayers can identify periods of mutual indebtedness involving interest-free periods and request the IRS to have their interest charges recalculated in accordance with procedures similar to those set forth in Rev. Proc. 99–19.

5. Interest and Look-Back Rules

The JCT staff recommends that the single interest rate also apply to the Code sections that reference the underpayment or overpayment rate under present law. The Treasury report does not address this issue. There are several provisions that allow taxpayers to re-determine their tax liability based on facts determined after the filing date of the return without requiring an amended return to be filed—the so-called "look-back" provisions. As we indicated above, we believe that a single interest rate should be applicable to the underpayments and overpayments of all taxpayers, but question the amount of the rate increase proposed by JCT. We are concerned that, in the context of these sections, under JCT staff's proposed rate structure, most taxpayers would face a significant increase in the amount of interest.

6. Exclusion of Individual Overpayment Interest from Income/Denial of Deduction

In an attempt to equalize rates on an after-tax basis for individual taxpayers and corporations, the JCT staff recommends that overpayment interest paid by the IRS to individuals be excludable from income. While acknowledging that the same rate and same tax treatment with regard to deficiency interest would provide equivalent effective interest rates for individual and corporate taxpayers, Treasury does not propose an exclusion for interest and believes a deduction for deficiency interest for individuals is not warranted.

While JCT's recommendation is one way to provide equivalent effective interest rates on underpayments and overpayments for individuals, the proposal is incomplete because it fails to clarify the deductibility of deficiency interest attributable to trade or business or investment activities of a non-corporate taxpayer. Section 163(h)(2) provides that, in the case of a taxpayer other than a corporation, no deduction shall be allowed for personal interest paid or accrued during the taxable year. The term "personal interest" does not include interest paid or accrued on indebtedness properly allocable to a trade or business. Temporary regulations section 1.163–9T(b)(2)(i)(A) provides, however, that interest relating to taxes is personal interest regardless of the source of the income generating the tax liability. This interpretation of the statute has generated considerable litigation and two different standards for the deductibility of interest on deficiencies incurred in a trade or business—a corporation filing a Form 1120 is clearly entitled to deduct deficiency interest while an individual operating an unincorporated trade or business reporting income on a Form 1040 return is denied the interest deduction. We believe section 163(h) should be modified to allow every taxpayer a deduction for interest attributable to a deficiency attributable to trade or business activities, regardless of the form in which the businesses is operated, or to investment activities.

7. Dispute Reserve Accounts

The JCT staff recommends that taxpayers be allowed to deposit amounts in a "dispute reserve account," a special interest-bearing account within the U.S. Treasury. These accounts are intended to help taxpayers better manage their exposure to underpayment interest without requiring them to surrender access to their funds or requiring them to make a potentially indefinite-term investment in a non-interest bearing account. The Treasury report does not contain similar relief.

We have some concerns about how the dispute reserve account system will operate. For example, will the IRS be permitted to use the offset provisions against amounts deposited into these accounts? Nevertheless, we believe the JCT staff's recommendation blends the good features of several current-law approaches to avoid deficiency interest charges and merits serious consideration.

8. Interest-Free Periods

Treasury recommends that, when administratively feasible, the 45-day rule restricting overpayment interest on refunds should be applied, in the case of early-filed returns, to the date the return was received, rather than the last day prescribed for filing the return. The JCT report does not recommend any changes with regard to these so-called rules of convenience.

Under the Code, taxpayers are given a 21-day interest-free grace period to pay tax liabilities (10 business days if the underpayment is in excess of $100,000) while the government is given 45-days to make tax refunds. In addition, overpayment interest accrues on an overpayment from the later of the due date of the return or the date the payment is made, until a date not more than 30 days before the date of the refund check.

Nuances associated with these special rules contribute to the complexity of interest computations. We believe that in the context of comprehensive interest reform, consideration should be given to reviewing and adjusting the application of these rules. The lengths of the grace periods were established years ago and may no longer reflect the actual length of time it takes to complete the assigned task (e.g., transmit data, issue refund checks, remit payment). On the surface, it seems patently unfair to give the IRS 45 days from the due date of a return to process a refund check while allowing some taxpayers only 10 business days to respond to an IRS bill. We believe that these rules should be updated, with a view toward simplification.

9. Application of Compound Interest Only to the Underlying Tax

The National Taxpayer Advocate recommends that compound interest apply only to the tax liability and that simple interest apply to penalties and/or additions to tax.

We disagree with that recommendation. Interest computations already are extremely complex; this proposal would add to that complexity. Further, such an approach would be inconsistent with the use of money principles on which interest is based.

10. Limitation on the Total Amount of Interest that Can Accumulate

The National Taxpayer Advocate recommends that the total amount of interest that can accumulate on a liability should be limited to 200% of the underlying tax liability.

We disagree with that recommendation as being inconsistent with the use of money principles on which interest is based.

STANDARDS APPLICABLE TO IRS

1. Standards

The JCT staff recommends that standards similar to those that apply to tax practitioners should be imposed on IRS employees.

We support the JCT staff's recommendation, but urge that sanctions be specified to encourage enforcement. As a matter of fairness and consistency, we recommend that, under current law, the IRS require revenue agents to have concluded that there is at least a "realistic possibility of success" before proposing an adjustment against a taxpayer. (If, as is proposed, the standards for tax return preparers are raised, the standard for IRS revenue agents should be raised similarly.) One method of ensuring that a position contained in a Revenue Agent Report has satisfied the standard could be to require that each Report be signed, evidencing supervisory approval, by an individual at the group manager or higher level, attesting to the fact that the proposed adjustments set forth therein meet the applicable standard. Implementing a policy such as this would be consistent with tax administration principles for the IRS set forth in Rev. Proc. 64–22, 1964–1 C.B. 689. Rev. Proc. 64–22 requires that the Service apply and administer the law in a reasonable and practical manner, and that issues only be raised by examining officers when they have merit, and never arbitrarily or for trading purposes.

2. Awards of Costs and Fees

Section 7430 of the Code currently requires the IRS to pay the reasonable administrative and litigation expenses of a taxpayer in certain circumstances if the IRS does not show that its position was "substantially justified." Such awards are not available, however, to taxpayers having a net worth above a certain dollar amount.

We recommend that recovery of such expenses under section 7430 be available to all taxpayers, regardless of their net worth. The IRS should be held accountable to all taxpayers and responsible for reimbursing a taxpayer for expenses it unduly causes the taxpayer to incur.

3. Monitoring and Reporting

The JCT staff recommends that the IRS be required to publish annually, information regarding payments made under section 7430 for taxpayers' administrative and litigation expenses and the administrative issues that resulted in the making of those payments.

Treasury recommends that, on an ongoing basis, the IRS undertake review of cases involving awards of attorney's fees and cases where penalties have not been judicially sustained, in order to enhance quality review of the administrative process.

We support the JCT staff's recommendation.

COMMUNICATIONS BETWEEN IRS AND TAXPAYERS

1. Communications with Individuals

The JCT staff recommends that the IRS place a higher priority on improving the processes by which the names and addresses of individual taxpayers are updated in the IRS's records.

Treasury recommends that on an ongoing basis the IRS improve the quality of its notices and communications to taxpayers regarding the basis for penalty and interest assessments and the abatement procedures. Treasury also recommends that the IRS institute procedures to reduce the burdensome nature of the current abatement process.

We support these recommendations.

2. Method of Communicating

The JCT staff recommends consideration by the IRS of the use of e-mail and fax instead of regular mail for communicating with taxpayers. The JCT staff also recommends that the IRS consider proposing legislation to provide for use of an alternative delivery system where current law requires use of regular mail.

We support the JCT staff's recommendations.

CONCLUSION

As stated earlier, we believe there is a need for a comprehensive review of the penalty and interest provisions in the Code and reforms to those provisions to ensure they are appropriately and fairly applied and are designed to accomplish their purpose. We welcome the opportunity to work with you now and in the future on such an undertaking.

Chairman HOUGHTON. Thank you very much, Mr. Ely. Mr. Shewbridge.

STATEMENT OF CHARLES W. SHEWBRIDGE, III, CHIEF TAX EXECUTIVE, BELLSOUTH CORPORATION, ATLANTA, GEORGIA, AND PRESIDENT, TAX EXECUTIVES INSTITUTE, INC.

Mr. SHEWBRIDGE. Thank you, Mr. Chairman. I am Chief Tax Executive for BellSouth Corporation in Atlanta, Georgia. I am here today as President of the Tax Executives Institute, the preeminent group of in-house tax professionals. Our 5,000 members belong to 52 chapters throughout the United States, Canada, and Europe and represent the 2800 largest corporations in North America.

TEI agrees that it is time for an in-depth review of the Code's interest and penalty provisions. The interest rules operate in an unfair manner and are difficult to administer. In many cases, the rules have served as an inappropriate penalty, such as with the estimated tax penalty, rather than as compensation for the time value of money. The interest calculation itself is extremely difficult and leads to errors by both the government and taxpayers.

In respect of the Code's penalty provisions, TEI believes that they should be simple, fair, and easy to administer. Unfortunately, the tax law has moved away from this concept since the penalty reform effort of 1989. Penalty has been piled upon penalty as Congress has sought to address particular areas on a piecemeal basis. We seem to have lost track of the concept that penalties should be applied only in cases of intentional noncompliance and not for every error or omission.

TEI believes that a comprehensive review will lead to the following conclusions: The interest rate differential should be repealed. The rate of interest on deficiencies and refunds should equal the applicable Federal rate, plus no more than two or three percentage points. The estimated tax penalty should be converted to an interest charge and safe harbors should be created for all taxpayers, corporate and individual. The Code's penalty regime should encourage disclosure by taxpayers. A dispute reserve account system should be established. Finally, certainty and fairness of application should play a more prominent role in encouraging compliance than an increase in penalty rates.

In my remaining time, I want to elaborate on two issues: the interest rate differential and the standard for the accuracy-related penalty.

The different interest rates for over and underpayments have spawned a major complexity: interest netting. In 1998, Congress established a net interest rate of zero where interest is payable on equivalent amounts of over and underpayment of tax. Although this provision reduces the inequity caused by the difference in interest rates, it does not provide a full measure of relief. It is also extremely complex to administer. TEI thus supports the Joint Committee's recommendation to eliminate the differential. This change would complete the reform effort Congress undertook 2 years ago.

The Code imposes a hodgepodge of penalties to ensure that a taxpayer's return is accurate. The standards now contained in the accuracy-related penalty provisions—more likely than not, realistic possibility of being sustained, substantial authority, reasonable basis, and not frivolous—are undeniably confusing. Taxpayers, practitioners and preparers have been reduced to assigning mathematical probabilities to each standard and then deciphering whether a proposed return position meets the applicable standard. Nevertheless, TEI believes that harmonization of taxpayer, practitioner, and preparer standards, as suggested by the Joint Committee and Treasury Department, is appropriate to encourage the filing of more accurate returns.

We question, however, whether sufficient attention has been paid to the effect on tax administration of imposing significantly higher standards for undisclosed and disclosed positions. Such an approach may unleash a flood of disclosures that wastes valuable IRS resources and distracts revenue agents from issues truly worthy of their scrutiny. Thus, TEI believes that if a taxpayer has substantial authority, no disclosure should be necessary to avoid a penalty.

Moreover, we do not believe that a case has been made for raising the taxpayer standard for disclosed positions from a reasonable basis to either a realistic possibility of success or a substantial authority standard. Overwhelming the system with disclosures will not aid the administration of the law, and care should be taken that the disclosures that are made are meaningful and useful.

Finally, Mr. Chairman, even with my 30 years of experience in the tax field, I find the differences among the various standards confusing. The higher standards proposed by Joint Committee and Treasury assume a level of mathematical precision that does not exist in reality. For example, it will not be easy to distinguish between substantial authority (a 40 percent chance) and a realistic possibility of success (which is a 33-1/3 percent).

Mr. Chairman, we commend you for calling this hearing to review the Code's interest and penalty provisions. TEI pledges its support for your efforts to effect meaningful simplification and reform.

I would be please to respond to your questions.

[The prepared statement follows:]

Statement of Charles W. Shewbridge, III, Chief Tax Executive, BellSouth Corporation, Atlanta, Georgia, and President, Tax Executives Institute, Inc.

Good morning. I am Charles W. Shewbridge, III, Chief Tax Executive for BellSouth Corporation in Atlanta, Georgia. I appear before you today as the President of Tax Executives Institute, the preeminent group of corporate tax professionals in North America. The Institute is pleased to provide the following comments on the Internal Revenue Code's interest and penalty provisions, with particular focus on the recommendations made in 1999 by the staff of the Joint Committee on Taxation and the Department of the Treasury. See Staff of the Joint Committee on Taxation, Study of Present-Law Penalty and Interest Provisions as Required by section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (Including Provisions Relating to Corporate Tax Shelters) (JCS–3–99) (July 22, 1999) (hereinafter cited as the "Joint Committee Study"); Office of Tax Policy, U.S. Department of the Treasury, Report to the Congress on Penalty and Interest Provisions of the Internal Revenue Code (October 1999) (hereinafter cited as the "Treasury Report").

I. BACKGROUND

Tax Executives Institute was established in 1944 to serve the professional needs of in-house tax practitioners. Today, the Institute has 52 chapters in the United States, Canada, and Europe. Our more than 5,000 members are accountants, attorneys, and other business professionals who work for the largest 2,800 companies in the United States and Canada; they are responsible for conducting the tax affairs of their companies and ensuring their compliance with the tax laws. TEI members deal with the tax code in all its complexity, as well as with the Internal Revenue Service, on almost a daily a basis. Most of the companies represented by our members are part of the IRS's Coordinated Examination Program, pursuant to which they are audited on an ongoing basis. TEI is dedicated to the development and effective implementation of sound tax policy, to promoting the uniform and equitable enforcement of the tax laws, and to reducing the cost and burden of administration and compliance to the benefit of taxpayers and government alike. Our background and experience enable us to bring a unique and, we believe, balanced perspective to the subject of the Internal Revenue Code's interest and penalty provisions.

