TAX GAP: OVERVIEW OF FEDERAL TAX PROVISIONS AND ANALYSIS OF SELECTED ISSUES

Scheduled for a Public Hearing
Before the
SUBCOMMITTEE ON SELECT REVENUE MEASURES
and the
SUBCOMMITTEE ON OVERSIGHT
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HOUSE COMMITTEE ON WAYS AND MEANS
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INTRODUCTION AND SUMMARY

The Subcommittee on Select Revenue Measures and the Subcommittee on Oversight of the House Committee on Ways and Means have scheduled a joint hearing for June 10, 2021, titled "Minding the Tax Gap: Improving Tax Administration for the 21st Century." A standard definition of the "tax gap" is the shortfall between the amount of tax voluntarily and timely paid by taxpayers and the actual tax liability of taxpayers. This document[1] prepared by the staff of the Joint Committee on Taxation, provides a description of Federal tax law and an analysis of selected issues relating to the tax gap.

[1] This document may be cited as follows: Joint Committee on Taxation, *Tax Gap*: *Overview of Federal Tax Provisions and Analysis of Selected Issues* (JCX-30-21), June 7, 2021. This document can also be found on the Joint Committee on Taxation website at www.jct.gov. All section references herein are to the Internal Revenue Code of 1986, as amended (herein "Code"), unless otherwise stated.

I. DEFINING AND MEASURING THE TAX GAP

A. Defining the Tax Gap

A standard definition of the tax gap is the shortfall between the amount of tax voluntarily and timely paid by taxpayers and the actual tax liability of taxpayers. It measures taxpayers' failure to accurately report their full tax liabilities on tax returns (*i.e.*, underreporting), pay taxes due from filed returns (*i.e.*, underpayment), or file a required tax return altogether or on time (*i.e.*, non-filing). Estimates of the tax gap provide a picture of the level of overall noncompliance by taxpayers for a particular tax year, and include shortfalls in individual income taxes, corporate income taxes, employment taxes, estate taxes, and excise taxes.[2] The individual behavioral responses to taxation that result in the tax gap raise a set of important policy questions, such as the optimal level of resources to devote to tax administration and the manner in which those resources are best deployed.

B. Measuring the Tax Gap

Total size of the tax gap

The Internal Revenue Service ("IRS") periodically conducts studies to estimate the size of the tax gap and analyze its components. Table 1 indicates that in the most recent study, the estimated annual gross tax gap, per year on average for tax years 2011-2013, was $441 billion[3] and the annual net tax gap, which is the gross tax gap adjusted for late payments and collections due to enforcement activities, was $381 billion. With total average tax liabilities of $2.7 trillion per year between 2011 and 2013, the voluntary compliance rate is 83.6 percent and the net compliance rate is 85.8 percent. Comparisons across tax gap studies can be difficult due to differences in estimation methods across years. However, IRS estimates in Table 1 show the voluntary compliance rate is likely stable, ranging between 82 and 84 percent for years 2001, 2006, 2008-2010, and 2011-2013.

[2] The basis for estimates of the individual income tax and self-employment tax underreporting tax gaps are statistically representative samples of individual income tax filers. These samples do not include "international" taxpayers for tax years after 2010.

[3] More recently, former IRS Commissioner Charles Rossotti estimates a tax gap of $574 billion in 2019; Natasha Sarin and Lawrence Summers estimate a tax gap of $630 billion in 2020; and in testimony to the Senate Finance Committee, IRS Commissioner Charles Rettig notes that the tax gap could be $1 trillion per year or more in future years. See Charles O. Rossotti, "Recover 1.6 Trillion, Modernize Tax Compliance and Assistance," *Tax Notes*, March 2, 2020, available at https://www.taxnotes.com/tax-notes-federal/compliance/recover-16-trillion-modernize-tax-compliance-and-assistance/2020/03/02/2c5p2; Natasha Sarin and Lawrence H. Summers, "Shrinking the Tax Gap: Approaches and Revenue Potential," *NBER Working Paper No. 26475*, 2019; Testimony of Commissioner Charles Rettig, Senate Finance Committee Hearing on "The 2021 Filing Season and 21st Century IRS," April 13, 2021, available at https://www.finance.senate.gov/hearings/the-2021-filing-season-and-21st-century-irs.