TEI has long believed that the Code's interest and penalty provisions are unduly complex and inequitable. The interest provisions can operate in an unfair manner and are difficult to administer, especially when taxpayers have overlapping periods of under-and overpayments. In many cases, the provisions (such as with the estimated tax provisions) have served as an inappropriate penalty, rather than as recompense for the time value of money.

Moreover, the calculation of interest itself—with its restricted interest provisions and requirements for compounding and netting—is inordinately difficult and leads to errors by both the government and the taxpayer. Almost every TEI member can recount a protracted tale, if not a horror story, of convoluted, complicated, and ultimately incorrect interest calculations. For good reason, taxpayers doubt the IRS's ability to compute interest accurately, and they frequently incur significant expense in hiring outside consultants to review interest charges—often without the benefit of a print-out of the IRS calculations. We recognize that much of the cause of the problem lies in the IRS's computer system (which is in the process of being replaced), but we believe the IRS can take immediate steps to assist taxpayers now—for example, by providing copies of interest calculations.[1]

In respect of the Code's penalty provisions, TEI believes that they should be simple, fair, and easy to administer. Unfortunately, the tax law has moved away from this concept in the last decade where penalty has been piled upon penalty to target specific areas such as transfer pricing and corporate tax shelters. Rather than being straightforward, direct, and effective, penalties have become almost as complicated as the underlying provisions they seek to enforce. Dangerously, too, the enactment of new or racheting up of existing penalties deprives the system of proportionality while representing a politically expedient way of raising revenues without increasing "taxes."

The tax law seems to have lost track of the concept that penalties should be applied only in cases of willful (or volitional) noncompliance, and not for every error or omission. The current structure does not effectively distinguish between the two, but instead places taxpayers who unintentionally fail to meet some requirement in the same category with those who willfully decide not to comply.

It is clearly time for an in-depth review of the Code's interest and penalty provisions. TEI commends Chairman Houghton and the Oversight Subcommittee for scheduling this hearing to determine the effectiveness of the current interest and penalty regime and to consider recommendations for reform.[2] The Institute believes that such a comprehensive review of the interest and penalty provisions will invariably lead to the following conclusions (among others):[3]

- The interest-rate differential should be repealed in its entirety and the interest charged on under-and overpayments should be equalized.
- The rate of interest on under-and overpayments should equal the applicable federal rate plus no more than two or three percentage points.
- The estimated tax penalty should be converted to an interest charge and a safe harbor should be created for all taxpayers, corporations and individuals.
- The Internal Revenue Service's ability to abate interest should be expanded.
- The Code's penalty regime should encourage disclosure by taxpayers. The standards for imposing penalties should be harmonized and consistently applied, and there should be a realization that certainty and fairness of application play a more prominent role in encouraging compliance than reflexively increasing penalty rates.
- The pension-related penalties should be consolidated for enforcement purposes under a single government agency.
- A dispute reserve account to suspend the running of interest while an issue is disputed by the taxpayer and the IRS should be established.

TEI will be pleased to assist the Oversight Subcommittee in effecting these changes.

II. Interest Provisions

A. Elimination of the Interest-Rate Differential

Section 6621 of the Code establishes the rate of interest to be paid on over-and underpayments of tax. The rate on overpayments of tax by a corporation is the federal short-term rate plus two percentage points; the underpayment rate is the fed-

[1] Section 6631 of the Code (added by the IRS Restructuring and Reform Act) requires that individual taxpayers be provided with interest calculations after December 31, 2000. TEI submits that this provision should apply to all taxpayers and should be implemented as soon as possible.

[2] These comments do not address recent studies and proposals in respect of corporate tax shelters, which were the topic of a separate hearing by the full Committee on Ways and Means on November 10, 1999. Upon request, the Institute would be pleased to provide a copy of that testimony.

[3] Both the Joint Committee staff and the Treasury Department make several recommendations concerning the interest and penalty provisions as applied to individual taxpayers. Given the composition of its membership and the business-tax focus of its activities, TEI has not addressed these recommendations, but suggests that many of them—such as the Joint Committee staff's recommendation that overpayment interest be excluded from the income of individual taxpayers—are worthy of consideration.

eral short-term rate plus three percentage points.[4] "Large corporate underpayments" are subject to an interest equal to the federal short-term rate, plus five percentage points (the so-called hot interest provision).[5] Thus, the rate of interest the government charges corporate taxpayers on tax deficiencies is higher than the rate of interest the government pays on refunds.[6]

The different interest rates for over-and underpayments, coupled with the differences for large corporations, have spawned major complexity in the tax law—interest netting. The situation arises when taxpayers both owe money to and are owed money by the government (but the debts bear interest at different rates) and is a common occurrence for large corporations that may have overpayments and underpayments of different taxes for several years as the result of multi-year and overlapping audits. For example, an IRS determination, say in Year 8, that a taxpayer should have deducted an expense in Year 1 instead of Year 2 could trigger an adjustment owing to the interest-rate differential, even though the taxpayer was a net creditor of the government during the entire period.

In the IRS Restructuring Act, Congress established a net interest rate of zero where interest is payable on equivalent amounts of over-and underpayments of tax.[7] Taxpayers must affirmatively request and—at least at present—calculate the adjustments needed to achieve a zero net interest rate. Although this provision ameliorates the inequity caused by the difference in interest rates, it does not provide a full measure of relief. It is also an extremely complex provision to administer.

Tax Executives Institute supports elimination of the interest-rate differential. When the differential was enacted, two reasons were given for having different rates for under-and overpayments: (i) financial institutions do not borrow and lend money at the same rate, and (ii) the differential between the tax interest rate and the market rate might cause taxpayers either to delay paying taxes or to overpay them, depending upon the rate of interest accruing. H.R. Rep. No. 99–426, 99th Cong., 1st Sess. 849 (1985) (hereinafter cited as "1985 House Report"); S. Rep. No. 99–313, 99th Cong., 2d Sess. 184 (1986) (hereinafter cited as "1986 Senate Report"). Contrary to the views expressed in the Treasury Report (at 121), TEI submits that these reasons—even if valid in 1986—are no longer applicable. Taxpayers do not deliberately "lend" money to the government. If such practices ever occurred, they were effectively put to an end nearly two decades ago by changes to the manner in which, and the rate at which, interest is calculated.[8] Moreover, returning to one rate of interest for both under-and overpayments will greatly reduce or eliminate the need for netting, thereby significantly simplifying the law and freeing up both taxpayer and IRS resources. Finally, the proposed amendment would address the inequities arising from the "same taxpayer" rule, pursuant to which under-and overpayments

[4] The IRS Restructuring Act eliminated the differential in respect of individual taxpayers, but not corporations.

[5] The higher large corporate underpayment interest rate applies only to periods after the "applicable date." The calculation of the applicable date differs. If the deficiency procedures apply, the applicable date is the 30th day following the earlier of the date on which (a) the first letter of proposed deficiency that allows the taxpayer an opportunity for administrative review in IRS's Office of Appeals, or (b) the statutory notice of deficiency is sent by the IRS. If the deficiency procedures do not apply, the applicable date is 30 days after the date on which the IRS sends the first letter or notice that notifies the taxpayer of the assessment or proposed assessment.

[6] Under section 6621(a)(1), the interest rate on corporate tax overpayments that exceed $10,000 is only AFR plus 0.5 percentage points, as opposed to AFR plus 2 percentage points. (This provision was enacted in 1994 as part of the Uruguay Round Agreements Act, Pub. L. No. 103–465, 108 Stat. 4809, and accordingly is often referred to as "GATT" interest.) Thus, the potential difference between the interest rate for under-and overpayments for corporations is 4.5 percentage points. Although the GATT interest rate is effective for purposes of determining interest for periods after December 31, 1994, the IRS has embraced an unduly narrow interpretation of the statute, applying the lower rate to overpayment interest accruing before the statute's effective date. IRS Service Center Advice Memorandum 1998–014 (April 24, 1997). Indeed, the 1997 memorandum represents a change in position for the IRS, which originally determined that overpayment interest accrued through December 31, 1994, would not be subject to the lower GATT rate. The statutory GATT interest provision and the IRS's narrow interpretation operate to exacerbate the unfairness of the interest-rate differential.

[7] The provision applies to interest for periods beginning after July 22, 1998. In addition, the provision applies if: (i) the statute of limitations has not expired with respect to either the underpayment or overpayment; (ii) the taxpayer identifies the overlapping periods for which the zero rate applies; and (iii) the taxpayer requests the netting before December 31, 1999. In Rev. Proc. 99–43, the IRS clarified the transition rule by providing that—assuming that both statutes of limitations were open on July 22, 1998—a taxpayer must file a claim requesting application of the net rate of zero by December 31, 1999, only if both the applicable statutes will have expired before that date.

[8] Before 1982, interest rates on tax overpayments and underpayments were adjusted only once every two years; now they are adjusted on a quarterly basis.

by related entities (such as with foreign sales corporation and related supplier adjustments) do not result in an overall increase in tax liabilities, but because of the different rates on over-and underpayments, interest may be owed.

Thus, the Institute believes that the elimination of the interest-rate differential would complete the reform effort Congress undertook in 1998. *See Joint Committee Study* at 73. Equalizing the rates would "provide a better mechanism for achieving the equivalent effective interest rate goal than the net zero interest rate approach of current law." Id. at 76. It would also make the benefits of the equivalent effective interest rates available to all taxpayers, not just those capable of preparing the complicated calculations.

TEI therefore recommends that the interest-rate differential be eliminated for all taxpayers.

B. Rate of Interest

Equalizing the interest rates on under-and overpayments raises the issue of the appropriate rate of interest to be charged. Current law imposes various rates of interest ranging from the short-term applicable federal rate (AFR) plus 0.5 (for overpayments) to 5.0 (for underpayments) percentage points. The *Joint Committee study* recommends equal rates of AFR plus 5.0 percentage points (Joint Committee Study at 73), whereas the Treasury study recommends an underpayment rate of AFR plus 2.0 to 5.0 percentage points (and an overpayment rate of AFR plus 2.5 points) (Treasury Report at 8).

A rate of AFR plus 5.0 percentage points (essentially 10 percent in today's market) is equivalent to the "hot interest" rate that applies to large corporate underpayments. TEI questions whether this high rate is appropriate for all or even any taxpayers. As the *Joint Committee Study* confirms (at 76), large corporations are generally able to borrow money at a much lower rate. For example, a corporate taxpayer with an "AA" credit rating can borrow money today in the commercial paper market at 5.62 percent for 30 days—an amount comparable to the short-term AFR. The current interest rate system—with its provisions for above-market interest and "hot" interest—operates essentially as a penalty. We recognize that a blended rate is necessary for ease of administration. We also recognize that, from a tax policy standpoint, an argument can be made that interest rates should be skewed, if anything, to encourage overpayment.[9] Nevertheless, we submit the goal should be to approximate a market rate of interest (which does nothing more than reflect the time value of money), and respectfully suggest that a rate of AFR plus 2.0 or 3.0 percent would be closer to reality.

C. Abatement of Interest

Under section 6404(e) of the Code, the Treasury Secretary is granted the discretion to abate the assessment of all or any part of interest due for any period on (i) a deficiency attributable in whole or part to any unreasonable error or delay by an IRS officer or employee acting in an official capacity when performing a ministerial or managerial act, or (ii) a tax payment, to the extent that any unreasonable error or delay in such payment is attributable to an IRS employee or officer acting in an official capacity being erroneous or dilatory in performing a ministerial or managerial act. An error or delay may be taken into account only (i) if no significant aspect of such error or delay can be attributed to the taxpayer involved, and (ii) after the IRS has contacted the taxpayer in writing with respect to such deficiency or payment. There is also limited authority to abate interest in respect of erroneous refunds or reliance on erroneous written advice of IRS personnel.

Both the Joint Committee staff and the Treasury Department agree that the IRS's authority to abate interest should be expanded, though Treasury's recommendation is more circumscribed.[10] The Joint Committee staff recommends that the IRS be permitted to abate interest in cases of gross injustice. *Joint Committee Study* at 91–92. Although the "gross injustice" standard establishes a high threshold, adoption of the Joint Committee staff's recommendation would mark the first time abatement would be permitted on general equitable grounds. TEI believes that the recommendation should be adopted, but suggests that the IRS's administration of this standard be monitored to determine whether the threshold should be lowered.

Furthermore, the Joint Committee staff recommends that abatement occur for periods attributable to any unreasonable IRS error or delay. *Joint Committee Study* at 91–92. This provision thus eliminates the managerial or ministerial acts require-

[9] That is to say, if the interest rate is to provide an incentive either to overpay or to underpay one's taxes, the incentive should be toward encouraging overpayment.

[10] The Treasury Department recommends that the abatement provision be expanded only in respect of reliance on erroneous written advice from the IRS. Treasury Report at 137.

ment, which creates complex factual issues that themselves can lead to audit disputes and litigation. The legislative history of the interest-abatement provision confirms that Congress did not intend the provision to be used routinely to avoid payment of interest, but rather that the provision should operate in instances where the denial of abatement would be widely perceived as grossly unfair. 1985 House Report at 844–45; 1986 Senate Report at 208–09. There may well be instances where the denial of an abatement request may be unfair, but the taxpayer fails to meet the standards set forth in the statute.

TEI therefore supports the Joint Committee staff's recommendations in respect of the abatement of interest and suggests that consideration be given to expanding its reach.

D. Dispute Reserve Account

In general, interest on under-and overpayments continues to accrue during the period that a taxpayer and the IRS dispute a liability. Under section 6404(g) of the Code, the accrual of interest on an underpayment is suspended if the IRS fails to notify an individual taxpayer in a timely manner, but interest will begin to accrue once the taxpayer is properly notified. No similar suspension is available for other taxpayers.

Taxpayers that are unable to promptly resolve their disputes with the IRS face limited choices. The taxpayer can continue to dispute the amount owed and risk paying a significant amount of interest, it can pay the disputed amount and claim a refund, or it can make a deposit in the nature of a bond.

The Joint Committee staff recommends that taxpayers be permitted to deposit amounts in a special "dispute reserve account" within the Treasury Department. *Joint Committee Study* at 97. Access to the account would be permitted upon notice to the IRS. According to the study, the account "would allow taxpayers to better manage their exposure to underpayment interest without requiring them to surrender access to their funds or requiring them to make a potentially indefinite-term investment in a non-interest bearing account." Id. at 99. It would also preserve the taxpayer's access to the U.S. Tax Court while encouraging the prepayment of disputed amounts. Interest paid on the account would be set at a rate that would provide reasonable compensation to the taxpayer for the use of its money, but should not encourage the use of dispute reserve accounts as an alternative to investment in other short-term instruments. Id. at 100.[11]

The Joint Committee staff's recommendation is a significant improvement over the cash bond requirement of current law, and TEI recommends that it be adopted. Moreover, TEI recommends that interest accrue on amounts deposited in the account at the rate established for under-and overpayments of tax.

III. Estimated Tax Penalty

A. Penalty in Lieu of Interest

Under section 6655 of the Code, corporate taxpayers are subject to a penalty if they *fail to estimate their tax liability and make quarterly deposits equal to either (i) 100 percent of their actual tax liability, or (ii) 100 percent of their prior year's tax liability. The "prior year's tax" option is generally not available to for so-called large corporations—roughly, corporations whose taxable income is $1 million or more in any of the preceding three years. The estimated tax penalty is imposed in lieu of an interest charge on the underpayments of tax.

Because of the lack of a meaningful safe harbor, the large corporate taxpayer generally faces the following choice:

- paying a penalty for underestimating its liability, or
- overpaying its taxes (in order to avoid the penalty).[12]

The second option—which large corporations are generally required to choose not only by internal business conduct policies but by the desire to avoid penalties—does not come without cost. The cost is the effective denial of interest on the amount of the compelled overpayment by operation of section 6611(e), which provides that in-

[11] The Treasury Report does not address this issue.

[12] The estimated tax rules provide an annualization method that may be employed to avoid any penalties. Determining annualized tax liability and quarterly estimated payments under section 6655(e), however, remains far from simple. This process effectively requires taxpayers to prepare five "mini" returns for their estimated tax payments plus their final return. By reinstating the prior year's liability safe harbor, Congress could remove the uncertainty associated with the determination of tax liability from the quarterly estimating and payment process.

terest on an overpayment will not begin to run until the filing of a claim for refund.[13] The rules thus act as a "non-penalty" penalty for corporations.

TEI agrees with the recommendation that the estimated tax penalty be converted to an interest charge at the rate provided under section 6621 of the Code, which would make the interest deductible by corporate taxpayers. *See Joint Committee Study* at 114–15.[14] The estimated tax penalty is, in reality, a charge for the time value of money and the law should reflect this fact. It is simply bad tax policy to disguise an interest charge as a penalty.

TEI therefore supports the Joint Committee staff's recommendations. We also agree with its recommendation (at 118–19) that, in the pursuit of simplification, the interest rates should be aligned so that, for any given estimated tax underpayment period, only one interest rate applies, i.e., the interest applicable on the first day of the quarter in which the estimated payment due date arises.

B. Safe Harbor

TEI is disappointed that neither the *Joint Committee Study* nor the Treasury Report addresses need for an estimated tax safe harbor for corporate taxpayers. Because they are not permitted to utilize the prior year's tax rule, large corporations must base their quarterly deposits on estimates of their current year's tax liability. Estimating taxes is not an exact science. The existing task is literally impossible in light of the complexity of the tax laws, the rapidity with which they have been changed in recent years, and the fact that the numerous adjustments to financial income can accurately be done only annually.

TEI submits that there is no valid tax policy reason for denying large corporations the availability of the prior year's tax rule under section 6655. We therefore recommend that a safe harbor, based on a percentage of the prior year's (or the average of a group of years') liability, be established for large corporate taxpayers.

V. Penalties

A. Accuracy-Related Penalties

The Code imposes a hodgepodge of penalties to encourage taxpayers to file accurate returns. These penalties employ a variety of standards, ranging from "more likely than not" (section 6662(d)(2)B)(i)) and "reasonable basis" (section 6662(d)(2)(B)(ii)) for taxpayers, to "realistic possibility of being sustained" (section 6694(c)) and "not frivolous" (section 6694(a)) for return preparers. The less stringent standards are generally applicable for positions that are disclosed on a return. See Joint Committee Study at 152, Table 7 ("Summary of Existing Standards for Tax Return Positions").

Section 6662(a) imposes a 20-percent penalty on the portion of an underpayment attributable to any of the following: (i) negligence or disregard of rules or regulations; (ii) a substantial understatement of income tax; (iii) a substantial valuation overstatement; (iv) a substantial overstatement of pension liabilities; or (v) a substantial estate or gift tax valuation understatement. The accuracy-related penalty was enacted in 1989 to replace several other penalties, including the negligence, substantial understatement, and valuation overstatement penalties. The penalty is generally not imposed with respect to any portion of the underpayment for which there is reasonable cause if the taxpayer acted in good faith. I.R.C. § 6664(c)(1).

For corporations, an understatement for any taxable year is "substantial" if it exceeds the greater of $10,000 or 10 percent of the tax required to be shown on the taxpayer's return. I.R.C. § 6662(d)(1). An exception to the penalty is provided for items in respect of which there is substantial authority or adequate disclosure of the taxpayer's position.[15]

The Code also imposes a two-tiered penalty on tax return preparers in respect of positions not having a "realistic possibility" of being sustained on the merits. Specifically, if the position results in an understatement, a penalty will be imposed unless the preparer takes steps to ensure the disclosure of the position and the position is "not frivolous." I.R.C. § 6694 (a) & (c).

[13] The filing of a tax return could constitute a claim for refund, but most calendar-year large corporations will not file returns until close to September 15 (the extended due date of their return), though any outstanding tax would have to be paid no later than March 15. Thus, there could be, at a minimum, a six-month period during which no interest would accrue on the amount of the overpayment.

[14] But see Treasury Report at 81 (recommending retention of current law).

[15] Special rules apply in respect of "tax shelters," where the penalty can be avoided only if the taxpayer establishes that, in addition to having substantial authority, it reasonably believed that the treatment claimed was more likely than not the proper treatment of the item; adequate disclosure has no effect on the application of the penalty in respect of tax shelters.

The Joint Committee staff and Treasury Department both recommend that penalty standards be harmonized, though they approach the issue in different ways. Their reports focus on two issues:

- The appropriate standard imposed on taxpayers and tax return preparers.
- The appropriate standard imposed for disclosed and undisclosed return positions.

The Joint Committee staff recommends that, for both taxpayers and preparers, the minimum standard for each undisclosed position on a tax return be that the taxpayer or preparer must reasonably believe that the tax treatment is "more likely than not" the correct tax treatment under the Code. *Joint Committee Study* at 153. For *disclosed* positions, the Joint Committee staff would require both substantial authority and adequate disclosure and would eliminate the reasonable cause exception of section 6664(c)(1). *Joint Committee Study* at 154–155, Table 8 ("Proposed Standards for Tax Return Positions"). Thus, under the Joint Committee staff's proposal, the standard in respect of disclosed positions would move from the disjunctive (substantial authority or disclosure) to the conjunctive (substantial authority and disclosure).

In contrast, the Treasury Department would retain the "substantial authority" standard for undisclosed positions and raise the standard for *disclosed* items to a "realistic possibility of success" for both taxpayers and tax return preparers. *Treasury* Report at 108.

The multitude of standards now contained in the Code—more likely than not, realistic possibility of being sustained, substantial authority, reasonable basis, not frivolous—is undeniably confusing and has reduced taxpayers, practitioners, and preparers to assigning mathematical probabilities to each standard and then divining (to the extent possible) whether a proposed return position meets or exceeds the applicable standard. The clarity suggested by the use of mathematical probabilities, however, is a false one, for the tax law is marked by many things, but mathematical precision is rarely one of them.[16]

These concerns notwithstanding, TEI believes that some adjustment to and harmonization of taxpayer, practitioner, and preparer standards may be appropriate to encourage the filing of more accurate returns. We question, however, whether sufficient attention has been paid to the effect of raising the standard in respect of *undisclosed* positions to "more likely than not" (as the Joint Committee staff suggests). Such an approach may unleash a torrent of disclosures that consumes valuable IRS resources and distracts revenue agents from issues more worthy of their scrutiny. Thus, although we appreciate the surface appeal of the statement that "'more likely than not' is a simple threshold that is easily understood" (*Joint Committee Study* at 153), we are concerned about how an "at least probably correct" standard (id.) will be applied in practice. As the Joint Committee staff notes, it is unrealistic to expect taxpayers to file a perfect return (id. at 152), and TEI is concerned that taxpayers may find themselves facing penalties where, several years after they grappled with the vagaries and interstices of the tax law, a revenue agent or court concludes—with the benefit of hindsight—that the taxpayer erred in concluding its position was "at least probably right." (This concern is heightened in light of the Joint Committee's recommendation that the reasonable cause exception of current law be repealed.)[17] If a taxpayer has substantial authority for a return position—e.g., if a court decision or regulation supports its position—no disclosure should be necessary in order to avoid a penalty. See *Treasury Report* at 108.[18]

Moreover, we do not believe that the case has been made for raising the standard for disclosed positions in respect of taxpayers from a reasonable basis to either a realistic possibility of success standard (as the Treasury proposes) or a substantial

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[16] TEI is also concerned about how meaningful a difference exists between the two proposed standards. What is the difference between the Joint Committee staff's recommendation of a "substantial authority" standard—which is defined as a 40-percent probability of success—and the Treasury Departments's "realistic possibility of success standard—which is defined as a 33-percent probability? We submit that it would be almost impossible to analyze a proposed transaction with such precision. More troublesome, we foresee situations in which a taxpayer's (or practitioner's) good faith judgment that a position satisfies the higher (40 percent) standard could be second-guessed by a revenue agent who concludes, also in good faith, that the possibility of success was 6.5 percentage points lower.

[17] It should also be recognized that the person making the decision whether the taxpayer was "at least probably right" (i.e., revenue agent, Appeals officer, or court) would not even reach that question until concluding that the taxpayer was wrong on the merits.

[18] Given the additional recommendation to increase the amount of the preparer penalty—from a two-tier penalty of $250 or $1000 per return to 50 or 100 percent of the fee (Joint Committee Study at 156)—TEI wonders whether sufficient attention has been focused on the potential adverse effect of the higher standards.

authority standard (as the Joint Committee staff proposes). Again, the Institute is concerned that raising the standard would be counterproductive. It may prompt taxpayers, out of an abundance of caution, to laden down their tax returns with myriad disclosure forms, thereby greatly diminishing the value of any particular "needle" in the burgeoning "haystack." Overwhelming the system with disclosures will not aid the administration of the law.[19]

B. Pension Benefit Penalties

Current law imposes several penalties in respect of the failure to file the Form 5500 series (the annual return/report for pension plans). The penalties are imposed by the IRS (under Code section 6652(e)), the Department of Labor (under DOL Reg. § 2560.502(c)–2(d)), and the Pension Benefit Guarantee Corporation (PBGC) (under PBGC Reg. § 4071.3).

The Joint Committee staff recommends the consolidation into one penalty of the present-law penalties imposed by the Internal Revenue Code and ERISA for failure to file the Form 5500 series. Joint Committee Study at 161. The penalty that would result from this consolidation would be no less than the existing ERISA penalty for failure to file. In addition, the staff would designate the IRS as the agency responsible for enforcing the reporting requirements and replace the Labor Department's voluntary compliance program with a similar program administered by the IRS. This would reduce from three to one the number of government agencies authorized to assess, waive, and reduce penalties for failure to file. Other penalties imposed for the failure to file certain reporting forms would also be eliminated. Id. The Treasury Department also supports consolidation of the penalties, but recommends that the administration of the penalties rest with the Department of Labor. Treasury Report at 141.

In TEI's view, consolidating the penalties would be a marked improvement over current law. It would simplify the Form 5500 series penalty structure, reduce the number of potential penalties for failure to file, strengthen incentives to comply, and encourage voluntary compliance by delinquent filers while retaining the most significant of the present-law penalties for failure to file. On balance, we favor the Joint Committee staff's proposal to have the IRS responsible for administration of the streamlined regime.

C. Administrative Proposals

The Joint Committee staff makes several recommendations concerning the administration of the penalty provisions. First, the staff recommends that the IRS improve the supervisory review of the imposition of penalties as well as their abatement (or waiver). Joint Committee Study at 169. Improving the level of review would improve consistency and combat the perception that penalties are often used as "bargaining chips." As the Joint Committee staff suggests, another way to improve supervisory review would be to institute penalty oversight committees, similar to the one established for administering the transfer pricing penalty under section 6662(e)(3) of the Code.

TEI believes that these suggestions are sound and encourages the IRS to consider whether the penalty oversight committees should be expanded to the review of other penalties, most especially, accuracy-related penalties.