Table 1.−Gross and Net Tax Gaps, Selected Tax Years
(Billions of Dollars)

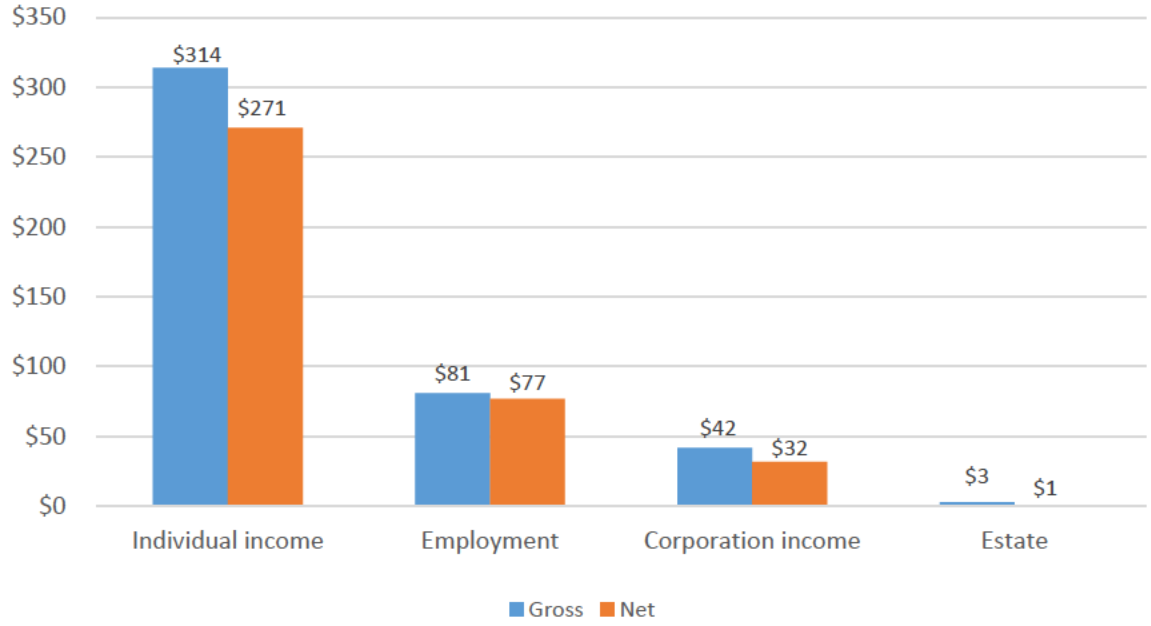
	Gross Tax Gap		Net Tax Gap	
	Nominal Dollars	**Voluntary Compliance Rate (Percent)**	**Nominal Dollars**	**Net Compliance Rate (Percent)**
2001	345	83.7	290	86.3
2006	450	83.1	385	85.5
2008 to 2010[1]	458	81.7	406	83.7
2011 to 2013[2]	441	83.6	381	85.8

Sources: Internal Revenue Service, *Tax Gap Estimates for Tax Years 2011-2013*, September 2019, https://www.irs.gov/pub/irs-pdf/p5364.pdf; Internal Revenue Service, *Tax Gap Estimates for Tax Years 2008–2010*, April 2016, https://www.irs.gov/pub/newsroom/tax%20gap%20estimates%20for%202008%20through%202010.pdf; and Internal Revenue Service, *Tax Gap Map for Tax Year 2001*, February 2007, www.irs.gov/pub/irs-utl/tax_gap_update_070212.pdf.
Notes: [1] These estimates are the average statistics for each tax year between 2008 and 2010.
[2] These estimates are the average statistics for each tax year between 2011 and 2013.

In its analysis of tax collections in 2011-2013, the IRS estimates the size of the gross tax gap by type of tax and category of error. These findings are similar to those in past reports. The largest source of the tax gap is the individual income tax, followed by employment taxes and the corporate income tax. These are also the three largest sources of Federal revenues, with $1,398 billion of total true tax liability for the individual income tax, $920 billion of total true employment tax liability, and $294 billion total true corporate income tax liability.

Figure 1 shows that for tax years 2011-2013, $314 billion of the gross tax gap was attributable to the individual income tax, constituting the largest source of the tax gap, followed by employment taxes and the corporate income tax. Less than one percent of the gross tax gap was attributable to estate and excise tax liabilities. After adjusting for late payments and collections due to enforcement activities, the net tax gap fell to $271 billion for individual income taxes, $77 billion for employment taxes, and $32 billion for corporate income taxes.