VI. Miscellaneous Recommendations

A. Standards Applicable to IRS Personnel

The Joint Committee staff makes several recommendations concerning the administration of the tax law by the IRS, including a revision of the standards applicable to IRS personnel under Rev. Proc. 64–22, 1964–1 C.B. 689, which among other things provides that IRS employees should not adopt a strained construction of the Code. As the Joint Committee staff notes, "the standards of conduct applicable to the IRS are an important component of taxpayers' perceptions of the relative fairness of the administration of the tax laws." Joint Committee Study at 167.[20]

TEI agrees that the standards to which IRS employees are held should be clarified. We also agree with the Joint Committee that some employees may have mis-

[19] The Joint Committee Study (at 156) acknowledges that no empirical evidence exists on whether or how effectively the IRS uses the taxpayer disclosures made under current law, and it recommends that the IRS be required to maintain records on its own usage of taxpayer disclosures. TEI supports this recommendation and suggests that, pending the gathering and analysis of information on the effectiveness of current law, Congress not rush to judgment on the need for more and better disclosures.

[20] The Treasury Report is silent on this issue.

construed the quoted language from Rev. Proc. 64–22—which also appears several places in the Internal Revenue Manual (IRM)—to suggest that a revenue agent's position need not be reasonable, it just cannot be strained. As the Joint Committee's report puts it: "[I]t may appear that an inappropriately low standard of conduct is applicable to the IRS." Joint Committee Study at 167. Thus, the Joint Committee staff recommends that the standards be revised to incorporate a higher standard of behavior by the IRS, similar to that for practitioners.

TEI agrees that a higher standard of conduct for IRS personnel is appropriate and recommends adoption of the Joint Committee staff's recommendation.

B. Failure-to-Deposit Penalty

The Joint Committee staff and Treasury Department make several recommendations concerning the four-tier failure-to-deposit penalty under section 6656(b). Although both suggest that no new legislation be enacted in this area for two years—in order to give the recent statutory changes time to be evaluated—the Joint Committee staff adds that the Treasury Department should consider revising its deposit regulations concerning events that trigger a change in the deposit schedule in a later calendar quarter. This would give the IRS an opportunity to notify the taxpayer of the change in status before it takes effect. It would also give the depositor time to recognize its new obligations and adjust its operating procedures accordingly. Both studies also recommend that the IRS continue to work with payroll service providers to expedite resolution of problems where a single error or mishap may affect multiple taxpayers. Joint Committee Study at 139–140; Treasury Report at 96.

TEI supports these recommendations, but suggests that consideration be given to implementing a mechanism to identify third parties who can provide an oral response to the IRS and receive information in return—without resorting to the time-consuming method for obtaining a power of attorney. Based on reports from our members, TEI understands that at least one District Office has experimented with including a unique identifying number on each notice of proposed penalty. If a caller responds to the notice and provides the name and employer identification number (EIN) of the taxpayer and the identifying number, the IRS assumes the caller is authorized to discuss the matter, eliminating the need for a power of attorney and providing a swift resolution of any questions. TEI recommends that such a procedure be implemented.

VII. CONCLUSION

Tax Executives Institute appreciates this opportunity to present its views on the interest and penalty provisions of the Internal Revenue Code. Any questions about the Institute's views should be directed to either Michael J. Murphy, TEI's Executive Director, or Timothy J. McCormally, the Institute's General Counsel and Director of Tax Affairs. Both individuals may be contacted at (202) 638–5601.

Chairman HOUGHTON. Thanks very much, Mr. Shewbridge. I am going to ask Mr. Coyne to ask the first question.

Mr. COYNE. Thank you, Mr. Chairman. Mr. Pearlman and Mr. Ely, I wonder if you could respond. We understand that the IRS audits and collections are at an all-time low. I just would like to have your two views on that situation.

Mr. PEARLMAN. Well, we understand the same thing. I think part of—it is a complicated issue, but I think it is an extraordinarily important issue. Part of it is attributable to the tremendous changes that are taking place at the IRS, and I think my impression is that the modernization project inevitably was going to result in some reduction in compliance activities, and hopefully, that is short-term and the Commissioner has indicated that is a short-term phenomenon and we expect it will be. Some of it is attributable to budget constraints and the need to shift personnel from one function within the Service to another.

Clearly, the Service has heard the message from the Congress that it needs to improve its quality of taxpayer service and it appears that they have devoted substantial resources for doing so, and that has had an effect on collection and audit. Finally, some of the effect certainly on the collection side has apparently been the result of the 1998 legislation and the potential liability, personal liability on IRS employees.

Again, if you listen to the senior management of the Internal Revenue Service, because of increased improved training in that regard, they believe that too is a short-term phenomenon. I think the most important issue, the most serious issue, is the question of audit coverage. I am more concerned about audit coverage than I am collection activity. I think the collection activity issue will sort of settle out. But I believe that audit coverage is a big issue. I don't know what the right level of coverage should be. I mean I don't hold the kind of expertise to know whether the numbers should be 1 percent or 2 percent. But my perception as a practitioner is that the lower audit coverage has had an effect on compliance, and I would expect that would continue. I think it is an issue that this committee really should take a look at, without having an agenda, but simply to try to get a feel from the experts, both within the government and outside, as to what is happening in terms of compliance and how audit resources can best be deployed to assure the highest level of compliance without being overbearing.

Mr. ELY. I will echo a lot of what Mr. Pearlman said. I do agree that the audit rate is historically low. I believe the rates are below 1 percent, maybe three-quarters of a percent. However, I think the IRS is taking the right approach, which is really to not so much focus on the audit coverage, whether it is 1 percent, a half a percent, 2 percent, I don't think that is going to make all the difference in the long term. I think what they should be focusing on, which I think what they are starting to do is focus on encouraging compliance in different ways, focusing on education, taxpayer outreach, tax system modernization, explaining the rules to taxpayers through identification so that they can comply on their own. I think if we are going to base our system on the IRS audit rate, I think it is going to fail. I think what we should do is to encourage compliant conduct. That is why I believe also the interest and penalty reform studies that you are doing now are so important, and should be focused towards that area.

Mr. COYNE. Thank you.

Chairman HOUGHTON. Mr. Portman.

Mr. PORTMAN. Thank you, Mr. Chairman. I appreciate you all being here. I apologize, we all have different things going on right now and I couldn't be here for all of your testimony, but I have seen the summaries of it and I do appreciate your specific input on interest and penalties, the focus of our hearing and what this subcommittee is trying to grapple with and come up with at the end of the day, are some recommendations for either legislative changes or encouraging Treasury and the IRS to make administrative changes that we think they already have the authority to do under existing law.

My question that I would like to focus on if I might is this differential issue. We studied this and the IRS Commission came up with some thoughts on it. I am not sure that the statute is clear on it, to be frank, and what I would like to do, if I could get input from as many of you as we have time for on how you have come out on this and really to process how we should get there.

The Joint Tax Committee study, as you know, proposes eliminating the differential altogether because it is so complicated. The underpayment, overpayment rate is a difficult one for the IRS to deal with. A lot of people who looked at it from the outside say that the taxpayers usually get it wrong. Someone said they always get it wrong and the IRS usually gets it wrong.

My question is should there be a single rate for overpayments and underpayments and would this be a significant simplification measure. I will go if I could from Ms. Akin down.

Ms. AKIN. I believe that your statement is right, that taxpayers can't figure it, the IRS can't figure it, and everybody does have a problem with it. It should be very simplified and should be the same rate for overpayment as underpayment.

Mr. PORTMAN. Ron?

Mr. PEARLMAN. Mr. Portman, I think you are absolutely right. I was on the Joint Committee staff in 1989 when the proposal was adopted, and I remember, I remember the day when I said to the then chairman of the Senate Finance Committee, this provision is going to create major problems, and I think there are two problems. One is a perception problem. People don't understand it. Even though there is a theoretical basis for the differential, people simply don't understand it, and the second problem is that it is inevitably complex, and no matter how hard people work on interest netting, it is always going to be complex. It seems to me the right way to deal with a problem that produces complexity and a perception issue is to get back to a more rational world, and I think a single rate is the rational world.

Mr. PORTMAN. Mr. Ely.

Mr. ELY. I would concur. We strongly believe that a single rate is the appropriate mechanism. Interest is not a penalty, it is solely for compensation for the use of money. We would, however, go a little further than the Joint Committee. I think a very good point that was brought up when you were here earlier talking with Mr. Mikrut was the issue of periods where there is a mutuality of indebtedness, where the government owes you money, you owe the government money. We believe absolutely that should be taken into account, under the use of money principles.

Mr. Mikrut brought up an example, and I think if you looked at an example of where you have a taxpayer with a single tax year, when a taxpayer, the same scenario where there is a 45-day rule, they file their return, they seek an overpayment, they get their money without interest. If that same taxpayer, it was later determined that taxpayer had a deficiency, under current law, and the IRS finally acquiesced to this after four cases, that taxpayer would not owe interest for that period of time from when the return was filed until they received their cash. That is really the appropriate approach to look at the interest, and all we are asking is that same approach be taken to other years. So we think it is the appropriate result.

Mr. PORTMAN. Mr. Shewbridge.

Mr. SHEWBRIDGE. I echo what they are saying. I think the interest calculation is among the biggest problems that corporate America has. I hear complaints about it all across the country and have for many, many years. I think that simplifying, by establishing one rate makes an awful lot of sense. We do believe, however, that the rate should be at a market rate and not at a punitive rate. We look forward to working with the Subcommittee on trying to establish a rate that makes sense and something that would greatly simplify the Code.

Mr. PORTMAN. Thank you again for your testimony. We look for to working with you as we go forward.

Thank you, Mr. Chairman.

Chairman HOUGHTON. Thank you, Mr. Portman. Is Mr. Weller here? Mr. Weller, do you have any questions?

Chairman HOUGHTON. I just have one question. Mr. Shewbridge, in your statement you mentioned the Joint Committee on Taxation, their study and the recommended change and we sort of danced around this thing, the creation of a special dispute reserve account. Do you want to break that down a little bit?

Mr. SHEWBRIDGE. Ms. Paull did a good job in her statement of describing how it would work. Basically, today you can make a deposit in the nature of a cash bond that cuts off interest charges for a tax issue that might be in dispute. Under the proposal, you would pay money into a "dispute reserve account," which would earn interest. The taxpayer could withdraw the money during the process if 45 days' notice is given to the IRS. The balance in the account can be used to pay the ultimate tax liability, plus interest, when the issue is finally resolved.

Chairman HOUGHTON. Okay. That is the only question I have. Do you have any more?

Well, ladies and gentlemen, thank you very much. We certainly appreciate it.

[Whereupon, at 12 noon, the hearing was adjourned.]

[Submissions for the record follow:]

AMERICAN COUNCIL OF LIFE INSURERS
February 10, 2000

A. L. Singleton
Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Re: Hearing on I.R.C. Penalty and Interest Provisions by the Subcommittee on Oversight of the House Committee on Ways and Means, January 27, 2000

Dear Mr. Singleton:

I am writing on behalf of the American Council of Life Insurers. The 435 member companies of the ACLI have 73.2 percent of the life insurance in force in the United States in legal reserve life and health insurance companies. Their assets represent 79.4 percent of all United States life and health insurance companies, 82.2 percent of the pension business, and 86.9 percent of the long term care insurance business with such companies. We appreciate the opportunity to present comments regarding the penalty and interest provisions of the Internal Revenue Code for inclusion in the hearing record of the Subcommittee.

In our letter responding to the Joint Committee on Taxation's Press Release 98–02 requesting comments on their Interest and Penalty Study, we raised a number of points, including one regarding "global netting" of interest on underpayments and overpayments of tax for overlapping periods. The relevant part of our letter dated February 26, 1999 was as follows:

Global Interest Netting: We note that since 1986, penalty provisions have been strengthened substantially to discourage inappropriate behavior. Because of the broad reach of the current penalty provisions, the time is ripe to equalize the overpayment-underpayment rates of interest to eliminate "hot" interest. The statutory interest rates should favor neither the Taxpayers nor the Government. While we understand that this problem was addressed as part of the IRS Restructuring and Reform Act of 1998 and the enactment of global interest netting provisions, these provisions are complex and do not completely resolve the problems caused by the interest rate differentials. We suggest that consideration be given to equalization of the interest rates. Absent such an equalization, our member companies have indicated that guidance is needed on the application of the global interest netting provisions, especially with respect to their applicability to pre–1999 tax years.

During 1999, the IRS did issue initial guidance on how to achieve netting of interest with respect to interest accruing before October 1, 1998 in Rev. Proc. 99–19, 1999–13 I.R.B. 10. Comments submitted by ACLI and others, led to some modifications that were included in Rev. Proc. 99–43, 1999–47 I.R.B. 579. While this guidance was helpful, and provided assistance to taxpayers who were approaching the December 31, 1999 statutory deadline for filing claims for relief for interest accruing before October 1, 1998, it did little to alleviate the ongoing computational and administrative problems that will face both taxpayers and the IRS in computing global netting relief for interest accruing both before and after October 1, 1998. The way to accomplish this is by eliminating the interest rate differential.

We note that support for a single interest rate was voiced by a number of witnesses at the Subcommittee's January 27, 2000 Hearing, including Lindy Paull, Chief of Staff of the Joint Committee on Taxation, IRS National Taxpayer Advocate Val Oveson, Charles W. Shrewbridge, president of the Tax Executives Institute, Mark Ely, representing the Tax Division of the American Institute of Certified Public Accountants, and Ronald Pearlman, chairman of American Bar Association's Section of Taxation task force on corporate tax shelters. The points they raised were similar to those we have given. We therefore reiterate our request that consideration be given to correcting the problem by eliminating the rate differential legislatively and establishing a uniform rate for underpayments and overpayments to be applicable to all taxpayers and to the government.