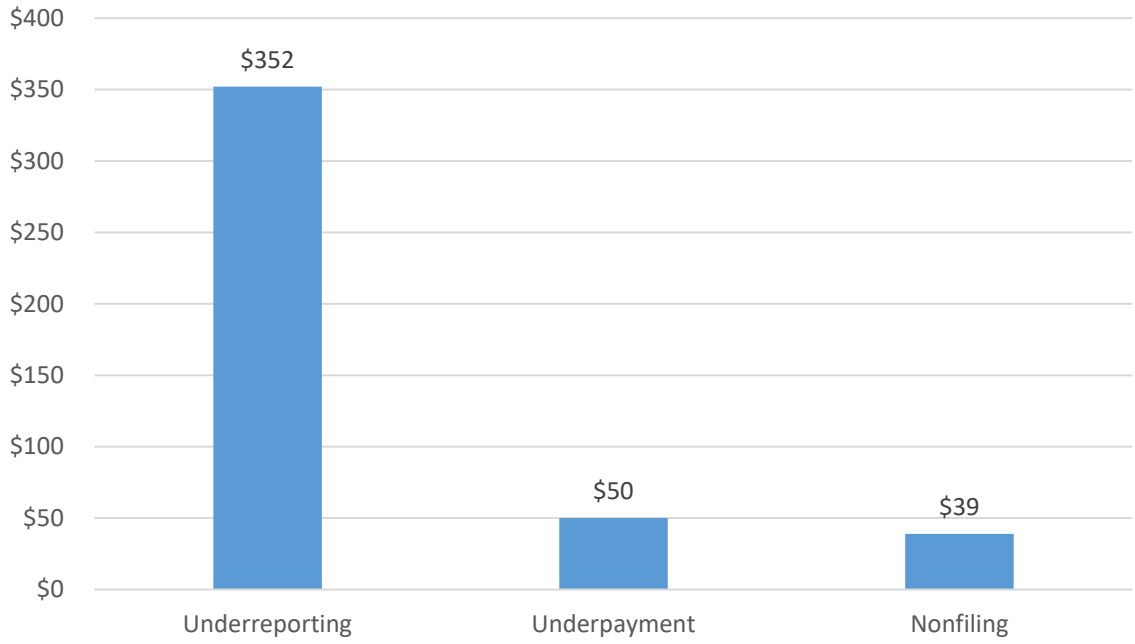
Figure 1.−Size of the Gross and Net Tax Gaps by Type of Tax, 2011-2013 (Billions) (Nominal dollars)



Source: Internal Revenue Service, *Tax Gap Estimates for Tax Years 2011–2013*, September 2019.

Figure 2 shows that for tax years 2011-2013 underreporting of total tax liabilities was the largest component of the tax gap. Only 20 percent of the gross tax gap was attributable to nonfiled tax returns (which includes many late-filed returns) and underpayment of tax liabilities.

Figure 2.−Size of the Gross Tax Gap by Category of Error, 2011-2013 (Billions) (Nominal dollars)



Source: Internal Revenue Service, *Tax Gap Estimates for Tax Years 2011–2013*, September 2019.

Data and methodology

IRS studies of the tax gap prior to 2000 rely on compliance data collected by the Taxpayer Compliance Measurement Program ("TCMP"). These earlier compliance studies are based on comprehensive in-person audits[4] of a representative sample of taxpayers in which taxpayers were required to provide documentation supporting every item on the tax return. Public opposition to the TCMP grew because of concerns about the burden imposed on taxpayers in the sample. The last TCMP examined tax returns from 1988, and the IRS canceled its plans to conduct another TCMP in 1995. Beginning in 2000, the IRS established the National Research Program ("NRP"), a new compliance data collection approach which was developed to meet a number of objectives, including minimizing the burden of data collection without sacrificing data quality.[5] The NRP is not an operational audit, but consists of a representative sample of audits that examine nearly all items on tax returns. The NRP also oversamples returns with high incomes or difficult to observe business income. Since the inception of the NRP, there have

[4] Field examinations or audits are generally performed in person by revenue agents, tax compliance officers, tax examiners, and revenue officer examiners. However, when appropriate, some field examinations are ultimately conducted through correspondence.