Sincerely,

MARK A. CANTER

AMERICAN COUNCIL OF LIFE INSURANCE
February 26, 1999

Lindy L. Paull, Esquire
Chief of Staff
Joint Committee on Taxation
1015 Longworth House Office Building
Washington, D.C. 20515

Re: Joint Committee on Taxation Press Release 98–02 Interest and Penalty Study

Dear Ms. Paull:

We are writing on behalf of the American Council of Life Insurance in response to JCT Press Release 98–02 which indicates that comments are being sought from the public on a number of issues relating to the administration and implementation by the Internal Revenue Service (the "Service") of the interest and penalty provisions of the Internal Revenue Code. The 493 member companies of the American Council of Life Insurance have 77.3 percent of the life insurance in force in the United States in legal reserve life insurance companies. Their assets represent 82.3 percent of all United States life and health insurance companies and 83.7 percent of the pension business with such companies.

In reviewing the issues noted in the press release, our members would like to submit the following comments.

Penalties Related to Information Returns: Our member companies file a substantial number of information returns, including Forms 1099–INT, 1099–R, 1099–LTC, and 1099–MISC. In filing these returns, the companies make extensive efforts to obtain the correct name and matching taxpayer identification number (TIN) and to otherwise comply with reporting and withholding obligations. At times, however, the name and TIN do not match, resulting in an assessed penalty to the company filing the information return. While assessed penalties can be and generally are waived upon a showing of reasonable cause by the Taxpayer filing the information returns, the waiver process is costly and time consuming for both the Taxpayers and for the Service.

Currently, we understand that the Service has a policy of not assessing a proposed penalty if a company is in significant compliance with the information reporting requirements. Based on our member companies' experiences, this significant compliance standard is considered to be met as long as 99.5% of the returns are correct. Thus, there is an informal "safe harbor" of .5%.

While we appreciate the Service's need for correct information returns, we believe that this standard is excessively stringent.

There have been legislative proposals in recent years to formalize and increase such a "safe harbor." We suggest that the Service issue guidance providing for a formal safe harbor of 5% so that as long as 95% of a company's information returns are correct, no penalty would be assessed. Increasing the threshold will not discourage any company from undertaking reasonable efforts to obtain the correct name and TIN or otherwise meet its reporting and withholding obligations. It will ease the burden to Taxpayers and the Service in applying for and processing waivers of proposed penalties.

Based on substantial experience in complying with reporting and withholding requirements, our member companies believe that there should be a presumption that financial intermediary payors (information return filers) have "reasonable cause" for errors made in information reporting. Based on the large number of information returns filed by financial intermediaries, inadvertent errors are inevitable and it should be presumed that they are not intentional. Companies filing information returns spend substantial amounts to establish and maintain systems and procedures to correctly report and withhold. The reporting and withholding by financial intermediaries assist the government in the orderly collection of tax revenue. Information reporting and withholding by financial intermediary payors should be viewed as a partnership enterprise between the government and the payors. Penalties for failure to fulfill reporting and withholding obligations should only be assessed in the event that a payor has clearly failed to exercise reasonable cause.

TIN Validation Program: Our member companies responsible for filing information returns obtain the name and TIN from their policyholders and payees. Currently, they have no method of validating that the name and TIN provided are correct prior to the filing of an information return. If there is an error, the Service advises them after the returns have been filed. The notice of an incorrect name/TIN is often accompanied by a proposed penalty notice for filing an incorrect information return. In many cases, the Service does not advise the Company of an error for a number of years after the return has been filed. In the case of returns filed annually, the company may have filed multiple information returns with an incorrect name or TIN by the time it is notified of the error.

Were companies able to check whether the name/TINs were correct prior to filing their information returns, they would better be able to contact the affected policyholders or payees to obtain the correct information. In a two-year pilot application, the Service permitted some name and TIN verification. It is our understanding that information filers were in favor of this program and have requested that the Service institute a broad-based name/TIN matching system. We suggest that a name/TIN verification program for information return filers be instituted to reduce the number of incorrect information returns. This would result in a saving of resources for both the Service and information reporters.

Changes in Information Reporting and Withholding Obligations: As a general matter, our member companies are concerned that the substantial additional computer systems and administrative costs imposed on them as payors are not adequately considered when there are changes in withholding and information reporting obligations. In a real sense, these additional costs are a "tax" on payors; ultimately, this tax is taken into account by companies in determining the amounts that they can pay to policyholders. In this regard, we urge that Congress, the Department of the Treasury and the Internal Revenue Service coordinate with the payor community and seriously consider the administrative costs imposed on payors prior to revising or adding to our reporting and withholding responsibilities.

IRS Communication with Taxpayers: Our members report that certain communications, including penalty notices, from the Service lack adequate explanation as to the nature of the issue raised by the Service and the actions that may be taken by the Taxpayer. Taxpayers have indicated that when they contact the Service for additional information, the contact person noted on the communication often has no further information than that provided in the original communication and is unable to assist the Taxpayer in resolving the issues raised by the communication. For example, certain penalty notices for incorrect information returns have been issued without identifying the reportedly erroneous return; when the Taxpayer contacts the Service for more information, the Service has been unable to identify the information return to which the penalty relates. In the end, the Taxpayer cannot respond to the proposed penalty notice. There have also been instances in which a Taxpayer believes that an issue has been resolved based on a telephone conversation with a Service representative, only to find later that not only does the issue remain unresolved, but that the Service records do not reflect the conversation with the Taxpayer.

We suggest that the Service provide background documentation in all communications to a Taxpayer in order to explain and support the issue raised. In addition, we suggest that the Service provide the contact name of the person who initiated the communication and who is familiar with the issues raised therein. In addition, Taxpayers who contact the Service with respect to a communication should be able to affirmatively rely on the representations made by the Service representative during this contact. As to situations in which the Taxpayer has contacted the Service concerning an undocumented communication, the Service should not assess penalties or interest during the time that the Taxpayer is working to obtain information necessary to resolve the issue.

Changes of Address: Several of our member companies have experienced situations in which the Service has changed the Taxpayer's name or address when the Taxpayer has not requested that such a change be made. For example, a corporation provides its address on Form 1120; subsequently, a communication is sent to the Service concerning the Taxpayer, either from a division of the Taxpayer at a different address, or from an outside representative. Taxpayers have found that the Service has changed the address of the Taxpayer in its records to that of the correspondent, with no instruction to do so. Once the address is changed, there have been cases in which the Service has sent future correspondence on unrelated matters to the new, incorrect, addresses. This incorrect mailing often delays Taxpayers' responses to Service correspondence. In other situations, Taxpayers have filed consolidated returns in the name of the corporate parent with the proper taxpayer identification number; subsequently, a communication is made to the Service concerning the return which notes the name of a subsidiary of the parent, with the parent's taxpayer identification number for reference. Taxpayers in this situation have found that the Service has changed the name of the corporate parent in its records to that of the subsidiary, again, without any instruction to do so.

In order to alleviate these inadvertent changes of name and address, we suggest that the Service be permitted to change its records of a Corporate Taxpayer's name or address only in one of three situations: (1) filing of a Form 1120 with a new name or address, (2) specific request on a Form 8822 or similar letter from the Corporate Taxpayer, or (3) the Service otherwise has actual knowledge of a change in name or address of the Corporate Taxpayer and advises the Taxpayer that the Services records are being changed.

Uniform Taxpayer Contacts: Our members report that, in some cases, the Service sends communications to various departments within the same corporation. Taxpayers have difficulty in timely responding to these communications when they are mailed to different locations or departments. In addition, the Service may not be aware in each situation as to the specific department within a corporation where any given correspondence should be sent and may select an incorrect department, thus delaying the Taxpayer's response.

As a means to centralize communications between the Service and Taxpayers, we suggest that Taxpayers be offered the ability to designate a corresponding officer within the company to receive either all of the Service's communications to the Taxpayer or all of a certain type of communications (such as all employment tax matters). Once the Taxpayer had made this election to designate a corresponding officer, the Service would be required to send all communications to this corresponding officer. There may be situations in which certain communications were sent to counsel for the Taxpayer pursuant to a power of attorney; once a designation is made, a copy of the original communication should also be sent to this corresponding officer. This designation could be made annually on the Form 1120 or Form 851, Affiliations Schedule. If a designation was made, the Service could be assured that its communications would be forwarded to the proper party.

Service Transfers of Tax Payments: Our member companies have indicated that the Service has, without their consent and often without notice, transferred funds between amounts paid to satisfy corporate income tax (Form 1120) obligations and those deposited with a Form 941, Form 945, or Form 1042 to satisfy income and employment tax obligations. That is, a Taxpayer who has made a Form 941 deposit may find that the Service has transferred the funds to the Taxpayer's 1120 account, with the result that there are insufficient funds in the Form 941 account. Insufficient funds in a Form 941 account can result in a penalty for failure to make adequate deposits.

We suggest that the Service be prohibited from transferring funds between different Taxpayer accounts absent specific consent by the Taxpayer. This prohibition will avoid the assessment of improper penalties for failure to make adequate deposits when in fact the deposits were timely made, but the funds were transferred by the Service to a different account. In the event that a prohibition is not feasible, we would suggest that, at a minimum, the Service be required to provide advance notice when funds are to be transferred among accounts. If amounts are transferred without consent or advance notice, the Service should be prohibited from assessing any penalties or interest which may arise due to a deficiency in any account from which funds were transferred.

Global Interest Netting: We note that since 1986, penalty provisions have been strengthened substantially to discourage inappropriate behavior. Because of the broad reach of the current penalty provisions, the time is ripe to equalize the overpayment-underpayment rates of interest to eliminate "hot" interest. The statutory interest rates should favor neither the Taxpayers nor the Government. While we understand that this problem was addressed as part of the IRS Restructuring and Reform Act of 1998 and the enactment of global interest netting provisions, these provisions are complex and do not completely resolve the problems caused by the interest rate differentials. We suggest that consideration be given to equalization of the interest rates. Absent such as equalization, our member companies have indicated that guidance is needed on the application of the global interest netting provisions, especially with respect to their applicability to pre–1999 tax years.

Disclosure and Penalties: Currently, Taxpayers are encouraged to disclose on their tax return items or positions that are not otherwise adequately disclosed on a tax return. Under section 6662(d)(2)(B) of the Code, if this disclosure is made, the Taxpayer may avoid the imposition of certain accuracy-related penalties. Disclosure does not reduce penalties, however, for items which are defined as "tax shelters." A tax shelter is broadly defined as "(I) a partnership or other entity, (II) any investment plan or arrangement, or (III) any other plan or arrangement, if a significant purpose of such partnership, entity, plan or arrangement is the avoidance or evasion of Federal income tax."

It should be clarified that this broad definition of tax shelter does not include tax planning which has as its result the reduction of Federal income tax. While Taxpayers may not evade tax, they are certainly able to arrange their affairs with the result that their tax burden is lower. Guidance is needed as to the distinction between whether a position is a result of tax planning or whether it is a result of a tax shelter transaction. In addition, for taxpayers who separately disclose positions under section 6662(d)(2)(B), there should be a presumption that the position taken is not taken to substantially understate taxes and should not be subject to penalties. This presumption will encourage Taxpayers to disclose their tax planning and will facilitate the Service's auditing of these returns.

Penalty Modification: Our members have reported varying experiences with respect to the ability of Service examining agents to adjust certain penalties during the examination process. In some districts, examining agents have indicated that they can modify penalties; in others, examining agents report that they are unable to do so. The ability to modify a penalty should be available at all levels of the administrative process. There are situations where an assessment could be accepted by a Taxpayer were penalties modified at the examination level. Often, when the penalties are not modified, the Taxpayer requests that the case be transferred to the Appeals Division of the Service. At this higher level, the penalties may be and often are modified, with the result of acceptance by the Taxpayer of an adjustment to the return. Were the ability to modify penalties available at the examination level, certain cases would not need to be referred to Appeals process. Thus, disputes could be resolved with use of fewer resources both by the Service and by the Taxpayers.

Estimated Tax Penalties: Taxpayers are subject to penalties for failure to pay the proper amount of estimated taxes. Under the current penalty structure, there is no exception to this penalty for underpayments which are due to erroneous estimates of investment return when that error is caused by market volatility. For example, a Taxpayer's capital gains will fluctuate each year depending on interest rates, asset performance and other market conditions. While Taxpayers make their best estimates of what their ultimate investment income will be and appropriately pay estimated taxes on this good faith estimate, in some years, this estimate will be different from the actual amount of income. As result of this discrepancy between the amount which the Taxpayer believed should be paid as estimated tax and the ultimate tax liability, Taxpayers may become subject to the penalty for underpayment of estimate taxes. We suggest that the penalty rules provide for an exception to the application of the underpayment penalty when the underpayment of estimated tax is due to unanticipated income as a result of market fluctuations.

In summary, the member companies of the American Council of Life Insurance support the review of the administration and implementation of the penalty and interest provisions of the Internal Revenue Code. Our member companies, both as corporate Taxpayers as well as information reporters, would like to work with you toward efforts to simplify penalty and interest administration and to reduce Taxpayer burdens. Thank you for your attention to these issues.

Sincerely,

JEANNE E. HOENICKE
LAURIE D. LEWIS

AMERICAN COUNCIL OF LIFE INSURANCE
May 14, 1999

Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044
Attn: CC:DOM:CORP:R (IT&A, Branch 1) Room 5228

Re: Comments Concerning Rev. Proc. 99–19—Interest Netting

Dear Sir or Madam:

I am enclosing comments on the above noted Revenue Procedure on behalf of the member companies of the American Council of Life Insurance in response to your request for comments in the Revenue Procedure. The 493 ACLI member companies have over 77 percent of the life insurance in force in the United States in legal reserve life and health insurance companies and assets representing 82.3 percent of all United States life and health insurance companies.

We appreciate the flexibility you have shown in soliciting comments on these difficult issues and providing initial guidance in a timely manner to enable meaningful dialogue. We understand that more comprehensive guidance will be forthcoming regarding application of these rules to interest accruing for periods beginning after July 22, 1998, and look forward to working with you on these as well. If there are any questions regarding any matter raised herein, or if further information is requested, please contact me. Thank you again for your assistance.

Sincerely,

MARK A. CANTER

encl.

COMMENTS CONCERNING REV. PROC. 99–19

Executive Summary

On March 16, 1999, the Internal Revenue Service published Rev. Proc. 99–19 providing guidance regarding application of section 6621(d) of the Internal Revenue Code. Section 6621(d) was enacted by section 3301 of the Internal Revenue Restructuring and Reform Act of 1998 (RRA), Pub. L. No. 105–206, 112 Stat. 741, and was amended by section 4002(d) of the Tax and Trade Relief Extension Act of 1998, Pub. L. No. 105–277, 112 Stat. 2681. It provides for a net interest rate of zero for overlapping tax underpayments and tax overpayments. Rev. Proc. 99–19 focuses on the procedural steps that must be taken for taxpayers to utilize the net interest rate of zero for periods beginning before July 22, 1998 (i.e., interest accruing before October 1, 1998). The following comments, prepared in response to the I.R.S. request for comments in Rev. Proc. 99–19, point out the following five areas of concern:

1. The procedure should allow for generic descriptions of overlapping tax underpayments and tax overpayments on Form 843, as in many instances not all of the information specified will be available by December 31, 1999.

2. The procedure should make clear that any tax overpayment that is not completely utilized for purposes of applying the zero net interest rate for a given tax

year should be available in the event of a subsequently uncovered tax underpayment for the same year.

3. The procedure should allow for offsetting of liabilities for periods of overlapping refunds and deficiencies, i.e., the "credit/offset approach."

4. The procedure should clarify the application of the interest netting rules for companies that are members of affiliated groups.

5. The procedure for furnishing a written statement in connection with returns of the taxpayer that are under consideration by any office of the Service provided in section 4.06 of the Revenue Ruling should be expanded.

1. Generic descriptions should be allowed for completing Form 843.

Many of our member companies are Coordinated Examination Program ("CEP") taxpayers whose returns are subject to continuous review by the Service. At any given point in time a number of tax years may be open, and extensions of the statute of limitations period are routinely executed. In addition to federal income tax returns, our members also file excise tax returns, payroll tax returns and, in connection with the products they sell, information and withholding reports, all of which may be subject to examination and adjustment. It is probable that there may be instances where examinations that may cause adjustments to pre-October 1, 1998 periods will not have commenced as of December 31, 1999. Legislative history of the RRA makes clear that "the Secretary will implement the most comprehensive netting procedures that are consistent with sound administrative practice . . . ". S. Rep. No. 105–174 (1998). The RRA itself requires that by December 31, 1999, taxpayers make a request to the Secretary to apply the zero net interest provisions of Code section 6621(d) to the pre-October 1, 1998 periods. Regarding identification of covered payments, the RRA requires that the taxpayer: "reasonably identifies and establishes periods of such tax overpayments and under-payments for which the zero rate applies . . . " RRA section 3301(c)(2). Given that (i) payments that are intended to receive the benefit of this provision may not be evident or have manifested to the taxpayer as to either the amount or even the nature of the tax, i.e., income, excise, payroll, etc., and (ii) the statute clearly requires some filing to be made by December 31, 1999, "reasonable" identification of the payments and periods involved for as yet unknown amounts can be accomplished only through a generic description such as "payments related to all open tax payment periods as of December 31, 1999, for interest payable for periods prior to October 1, 1998."

2. The procedure should make clear that overpayments not completely utilized should be available in the event of a subsequently uncovered Tax Underpayment for the same year.

The Revenue Procedure notes that the Conference Report accompanying the RRA indicates that in calculating the net interest rate of zero without regard to whether the overpayment or underpayment is currently outstanding, each overpayment or underpayment should be considered only once in determining whether equivalent amounts of overpayment and underpayment overlap for a particular period. Given the wide variety of tax payments that can be attributable to a given period, and differing examination schedules that may be applicable to the same period of time, but for different returns, it is possible that a number of separate underpayments for a particular reporting period may be assessed at different times. If the amount of an underpayment that is applied against an overpayment for the same period is less than the overpayment, the excess should be available for any subsequent underpayment assessment for the same period. For example, if there is an overpayment of income tax of $200,000 that accrued interest for calendar year 1996, and underpayments of income tax or any other type of tax of $100,000 were subsequently assessed and accrued interest in both 1997 and 1998, the 1996 overpayment should first be offset against the $100,000 underpayment in 1997, with the remaining $100,000 being available to offset the 1998 underpayment (assuming applicable statutes of limitation are still open). Guidance should be provided clarifying this treatment.

3. Rather than calculating deficiency interest and refund interest for overlapping periods at the same rate, the credit/offset approach should be used.

Implementing the provisions of Code section 6621(d) by calculating deficiency interest on an underpayment and then calculating refund interest at the same rate for matching overpayments for the same time periods would create needless extra work for both the IRS and the taxpayer. In addition, there may be situations in which interest paid to the taxpayer will not be completely offset by interest deductible by the taxpayer due to circumstances such as sourcing rules, i.e., interest received on a refund will be U.S. source income, while interest paid on a deficiency may have to be allocated to foreign sources subject to limitation on deductibility. The alternative method for applying a net interest rate of zero is the "credit/offset approach." Where interest is both payable from and allowable to a taxpayer for the same period, the IRS should offset the liabilities rather than processing them separately and netting the interest to zero. Thus, for the same period, no overpayment or underpayment would be outstanding, rather than creating both an overpayment and an underpayment running at the same interest rate.

4. Additional guidance should be provided for companies that are members of affiliated groups.

Section 6621(d) provides for netting of interest for overpayments and underpayments of all categories of federal taxes, not just income taxes. In many instances, tax returns for employment or excise taxes will be filed under the Taxpayer Identification Number (TIN) of a subsidiary company, rather than under the TIN of the parent company of a group of affiliated companies. The decision by Congress to expand the netting regime to taxes other than income taxes implicitly recognizes that netting should be available even where the returns involved may not all be filed under the same TIN. Guidance should be provided and systems created to implement these expanded offset possibilities.

In addition, there will be situations in which the affiliated group filing an interest netting request under the Revenue Procedure will be different from that in existence at the time the offsetting overpayment and underpayment interest accrued. In connection with corporate reorganizations and acquisitions, there may be circumstances in which affiliated corporations join, leave or move in the group's corporate hierarchy. The Revenue Procedure should make clear that interest netting should be applied in a manner that allows underpayments and overpayments made by any member of the affiliated group to be available to offset overpayments or underpayments made by any other member company of the affiliated group for the same time period.

5. Clarify special procedure under section 4.06 of the revenue procedure.

Section 4.06 provides for special procedures (including no Form 843 submission and abbreviated information filing requirements) where global netting relief is requested by "a taxpayer in connection with a return (or returns) of the taxpayer under consideration by any office of the Service." Our members believe section 4.06 should be amended to clarify that the term "under consideration by any office of the Service" covers post-IRS Appellate Division consideration, including years in litigation regardless of the judicial forum. The justification for allowing abbreviated procedures pursuant to section 4.06 for years under IRS review applies equally to years in litigation.

Furthermore, taxpayers eligible to file under section 4.06 for at least one tax year (or set of years) should be permitted to file one statement under section 4.06 covering all taxable years (including years not yet under audit) for which filings must be made by December 31, 1999 under Rev. Proc. 99–19. This approach would greatly reduce the incidence of multiple submissions by a single taxpayer, thereby lessening the burden on both taxpayers and the Service and making the process much less confusing to all parties. A single submission under section 4.06 covering years not yet under audit is appropriate because taxpayers will have even less specific information about netting opportunities for years not yet under audit than they have for years now covered by section 4.06.

Moreover, section 4.06 should be modified to clarify that identification of refunds and payments required by section 4.06(3) need not be specific; rather, the provision would be satisfied through a generic description such as "payments related to all open tax payment periods as of December 31, 1999, and refunds on which interest is payable for periods prior to October 1, 1998." Examples illustrating this concept would be helpful.

Finally, section 4.06 should be modified to clearly note the place where the section 4.06 submission must be filed. Similar information is now provided under section 4.02 for Form 843 filings. This will assure that coordination occurs with respect to all possible examinations and returns for which a section 4.06 filing must be made by December 31, 1999. Our members believe that all section 4.06 statements should be filed with the District Office where the taxpayer most recently filed its federal income tax return and that such filing will be deemed adequate notice to the National Office and any other District Office of the Service that may be examining any returns of the taxpayer.

Summary

Based upon the above, we urge the Internal Revenue Service to modify the guidance provided by Rev. Proc. 99–19 so that (i) generic descriptions of the payments and periods covered are acceptable for the Form 843 filing due by December 31, 1999; (ii) it is clear that the excess of overpayments not fully utilized are available for purposes of calculating the net interest rate of zero for subsequent underpayment amounts related to an overlapping period; (iii) zero net interest is implemented by the credit/offset approach; (iv) issues involving companies that are members of affiliated groups are addressed; and (v) greater details are given for the filing procedures provided in section 4.06 of the Revenue Procedure regarding written statements of taxpayers subject to examination by the Service.

Statement of James R. Burkle, Vice President, Corporate Tax, Ceridian Corporation, Minneapolis, MN

Mr. Chairman, thank you for the opportunity to provide comments on the penalty provisions of the Internal Revenue Code (IRC) and on the recommendations for improvement made by the Joint Committee on Taxation (JCT) and the US Treasury.

Ceridian Corporation, headquartered in Minneapolis, Minnesota, is a leading information services company that provides outsourced payroll processing, tax filing services, and integrated human resource management systems to predominantly large and mid-sized businesses. Ceridian's Tax Service is a high volume automated bulk filer serving approximately 60,000 employers. Ceridian collects and deposits $98 billion in employment taxes annually, files in excess of 800,000 quarterly tax returns with the IRS and 6,000 other tax agencies, and processes more than 2.6 billion electronic payroll tax transactions on behalf of clients. Ceridian has over 20 years of tax filing experience.

Ceridian's payroll and tax filing service, including the depositing of employment taxes, is comprised of many processes and procedures, all of which are designed to insure the accurate and timely filing and depositing of all federal and state tax liabilities, and are continually updated in order to fulfill the ever-changing needs of our client base and meet reporting requirements. The timely depositing of tax liabilities to the Internal Revenue Service (IRS) on behalf of clients ranks as Ceridian's highest priority.

Ceridian was pleased to submit a statement to the JCT and US Treasury when they invited comments from interested parties for their studies on tax penalty administration. As stated in those comments, we believe that the current administration of the tax penalty system is inadequate and unfairly treats taxpayers that are and want to be compliant with the system. The IRS penalty handbook in Part XX of the Internal Revenue Manual states that "penalties are used to enhance voluntary compliance." (IRM (20)121). But the system has failed to uphold this basic tenet by administering penalties arbitrarily, and by putting the burden on the taxpayer to prove good faith compliance. The penalty system for employers needs improvement in the following three areas:

1. Current administration of the penalty system fails to distinguish between employers that want to comply and those that are deliberately non-compliant.
2. The penalty provisions of the IRC are not uniformly applied. While the IRS national office may advocate one policy and set of goals, the IRS field offices generally do not follow that stated policy, resulting in delays and inconsistent policies based on local rulings.
3. The size of the penalty is often not proportionate to the offense.

1. A fair and effective penalty system should take into account tax deposit history

Mr. Chairman, in your opening statement at the January 27, 2000, hearing you said, "penalties and interest can be quite severe, even debilitatinga. . .we must minimize the number of taxpayers who are caught in the penalty system, not because they were cheating, but because they were mistaken." We agree. The Code's penalty and interest provisions are intended to deter noncompliance and prevent tax avoidance and fraud. But today the provisions are applied without regard to the taxpayer or type of error.

Taxpayers that fail to make deposits out of willful neglect, have a truly egregious compliance history and demonstrate a pattern of noncompliance, should be penalized severely. But the system fails to distinguish between taxpayers that won't comply, and taxpayers that want to comply or have economic difficulty doing so.

Taxpayers that make every effort to comply can be severely penalized for inadvertent, human errors or tax system problems. For example, as a result of human error, Ceridian transmitted a client's payroll using an incorrect client ID number, resulting in tax deposits being misapplied. Ceridian corrected the error and immediately implemented procedures to ensure that a similar error does not recur. But Ceridian did not have visibility of the error until after the deposit was made and penalty and interest already were assessed. Despite a history of compliance and having reasonable cause for the late deposit, the taxpayer and Ceridian had to go through extraordinary efforts to prove good faith compliance. Penalties are automatically assessed regardless of the type of error, putting the burden on the taxpayer to prove good faith compliance.

A particular concern of bulk filers and large employers is that penalties are unnecessarily punitive on taxpayers that process a large number of transactions annually and incur one or two errors as opposed to taxpayers with very few transactions that incur the same number of errors. The result is that taxpayers with high compliance rates are penalized as severely as those with high error rates. An important indication of a taxpayer's willingness or unwillingness to comply—the taxpayer's record of compliance—is not taken into consideration by the IRS when assessing penalties.