[5] Charles Bennett, "Preliminary Results of the National Research Program's Reporting Compliance Study of Tax Year 2001 Individual Returns," in Justin Dalton and Beth Kliss (eds.), *IRS Research Bulletin*: *Proceedings of the 2005 IRS Research Conference*, 2006, pp. 3-14. Available at www.irs.gov/pub/irs-soi/05bennett.pdf.

been multiple studies of the tax gap, including for tax years 2001, 2006, 2008-2010, and 2011-2013.[6]

In the most recent 2011-13 tax gap study, the IRS relies heavily on the NRP to estimate individual income tax underreporting, the largest component of the tax gap.[7] The IRS collects information each year from examinations of a random sample of about 13,000 taxpayers under the NRP. The IRS sampling methodology is designed to result in a sample that is representative of the total filing population. One advantage of this random sampling is that it includes individuals who would not normally have been selected for a regular IRS audit, providing the IRS both with information on compliant taxpayers as well as on noncompliant taxpayers who would not be identified through existing IRS detection tools.

Each annual individual income tax return in the NRP sample contains information from a wide array of tax return line items and is a rich source of data for compliance analysis. For the most complicated returns as well as certain returns with reported self-employment income, the IRS conducts a full-scale audit, requiring either an in-person interview or a field audit with an examiner or revenue agent reviewing most of the return. In many other cases, however, the IRS identifies only a few questionable items and sends taxpayers a letter requesting documentation supporting these claims. In the simplest cases, the IRS compares the taxpayers' returns to information available from third parties and does not contact the taxpayers at all. Varying the degree of taxpayer interaction with the complexity of the return reduces the study's cost to the IRS as well as the burden imposed on taxpayers, especially those who are compliant and who would not typically be selected for an audit.[8]

In order to estimate other components of the tax gap (*i.e*. other than individual income taxes), the IRS uses a variety of data sources and empirical methods. For example, the IRS uses administrative data from operational audits to estimate underreporting of corporate income taxes. Unlike the examination of individuals, these businesses are not selected randomly. Various econometric techniques are employed to adjust for the statistical bias resulting from use of a nonrandom sample, but these techniques may not overcome all of the data limitations. The IRS uses yet another approach to determine underreporting of payroll taxes (other than self-employment income taxes). For example, in the absence of more recent audit data, the IRS applies estimated compliance rates from a payroll tax study released in 1993 to the reported taxes

[6] In the 15 years prior to the NRP, the IRS conducted three studies on the tax gap for tax years 1985, 1988, and 1992.

[7] According to this study, revenue lost due to underreporting is larger than that due to nonfiling and underpayment for individual income taxes, employment taxes, corporate income taxes, estate taxes, and excise taxes.

[8] Joint Committee on Taxation, *Factors Affecting Revenue Estimates of Tax Compliance Proposals: A Joint Working Paper of the Congressional Budget Office and the Staff of the Joint Committee on Taxation* (JCX-90-16), November 2016. This document can be found on the Joint Committee on Taxation website at www.jct.gov.

over the 2008–2010 period. In these examples, the lack of a representative, randomly sampled data source may present technical difficulties with accurate estimation of taxpayer compliance.[9]

Measuring the distribution of noncompliance

Policymakers may be interested in patterns of noncompliance along the income distribution. Differing degrees of tax noncompliance may be associated with higher or lower income taxpayers if some taxpayers have sources of income that are more or less difficult for the IRS to identify and monitor than others, and if certain taxpayers face disparate incentives and behave in different ways than do others.

One important difficulty with estimating the distributional pattern of noncompliance is the possible disconnect between reported income and "true" income. When taxpayers misreport their incomes, their "true" income is often invisible to the IRS, to policymakers, and to researchers. For purposes of tax gap analysis, therefore, researchers adjust for undetected income using an econometric technique called detection-controlled estimation ("DCE").[10] Estimates using the DCE method and data from the NRP in 2001 show that taxpayers with relatively high levels of "true" income are more likely to misreport their income than those with relatively low levels of "true" income.[11] However, the DCE method may not adequately account for any systematic errors in reported income that are related to true income.[12] For example, if auditors are systematically less likely to detect misreporting for either lower or higher income taxpayers or misreporting of higher income taxpayers is more sophisticated and harder to detect, the DCE method is unable to completely correct for these factors.[13]

Some recent preliminary research notes these limitations in the use of the DCE method and the use of NRP random audit data to estimate distributional effects of tax noncompliance. If sophisticated forms of misreporting are more likely to be used by higher income taxpayers, and are less likely to be detected in random audits, the DCE method may not account adequately for the degree of undetected misreporting and the use of NRP data to study these taxpayers will be

[9] Internal Revenue Service, *Tax Gap Estimates for Tax Years 2008–2010*, April 2016.