The seemingly unfair treatment of taxpayers that have a history of demonstrated compliant behavior directly undermines what is the stated goal of a voluntary tax system, encouraging taxpayer compliance.

Recommendation: In a voluntary tax system, the taxpayer's prior actions and conduct should weigh heavily in determining the assessment of any penalty and interest. Otherwise, human or technical error is penalized to the same degree as willful noncompliance. The type of reporting should also be taken into account. A bulk filer with a client base in the thousands has voluntary compliance as its implied, if not stated goal. An assessment of a Failure to Deposit Penalty for such an entity because of human error, for example, does little to encourage voluntary compliance and much to prove the system's arbitrariness. An analysis of past behavior is the best, and at times, the only way to gauge the "intent" of the taxpayer and identify the members of the non-compliant group. Targeting taxpayers that are willfully noncompliant would improve administrative efficiencies and establish "the fairness of the tax system by justly penalizing the non-compliant taxpayer," as stated in the IRM XX-Penalty Handbook.

2. Penalty provisions should be applied uniformly to encourage greater compliance

The Joint Committee on Taxation acknowledged in their study that penalty assessment and abatement is not uniform across the IRS. The IRS national office's policies for encouraging voluntary compliance by the taxpayer often are not the policies of the IRS field offices. Uniform application of penalty and interest provisions across all levels of the IRS (including IRS service centers and district offices) as is intended in the Code and under the IRM XX-Penalty Handbook, would produce more efficient and effective administration of the tax system. It also would improve the perception of fairness in the tax system and encourage greater compliance. The reality is that the penalty provisions are not being uniformly implemented or administered.

For example, past experiences of large employers and bulk filers have been that each IRS service center would interpret the facts in similar penalty abatement requests differently, resulting in abatement in one case and upholding the assessment in another. The unintended result is service center "shopping" by large employers and bulk filers. Also, as a bulk filer, it has not been unusual for penalty and interest abatements issued by the service center with jurisdiction over the client taxpayer to be rescinded by another service center. The tax system is undermined when the national office's stated policies and goals are not followed by IRS offices in the field that have direct contact with taxpayers. If the penalty and interest provisions were applied uniformly, the administration of the tax system would be more effective and fair as intended by the IRS.

Recommendation: The issue of uniformity is important to the integrity of the tax system. The JCT recommends that the IRS improve its supervisory review of penalty imposition and abatement and establish oversight committees for specific penalties—similar to the Transfer Pricing Penalty Oversight Committee. Ceridian agrees that supervisory review emphasizing consistent policies between the national and field offices could achieve more effective administration of penalties and abatement.

Ceridian also recommends establishing a single point of contact within the IRS to oversee penalty issues for the large number of employers represented by bulk filers. The JCT and US Treasury recognize that the IRS' case-by-case procedure for handling penalties is not efficient for bulk filers and their clients, or the IRS, when one software change can cause penalties to be imposed on hundreds or thousands of taxpayers across every state. The US Treasury recommends working with bulk filers to develop a "proxy" penalty that would alleviate the problem of dealing with many taxpayers individually on the same inadvertent error. The JCT recommends that the IRS work with bulk filers "to expedite resolution of problems where a single error or mishap may impact multiple taxpayers." Ceridian suggests that resolution of these problems can be expedited by designating a national point of contact for bulk filers.

″One point of contact" already is being implemented for taxpayers under IRS' reorganization of its 33 district offices and 10 service centers into 4 operating divisions. Each division will have responsibility for specific taxpayer groups from prefiling to post-filing. Many bulk filers, however, will have clients in more than one division with no identified point of contact for specific issues pertaining to these taxpayers. A single, national point of contact would simplify the tax payment and filing process and reduce the compliance burden on both the taxpayer and the IRS.

3. The size of the penalty should be proportionate to the offense

The perceived fairness of the tax system is diminished by the amount of penalty and interest that can be assessed because of one inadvertent, human mistake or technical error. The tax system not only puts the burden squarely on the taxpayer to prove good faith compliance, but it could cost the taxpayer excessive penalties.

A good example is the Failure to Deposit penalty for failing to use the correct deposit method, especially with regard to the Electronic Federal Tax Payment System (EFTPS). Employers are automatically penalized 10 percent per tax deposit if payments are not made through EFTPS—even if tax liabilities are paid on time and the taxpayer has an otherwise unblemished deposit record. The amount of the penalty often is many times greater than the actual loss of revenue to the IRS and is disproportionate to the offense. The IRS and Congress have taken action to waive the 10 percent penalty for some employers, but the waiver does not address the unnecessary severity of the penalty.

It also does not address the issue that a taxpayer should never be penalized in instances where their payments are on deposit with the IRS or its depository on or before the tax due date. The fact that payment has been deposited should be taken into account before assessing penalties. The imposition of a penalty in such an instance is wholly inappropriate and not proportionate to the error.

Recommendation: Ceridian agrees with the US Treasury's recommendation to reduce the 10 percent deposit penalty to 2 percent because the severity of this penalty often exceeds the taxpayer error. However, reducing the penalty amount does not address the issue of fairness. An honest mistake by a taxpayer with a history of compliance would still be penalized to the same degree as a willfully non-compliant taxpayer. A taxpayer's compliance record should be taken into account in administering penalties. Ceridian also agrees with the JCT's recommendation to revise deposit regulations so that taxpayers whose deposit schedules change are notified by the IRS of the change in status before it takes effect. Employers may not realize that their deposit schedule has changed until they receive a penalty notice months later and start incurring penalties.

CONCLUSION

The JCT and US Treasury studies were important undertakings that should prompt needed change. The vast majority of taxpayers want to comply and should be assisted and encouraged to do so. As Commissioner Rossotti has stated numerous times, the IRS is working to encourage compliance by providing clearer communications, marketing the benefits of electronic payment and offering improved taxpayer service and education.

This is a tremendous step in the right direction. But the current administration of tax penalties does little to instill confidence in the tax system and fails to effectively target and reduce severe noncompliance. The penalty system has become arbitrary where taxpayers in different parts of the country may receive different treatment in similar situations. The arbitrariness extends to the actual amount of the penalty where excessive penalties can be automatically assessed without regard to the reason for the error or the taxpayer's deposit history. Resources should be focused more effectively. Uniform goals across all levels of the IRS and targeting efforts toward deterring noncompliance among willfully non-compliant taxpayers will produce a more efficient and equitable system.

Thank you, again, for the opportunity to comment on the penalty provisions of the Internal Revenue Code and the studies completed by the JCT and the US Treasury.

Statement of Coalition for the Fair Taxation of Business Transactions [1]

The Coalition for the Fair Taxation of Business Transactions (the "Coalition") is composed of U.S. companies representing a broad cross-section of industries. The Coalition is opposed to the broad-based "corporate tax shelter" provisions in the Administration's budget because of their detrimental impact on legitimate business transactions. The Coalition is particularly concerned with the broad delegation of authority provided to IRS agents under these proposals, which would reverse some of the reforms of the IRS Restructuring Act, passed just last year.

Pursuant to section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998, the Department of Treasury, on October 25, 1999, issued a report [2] on the penalty and interest provisions of the Code. The Joint Committee on Taxation ("JCT"), on July 22, 1999, released a study [3] of present-law penalty and interest provisions. Both studies include recommendations regarding penalty and interest provisions in the Code. Many of the recommendations in the studies are directed at rules for individuals, the Coalition will focus its comments on those recommendations we believe will have an impact on corporate taxpayers.

I. ACCURACY-RELATED PENALTY

The American scheme of income taxation is based on the fundamental premise of "self-assessment" by taxpayers of their tax liability.[4] It is clear that the existing tax system could not function properly if the majority of taxpayers did not report the correct amount of tax without the government's prior determination of the tax liability.

To encourage taxpayers to comply with this self-assessment system of taxation, the Internal Revenue Code ("Code") contains provisions to punish taxpayers and return preparers that fail to comply with minimum tax return reporting standards.[5] For taxpayers, return positions must meet the "reasonable basis" standard to avoid penalties. For return preparers, the minimum standards to avoid penalties for undisclosed return positions is the "realistic possibility of success on the merits" standard and the "not frivolous" standard for disclosed positions.

JCT and Treasury each recommend raising the minimum standards that must be met in order for taxpayers and return preparers to avoid the impositions of penalties. We believe these recommendations would raise the minimum standards to unjustifiable levels. It is unrealistic to expect taxpayers to file "perfect" returns, on which every item is unquestionably correct. Federal tax law is complex, ambiguous and constantly evolving. The determination of a taxpayer's correct amount of tax is often not clear-cut. The recommendations to raise the minimum accuracy standards to avoid the accuracy-related penalty and return preparer penalties are too harsh and are not justified.

A. Joint Committee and Treasury Proposals

JCT recommends that for both taxpayers and return preparers the minimum standard for each undisclosed position on a tax return is that the taxpayer or preparer must reasonably believe that the tax treatment is "more likely than not" the correct tax treatment. This standard requires a greater than 50 percent likelihood that all undisclosed positions would be sustained if challenged. For adequately disclosed positions, JCT recommends the minimum standard be substantial authority. JCT also recommends repeal of the reasonable cause exception for the substantial understatement penalty.

Treasury recommends that for both taxpayers and return preparers the minimum accuracy standard for undisclosed positions be the substantial authority standard.

[1] This testimony was prepared by Arthur Andersen on behalf of the Coalition for Fair Taxation of Business Transactions.

[2] Department of the Treasury, *Report to Congress on Penalty and Interest Provisions of the Internal Revenue Code,* October 1999

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

[4] *Commissioner v. Lane Wells Co.*, 321 U.S. 219 (1944).

[5] See I.R.C. § § 6662 and 6694.

For positions disclosed in a tax return, Treasury recommends that the minimum accuracy standard be the realistic possibility of success on the merit standards.

B. Analysis

As justification for raising the minimum reporting standard for undisclosed positions on a tax return to a "more likely than not standard," JCT argues that a tax return is signed under penalties of perjury, which implies a high standard of diligence in determining the positions taken on a return. JCT believes this requires a minimum reporting standard that an undisclosed return position satisfy a "more likely than not" reporting standard.

The accuracy-related penalties are designed to reinforce a taxpayer's self-assessment obligation. The current accuracy-related penalty and reporting standards, which require substantial authority for an undisclosed return position and reasonable basis for a disclosed return position, already provide a powerful incentive for corporate taxpayers to closely review and analyze positions taken on their tax returns.

A basic premise of our tax system is that a taxpayer is entitled to contest a dispute with the Internal Revenue Service in the United States Tax Court prior to payment of the tax liability in dispute. This ability is critical in certain situations where IRS agents aggressively assert a position that cannot be justified based on a careful analysis of the tax law in the area.[6] Taxpayers are not required to possess certainty of the correctness of a position in order to advance that position on the return. Given the complexity of the tax system, it is unreasonable to expect every position on every return to be unquestionably correct. A standard that requires a taxpayer to possess a "more likely than not" certainty of the position advanced on the return effectively prevents a taxpayer from advancing a position and litigating it in the prepayment forum of the Tax Court because of the probable imposition of a penalty if the taxpayer does not prevail. Accordingly, the reporting standards recommended by JCT and Treasury would, as a practical matter, require a taxpayer to self-assess a tax liability according to the government's position on a tax issue, pay the tax, and pursue relief by filing a refund suit.

The recommendation of JCT is further flawed because the more likely than not standard applies to both the substantial understatement penalty and the negligence penalty. The effect of the JCT proposal is to create one accuracy-related penalty that requires a stricter reporting standard than the substantial understatement, while no longer requiring the existence of a substantial understatement of tax for the penalty to apply. As a result of this proposed reporting standard, any mistake, whether intentional or inadvertent, results in the automatic imposition of an accuracy-related penalty. Treasury's recommendation is subject to the same criticism. By raising the minimum reporting standard, the substantial understatement penalty subsumes the negligence penalty and reverses the long-standing policy of requiring a higher reporting standard for taxpayers with substantial understatements.

For return positions disclosed by taxpayers, JCT recommends that the minimum standard for the disclosed return position be substantial authority. This minimum standard applies to the negligence penalty and the substantial understatement penalty. JCT also recommends the repeal of the reasonable cause exception to the substantial understatement penalty. Treasury recommends the minimum reporting standard to avoid these penalties for disclosed positions be the realistic possibility of success on the merits standard. Raising the minimum reporting standard for disclosed return positions is unjustified for three reasons. First, the recommended standards eliminate the long-standing policy of distinguishing between any understatement of tax and a substantial understatement of tax. Second, the recommended standards are so high that they are likely to have the effect of taxpayers disclosing less. This is because if uncertain of a position, a taxpayer may be more likely to take the chance the Internal Revenue Service will not audit the return rather than disclose the position on the tax return. Third, under each of the recommendations, the substantial understatement subsumes the negligence penalty.

II. Estimated Tax Penalty

If a corporation fails to make timely estimated tax payments, then a penalty is imposed under section 6655. The penalty imposed under section 6655 is determined

[6] For example, since the Supreme Court decision in *Indopco, Inc. v. Commissioner*, 503 U.S. 79 (1992) (requiring expenditures that give rise to more than incidental future benefits to be capitalized rather than expensed) IRS agents aggressively try to require taxpayers to capitalize expenditures with taxpayers ultimately prevailing in court. See *RJR Nabisco v. Commissioner*, T.C. Memo 1998–252.

by applying the underpayment interest rate to the amount of the underpayment for the period of the underpayment. Although Treasury recognizes that this sanction has attributes of interest and of a penalty, it recommends that the current-law sanction remain a penalty.