[10] For a detailed description of the DCE method, see Andrew Johns, and Joel Slemrod, "The Distribution of Income Tax Noncompliance." *National Tax Journal*, vol. 63, 2010, pp. 397–418.

[11] *Ibid.*

[12] An alternative method uses income-specific underreporting rates. However, using average underreporting rates by type of income to estimate the distribution of underreporting misses the pattern of declining detected evasion at the top of the reported income distribution, and because they are multiplied by reported income, returns will be incorrectly assigned more underreporting if they lower their underreporting. To avoid these issues, since 2012, the IRS has used a micro-based approach to estimate underreporting and evasion. However, distributional estimates from the IRS micro-based approach are not available. See Kim Bloomquist, Ed Emblom, Drew Johns, and Patrick Langetieg, "Estimates of the Tax Year 2006 Individual Income Tax Underreporting Gap," *IRS Research Bulletin: Proceedings of the 2012 IRS/TPC Research Conference*, 2012, pp. 70–78. Available at www.irs.gov/pub/irs-soi/12resconEstimates.pdf.

[13] Jason DeBacker, Bradley Heim, Anh Tran, and Alexander Yuskavage, "Tax Non-compliance and Measures of Income Inequality," *Tax Notes Federal*, February 17, 2020, pp. 1103–1118.

inherently flawed. For example, this new research shows that NRP audits often fail to detect offshore evasion and underreporting of passthrough business income and that DCE methods also fail to adequately account for the degree of misreporting in these areas. Augmenting the NRP data with additional sources of data on offshore income and wealth and passthrough business income shows estimates of misreporting for high income taxpayers that are higher than in existing studies of evasion. For example, estimates using augmented data show unreported income as a fraction of "true" income is seven percent in the bottom half of the income distribution and 20 to 25 percent in the top one percent of the income distribution.[14] The estimated degree of high income evasion (*i.e.* underreporting by taxpayers in the top one percent of the income distribution) is higher using the augmented data than estimates using NRP data only.[15] However, for reasons described above, all such estimates are highly uncertain.

A variety of current policies may reduce high-income tax evasion. Policies introduced in the 1950s and 1960s expanded income tax withholding, third-party reporting, and coordination of audits with intergovernmental agreements. These policies appear to successfully target those with high incomes and cause proportionally larger increases in income reporting among those with higher incomes than on average.[16]

In addition, audits are higher than average at the very top of the reported income distribution. For example, in 2014, sixteen percent of returns with adjusted gross income of at least $10 million were audited, and less than one percent were subject to audits across all income levels.[17] More recently, however, the rate of audits for high-income taxpayers has fallen steeply.[18]

Furthermore, information reporting on cost basis which began about a decade ago may help limit high-income capital gains tax evasion. Since 2011, the IRS receives information on Form 1099-B regarding the cost basis of stocks purchased. In subsequent years, the cost basis of other assets is also required to be reported. Due to the slow turnover of many assets, the compliance effect of this information reporting may accumulate over time. Similarly, the information reporting regime with respect to foreign account tax compliance and cross-border transactions ("FATCA") that was enacted in 2010[19] may improve reporting among those with high incomes, but because of the need for a series of bilateral intergovernmental agreements to

[14] John Guyton, Patrick Langetieg, Daniel Reck, Max Risch, and Gabriel Zucman, "Tax Evasion at the Top of the Income Distribution: Theory and Evidence," *NBER Working Paper No. 28542*, 2021.

[15] *Ibid*, p. 40.

[16] Troiano, Ugo. "Do Taxes Increase Economic Inequality? A Comparative Study Based on the State Personal Income Tax," *NBER Working Paper No. 24175*, 2017.

[17] Note that a risk assessment targets audits within each income group to determine if an audit is warranted. Inspector General for Tax Administration, Department of the Treasury, *Improvements are Needed in Resource Allocation and Management Controls for Audits of High-Income Taxpayers*, (TIGTA 2015-30-078), 2015.

[18] See Figure 4 and Table 5 below.

[19] For a discussion of FATCA, see III.A.3 below.

overcome domestic legal barriers faced by foreign financial institutions, the compliance effect of this policy may also accumulate over time.

Finally, other expansions in information reporting may affect some high-income taxpayers. Since 2011, credit card and third-party network transactions are reported to the IRS with Form 1099-K. Beginning in 2022, Form 1099-K covers more income. Before, third-party settlement organizations were not required to report unless transactions for a taxpayer exceeded $20,000 and the total number of transactions was more than 200. In the future, reporting will be required if total transactions are more than $600, independent of the number of transactions.[20]

Measuring noncompliance in the informal economy

One source of noncompliance that is not explicitly included in the IRS tax gap studies and that is uniquely difficult to observe and measure is the gap generated by the informal economy. The informal economy is sometimes defined as consisting of the informal sector, which produces legal goods and services in an unregulated environment; the underground sector which produces legal goods and services, but uses illegal production and distribution processes; and the criminal sector, which produces illegal goods and services and distributes those illegally. Economies were once thought to consist of formal and informal sectors, with the informal economy a separate and hidden economy having no direct links to the formal economy. However, an evolving understanding points to formal and informal sectors as interrelated, interdependent, and sometimes overlapping. Attempts to define and measure the size of the informal economy have not yet yielded a standardized set of concepts, and definitions of the informal economy vary across studies and continue to change, as do theories about their effects on employment, productivity, and growth. As definitions of the informal economy vary from study to study, so also do estimates of the size of taxed and untaxed economic activity in the informal economy.[21]

The informal economy, which may be marked by evasion of employment regulations or taxation, is not easily visible and currently is generally unmeasured in the United States. In the absence of direct measures, research identifies a high level of overlap between informal employment and three types of non-standard employment: own account self-employment, temporary employment, and part-time employment.[22] In the United States in 2019, 6.1 percent of total employment was own account self-employment[23] and in 2008, 7.0 percent was own

[20] Sec. 6050W(e); Joint Committee on Taxation, *Technical Explanation of the Modification of Exceptions of Reporting Third Party Network Transactions in New Section 9674 of Subtitle IX of the America Rescue Plan Act Of 2021, as Amended by the Proposed Manager's Amendment*, March 2021. This document can be found on the Joint Committee on Taxation website at www.jct.gov.

[21] For more on various definitions, see The Brookings Institution Metropolitan Policy Program, "Measuring the Informal Economy- One Neighborhood at a Time," September 2006.

[22] Women in Informal Employment Globalizing and Organizing (WIEGO), "Statistics on the Informal Economy: Definitions, Regional Estimates and Challenges," April 2014.

[23] Own account self-employment refers to those workers who work on their own account or with one or more partners, hold the type of jobs defined as "self-employment jobs" and have not engaged any employees to

account self-employment, 4.2 percent was temporary employment, and 12.2 percent was part-time employment.[24]

The amount of income not reported by participants in the informal economy is not well understood. The types of tax not reported by these participants may include individual income tax, particularly from business income, and self-employment tax. As measured by the IRS, the gross tax gap from non-filing and underreporting of individual business income and self-employment tax was between $194 billion and $220 billion on average for tax years 2008-10.[25] These estimates are suggestive, but may not accurately describe the informal economy because a substantial and unknowable fraction of total non-filing and underreporting may stem from non-filing and underreporting in the formal economy. Furthermore, if activity in the informal economy is difficult for the IRS to detect, there may be significant additional unreported tax.

work for them on a continuous basis. These statistics are available at http://www npdata.be/Dok/OESO/Work/OECD-Labour-2017.pdf.

[24] These data are available at http://stats.oecd.org/index.aspx.

[25] Joint Committee staff calculations based on Tax Gap Map from IRS, *Tax Gap Estimates for Tax Years 2008-2010* April 2016, p. 3, available at https://www.irs.gov/pub/newsroom/tax%20gap%20estimates%20for%202008%20through%202010.pdf.

II. THE ECONOMICS OF TAX COMPLIANCE

A. Role of Taxpayer Behavior in the Tax Gap

Faced with a statutory tax, a taxpayer may avoid the tax by foregoing the activity which generates the tax, or evade the tax by underreporting the amount, underpaying the amount, or failing to file a return altogether. In the first case, the taxpayer's avoidance by foregoing the activity is legal. In the second, third, and fourth cases (*i.e*. underreporting, underpaying, or failing to file a return), the taxpayer's evasion[26] is illegal. Policymakers may try to minimize the degree of legal avoidance by designing policies that are clearly written and allow for few loopholes, and they may try to minimize illegal evasion by instituting various enforcement mechanisms, such as allowing for third party verification through information reporting, and increasing penalties and audits.