We believe this sanction is more appropriately treated as an interest charge rather than a penalty. As JCT recognized in its penalty study, the conversion of the corporate estimated tax penalty (and individual estimated tax penalty) into interest charges more closely conforms the title and descriptions of these provisions to their effect. These penalties are computed as an interest charge, therefore, conforming their titles to the substance of their function will improve taxpayers' perceptions of the fairness of the tax systems. Because these sanctions are essentially a time value of money computation, which is not punitive in nature but rather compensatory, calling them penalties makes the offense of underpaying estimated taxes seem greater than it is and wrongfully denies an appropriate deduction to business entities.

For the reasons stated above, we recommend following the JCT recommendation to convert the existing penalty for failure to pay estimated tax into an interest provision.

III. Interest

Under current law, there is an interest rate differential between the interest the government pays on large corporate overpayments of tax and what it charges on large corporate underpayments of tax. Treasury recommends in its penalty study to retain this interest rate differential. JCT recommends that this interest rate differential be repealed. We agree with the JCT recommendation for the reasons set forth in their study.

JCT recommends providing one interest rate for both individuals and corporations applicable to both underpayments and overpayments. Accordingly, JCT recommends eliminating the so-called "hot interest" provision that applies a higher rate of interest to certain corporate underpayments, as well as the special rule that applies a lower interest rate to certain corporate overpayments. This proposal also limits the need for interest netting for corporations, a very complex burden for both taxpayers and the Service.

As recognized by JCT, the recommended changes to the interest rate provisions would complete the policy begun by the IRS Reform Act of providing equivalent effective interest rates on underpayments and overpayments. The recommended changes to the interest rate provision would, on a prospective basis, provide a better mechanism for achieving the equivalent effective interest rate goal than the net zero interest rate approach of present law. This is because the proposed changes would, at least on a prospective basis, automatically achieve the desired result. On the other hand, the implementation of the net zero interest rate under present law requires taxpayers to identify the appropriate periods to which the net zero rate should apply and the recalculate interest for those periods. The recommended changes would make the benefits of equivalent effective interest rates available to all taxpayers on a prospective basis, not only to those taxpayers capable of preparing complex net zero rate calculations.

Statement of Mark M. Ely, Harry L. Gutman, David L. Veeder, Dallas, TX, and R. David Miller, Tampa, FL, KPMG Interest Netting Coalition

We are writing on behalf of the KPMG Interest Netting Coalition in support of the recommendation of the Joint Committee on Taxation (the "Joint Committee") to impose a single statutory rate of interest on corporate tax underpayments and overpayments.[1]

Under current law, a higher rate of statutory interest is imposed on corporate tax underpayments than on corporate tax overpayments. Charging a higher interest rate on corporate tax underpayments is equivalent to subjecting corporate taxpayers to a penalty equal to the interest differential. There is no policy basis for assessing a different figure for the time value of money depending upon whether the debtor is the federal government or a corporate enterprise. Imposing a single rate of interest on overpayments and underpayments would eliminate this unjustified differential.

1 In JCT Interest and Penalty Study, JCS–3–99, July 22, 1999, page 3.

Imposition of a single statutory rate of interest on overpayments and underpayments also has the advantage of being easier to administer than the current global interest netting rule. The global interest netting rule often requires a taxpayer to produce complex calculations to demonstrate periods of overlap and the amounts of overpayments and underpayments eligible for netting. Imposing a single rate of interest, by contrast, would generally have the effect of accomplishing "interest netting" automatically.

Finally, imposing a single rate of interest has the advantage of rendering moot several difficult interpretive questions raised by the global interest netting rule enacted last year as part of the IRS Restructuring and Reform Act, as more fully explained below.

The global interest netting rule generally provides that a taxpayer is entitled to a net interest rate of zero for equivalent tax overpayments and underpayments during applicable periods of overlap. Questions have been raised as to whether the global interest netting rule applies where one taxpayer has an underpayment and a related taxpayer has an overpayment. As explained by the Joint Committee:

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

[However,] [c]ertain taxpayers are prevented by the Code from joining in a consolidated return even though one taxpayer is the wholly owned subsidiary of the other. . .

For example, a wholly owned foreign sales corporation (FSC) is prohibited from joining in a consolidated return with its parent. A United States parent will typically transfer property that will be exported to its FSC at one price, and the FSC will sell the property to the foreign purchaser at a higher price. The FSC is allowed to exclude a portion (15/23) of its net income from Federal income tax, creating an incentive for the transfer from the parent to the FSC to take place at as low a price as possible. If the IRS successfully challenges the transfer price as tax law, the parent will be required to increase its income and a correlative adjustment will be made to the FSC decreasing its income by the same amount. This will generally result in an underpayment by the parent and an overpayment arising from the same adjustment. Interest payable on the underpayment may be accrued at a rate as high as short-term AFR plus 5 percentage points, while the interest on the overpayment is allowable at a rate as low as short-term AFR plus one-half percentage point.[2]

If the tax law imposed a single statutory rate of interest on tax overpayments and tax underpayments, the difficult interpretive questions raised where interest is owed by one taxpayer and interest is payable to a related taxpayer would be eliminated.

Despite our general agreement with the recommendation of the Joint Committee to impose a single statutory rate of interest, the proposal does not resolve a situation in which a taxpayer has an outstanding overpayment and underpayment during an overlapping period and interest is either not allowable on the underpayment or not payable on the overpayment.

For instance, the Internal Revenue Code provides that if the IRS processes a request for a refund within 45 days no interest may be paid on the overpayment. Interest only runs if the overpayment is not refunded within the 45-day grace period. Likewise, interest is not imposed on an "addition to tax" if it is paid within 21 business days of the date the IRS issues a "notice and demand" -or request for payment (10 business days if the amount of the penalty is at least $100,000). Despite these legislative grace periods, in each case there is still an outstanding tax overpayment or underpayment, and under "use of money" principles, interest should be accruing. We would recommend that the global interest netting rule be expanded to apply during these grace periods when there are overlapping overpayments and underpayments, regardless of the fact that, under the Internal Revenue Code, interest is not paid.

For example, if the taxpayer claimed a refund and the IRS made the refund on the 45th day (and, therefore, includes no interest), by operation of the global interest netting rule, no interest should accrue during those 45 days on an underpayment of the taxpayer up to the amount of the refund. This approach would take account of the mutuality of indebtedness between the taxpayer and the government during the period of overlapping overpayments and underpayments.

2 JCT Interest and Penalty Study, p. 95.

MEMBERS OF THE KPMG INTEREST NETTING COALITION INCLUDE:

Allstate Insurance Company
California Federal Bank
Comdisco
Costco Wholesale Corporation
DaimlerChrysler Corporation
Federated Department Stores
Gillette Company
Household International (Beneficial)
HSBC Bank USA
Norfolk Southern Corporation
Royal & SunAlliance
Sears, Roebuck and Company
Wells Fargo & Company
Willamette Industries, Inc.

Statement of Profit Sharing/401(K) Council of America

This statement for the record is submitted on behalf of the Profit Sharing/401(k) Council of America. The Council would like to take this opportunity to provide the following comments on the Internal Revenue Code interest and penalty provisions with particular focus on areas that were not touched on by the Treasury and the Joint Committee on Taxation reports except for three ERISA related penalties that apply to failure to file in a timely manner certain required reports.

The Profit Sharing/401(k) Council of America for over half a century has represented employers who sponsor defined contribution plans including profit sharing and 401(k) plans. There are 2,500 members whose plans cover approximately 4 million participant-employees. The Council played a major role in urging the enactment of 401(k) plans which are now the predominant form of retirement vehicles in the nation. The Council is the foremost advocate for employers and their employees who participate in 401(k) plans.

Consolidation of failure to file and/or late filing fees

Title I (DOL), Title II (IRC), and Title IV (PBGC) of ERISA each contain provisions for imposing penalties for failure to file or late filing of Form 5500 and related attachments. The penalties imposed by each agency are different. IRC rules permit abatement of penalties, but not reduction, if a taxpayer can show reasonable cause for the delay. However, the rules for DOL and PBGC permit the penalties to be reduced or waived. Both the Treasury and Joint Committee recommend that these penalties be consolidated and administered by a single agency. However, the Treasury report recommends this duty be assigned to DOL, while the Joint Committee report recommends the duty be assigned to the IRS. The Council whole-heartedly endorses the recommendations to consolidate the penalties but expresses no view as to which agency should administer these penalties. However, in the event either agency declares an amnesty for plan administrators who failed to file (or are deemed to be late filers) of Forms 5500, it should be initiated jointly and administered by one agency.

Excise Taxes Which Operate as Penalties

In addition to certain other penalty provisions found in Title I and Title II of ERISA, there are many excise taxes found in the Internal Revenue Code which are part of Title II and which are levied, where appropriate, by the Internal Revenue Service. These excise taxes should be reviewed to determine if they should be repealed or modified. These excise tax provisions are set forth under Subtitle D-Miscellaneous Excise Taxes, Chapter 43, IRC. Some of the excises under this Chapter apply to sponsors of defined benefit plans, others are imposed on employer sponsored group health plans and on medical savings accounts. The Council does not intend to discuss or make recommendations regarding these latter types of excise taxes.

Sec. 4972-Tax on Nondeductible Contributions to Qualified Plans

Section 404 limits the total amount of annual employer contributions to sponsored qualified plans to 15% of covered compensation. If this limit is exceeded, the excess contributions are not deductible. But in addition, a 10% excise tax is imposed on the excess amount. It should be sufficient that the excess contributions are not tax deductible. The Council recommends that this excise tax be repealed. Better still, the limit on employer contributions, while it served a purpose in the past, currently serves no viable purpose under present ERISA rules. The present nondiscrimination rules and various other limits imposed on the amount an employer and the employee can receive in benefits or be allocated to the latter account in the qualified plan are more than adequate. In fact, the 404 limitation frequently results in less benefits to employee-participants as employers strive to stay within the 15% limit in order to keep from paying the 10% excise tax.

Section 4974-Tax on Under Payout of Required Minimum Distributions

The IRC generally requires that when a participant attains the age of 70 that each year distributions must be made that are equal to the amount of his account divided buy his or her life expectancy. The excise tax is equal to 50% of the underpayment of the required minimum distribution each year. Distributions are not required for those age 70 as long as they continue to be employed by the plan sponsor. However, this exception does not apply if the participant is a 5% shareholder in the employer-sponsor.

This requirement was placed in ERISA at a time when a decedent interest in his qualified retirement plan was exempt from estate tax. That estate tax exemption has been repealed. The Council has several recommendations to make with respect to this excise tax. First, it be should be repealed. As the life expectancy has dramatically increased and is likely to continue increasing for some time yet, more people are concerned with conserving their pension assets to make sure they have enough to live on over their lifetime. More of them take full or part-time jobs when they retire from their career occupations. As retirees are generally healthier they tend to be more active and often seek post-career employment.

The exception for workers who continue working past age 70 is a good one, but there is no reason why a 5% or more stockholder-employee should not qualify for the same exception.

As an alternative to repeal, this excise tax is far too high and should be substantially reduced. Furthermore, the excise tax falls on the participant who is not likely to have made the clerical error that caused the underpayment and, and if it occurs, may not realize that fact. Admittedly, the section does provide for waiver of the tax if the shortfall is due to reasonable error and steps are taken to remedy the situation.

The Council further recommends that some part of the retiree account balance be exempted from the minimum distribution requirements so that the participant has a safety net if he is in danger of depleting his account. Furthermore, there are complaints that the Service is not employing the most current mortality tables when calculating life expectancies of retirees.

Section 4975–Tax on Prohibited Transactions

This section of the Internal Revenue Code provides for the imposition of an excise tax if the fiduciary or other disqualified persons enters into transactions or provides services with a qualified plan in one of a series of transactions specified in the section that may constitute a conflict of interest and hence a breach of fiduciary responsibility. The prohibited transaction rules in the IRC call for a 15% excise tax to be imposed on the amount involved in the prohibited transaction. If the transaction is not undone within a reasonable period after the first tier tax is imposed, then a second tier tax of 100% of the amount involved in the transaction is imposed. Title I of ERISA also contains similar provisions (ERISA sec. 406) but do not impose a flat penalty, so the DOL can impose a penalty, presumably adjusted to the facts and circumstances, but not in excess of 5%, or 100%, if the transaction is not undone. (See ERISA Sec. 502(i). Under Title III of ERISA the Service is required to notify the DOL when it intends to impose this excise tax. Likewise, the DOL must notify the Service if it believes a prohibited transaction has occurred. Additionally, ERISA Sec. 502(l) provides that the DOL can impose penalties for breaches of fiduciary responsibilities. After consultation between IRS and DOL, the IRS may waive imposition of this excise tax. To the Council knowledge the Service has seldom, if ever, waived these excise taxes (first and second tier taxes) upon a recommendation of DOL. The fact is, this excise tax is a trap that many small and mid-size business plan sponsors inadvertently violate. The Council recommends that a more modest penalty be imposed that fits the violation. In addition, the requirement that the transaction be undone, in many instances, may work to the disadvantage of the qualified plan. The penalties imposed by DOL for breaches of fiduciary duty should be the pattern for the Service to follow and the current arbitrary and inflexible excise taxes should be repealed. Sponsors, who with the best of intentions, are often hit with one or both of the PT excise taxes may be discouraged from continuing to maintain their private retirement plans. Breaches of fiduciary duties should not go unpunished, but the size of the penalty should depend on whether the transaction was for the purpose of benefiting the plan and whether, indeed, the plan did benefit from the transaction.

The Council recommends that the excise tax be repealed and, in its place, a discretionary penalty based on intention and the degree of detriment to the plan participants, as provided in Title I, be imposed. Barring this, the amount of the inflexible flat excise taxes should be sharply reduced.