In some cases, taxpayers may choose whether or not to evade taxes by weighing the expected costs (for example, the probability of being caught and the consequences when caught, including social stigma) against the expected benefits of such evasion (for example, the likelihood of not being caught and the benefit of retaining money not used to pay taxes).[27] Evidence also shows that taxpayers do not always fully optimize their behavior by weighing costs and benefits as described, and that simple and salient tax policies often improve taxpayer compliance.[28]

In addition, observers note that voluntary compliance significantly relies on taxpayers' intrinsic motivation to pay taxes, *i.e.*, tax morale. Efforts to create tax systems and policies that are perceived to be simple and fair may improve tax morale and, therefore, compliance.[29]

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[26] In the economic analysis in Parts I and II, the term *evasion* refers to illegal non-payment or underpayment of tax liabilities due, even in the absence of criminal intent or activity. In contrast, in legal analysis, evasion is used to refer to willful conduct that may fall within the scope of Code section 7201 which provides that evasion is a criminal offense.

[27] Gary Becker, "Crime and Punishment, an Economic Approach," *Journal of Political Economy*, vol. 76, no. 2, 1968, pp. 169-217; Michael G. Allingham, and Agnar Sandmo, "Income Tax Evasion: a Theoretical Analysis," *Journal of Public Economics*, vol. 1, 1972, pp. 323-338.

[28] Raj Chetty, Adam Looney, and Kory Kroft, "Salience and Taxation: Theory and Evidence," *American Economic Review*, vol. 99, 2009, pp. 1145-1177.

[29] OECD, Public Consultation Document, "What is Driving Tax Morale?" 2019, pp. 6-10.

B. Role of Policymakers and the IRS in the Tax Gap

In designing policy and enforcement tools, policymakers who seek to achieve optimal levels of tax compliance may likewise weigh the relative costs of these initiatives (for example, more audits and enforcement activity as well as increased burdens on individuals as they attempt to comply with laws)[30] against the relative benefits (for example, increased tax revenue, and an increased perception that the system is fair).[31]

Lawmakers may also consider how much IRS funding is optimal. Optimal policies are those that improve compliance while best utilizing limited IRS resources. However, not all efforts to eliminate the tax gap are optimal. For example, a dollar used to increase IRS enforcement efforts is not desirable policy if it does not result in at least a dollar of additional tax revenue collected. It is rarely, if ever, optimal to attempt to reduce the amount of taxpayer evasion to zero because at higher levels of spending the additional revenue collected from increasing enforcement activities may fall below the additional cost of these activities.

Return on Investment (ROI)

The ROI of an enforcement program is calculated by dividing the expected revenues that would be collected under the program (including taxes, interest, and penalties) by the additional cost. The estimates of additional cost are based on the cost of the employees required to implement new enforcement functions, taking into account the pay grades of needed new employees and the number of hours worked.[32]

[30] Joel Slemrod, "Which is the Simplest Tax System of Them All?" in Henry Aaron and William Gale (eds.), *Economic Effect of Fundamental Tax Reform*, The Brookings Institution, 1996, pp. 355-391.

[31] Joel Slemrod, and Shlomo Yitzhaki, "The Optimal Size of a Tax Collection Agency," *Scandinavian Journal of Economics*, vol. 89, 1987, pp. 183-192.

[32] Studies that estimate ROI may limit the analysis of additional costs to include only employee compensation costs (excluding the cost of facilities, maintenance, equipment, and other costs) at least partly because these constitute the largest fraction of total costs. In fiscal year 2018, 94 percent of the IRS enforcement budget was attributable to the cost of personnel compensation, and less than six percent was attributable to the cost of facilities, maintenance, and equipment. See Janet Holtzblatt and Jamie McGuire, "Effects of Recent Reductions in the Internal Revenue Service's Appropriations on Returns on Investment," *Tax Policy Center*, June 26, 2020, available at https://www.taxpolicycenter.org/publications/effects-recent-reductions-internal-revenue-services-appropriations-returns-investment/full.

Table 2 shows ROIs based on actual costs and actual revenues were stable for overall IRS enforcement programs during fiscal years 2015 through 2019. For each dollar of spending on enforcement, the IRS estimates it collected an average of $5 of revenue from these efforts.[33] These estimates may understate total actual returns because they do not include the revenue collected as a result of the deterrence effect of IRS enforcement programs and do not include any returns from the effects of education and outreach on voluntary tax compliance.

Table 2.–Returns on Investment in IRS Enforcement Programs, 2015-2019 (dollar amounts in billions)

Fiscal Year	Amount collected	ROI
2019	$57.50	5.0
2018	$59.40	5.3
2017	$56.90	5.1
2016	$54.30	5.0
2015	$54.20	5.0

Sources: Department of the Treasury, *Budget-in-Brief, Fiscal Year 2021*, February 10, 2020; *Budget-in-Brief, Fiscal Year 2020*, March 2019; *Budget-in-Brief, Fiscal Year 2019*, March 4, 2018; *Budget-in-Brief, Fiscal Year 2018*, March 23, 2017; *Budget-in-Brief, Fiscal Year 2017*, February 9, 2016; available at https://home.treasury.gov/about/budget-financial-reporting-planning-and-performance/budget-requestannual-performance-plan-and-reports/budget-in-brief.

[33] Each *additional (or "marginal")* dollar of spending on additional IRS efforts may yield more or less than $5 of additional revenue collected. The concept measured here is the *average* return on investment. All else equal, we expect that the *marginal* ROI drops to zero at very high levels spending on enforcement.

Table 3 shows the estimated ROIs based on actual cost and actual revenue collected for fiscal years 2012 through 2018 for three major IRS enforcement programs, Examination, Collection, and Automated Underreporter ("AUR").[34] For example, in 2019, a dollar spent on the AUR program yielded $21.60 of collected revenue, and a dollar spent on Examination enforcement programs yielded $3 of collected revenue. Both the Collection and the AUR programs yielded larger amounts of revenue at relatively low cost, while Examinations yielded more modest amounts of additional revenue at relatively higher cost. For all three programs, however, the ROI is significantly greater than one, indicating that one additional dollar spent on enforcement yields significantly greater than one additional dollar in revenue.

Table 3.–Return on Investment for Major IRS Enforcement Programs, 2014-2019

	2014	2015	2016	2017	2018	2019
Examination	4.8	3.4	3.2	4.1	4.0	3.0
Collection	20.5	25.2	23.6	22.8	23.8	25.7
Automated Underreporter (AUR)	19.4	20.5	21.4	24.9	25.7	21.6

Source: Department of the Treasury, *Congressional Budget Justification and Annual Performance Report and Plan, Fiscal Year 2020*, March 2019, available at https://home.treasury.gov/system/files/266/02.-IRS-FY-2020-CJ.pdf,; Department of the Treasury, *Congressional Budget Justification and Annual Performance Report and Plan, Fiscal Year 2021*, available at https://home.treasury.gov/system/files/266/FY-2021-CJ.pdf.

[34] The Examination Program conducts audits of individual taxpayers, businesses, and other types of organizations to verify that reported tax liability is correct. The Collection Program collects delinquent taxes through the use of enforcement tools, such as lien, levy, seizure of assets, installment agreement, offer in compromise, substitute for return, summons, and others. The AUR program matches the data on third-party information returns to self-reported information on tax returns and contacts taxpayers to resolve discrepancies.

C. Tools for Improving Tax Compliance

A number of policy tools allow policymakers to facilitate and encourage voluntary tax compliance. Such tools include information reporting and withholding, math error authority, audits, and penalties.

Information reporting and withholding

The IRS gathers independent information about income received and taxes withheld in order to verify self-reported income and tax filed on tax returns.[35] The use of reliable and objective third-party verification of income increases the probability of tax evasion being detected and increases the cost of evasion to the taxpayer, thereby decreasing the overall level of tax evasion by taxpayers. Information reporting by payors and brokers is required in a broad category of payments to taxpayers, including wages and salaries, dividends, interest, share sales, real estate sales, and other categories.[36] Ample empirical evidence shows that the introduction of third-party information reporting in tax administration leads to more accurate reports of income on tax returns. For example, an analysis of small businesses operating as sole-proprietorships in 2011 shows a sharp increase in accuracy of reporting of business receipts in response to a new information reporting regime, Form 1099-K (relating to payment card and third-party network transactions). The overall effect on evasion, however, was dampened by a simultaneous increase in deduction of reported expenses, which are not observable to the IRS.[37]

In addition, empirical evidence suggests that increasing withholding rates may, in certain settings, improve total tax collections.[38] In simple textbook models of taxation, the question of who remits the tax should not affect overall collections or levels of tax evasion. However, when taxpayers do not behave in ways that optimize their income or accurately reflect a demand for liquidity, requiring tax remittance from one party rather than another, may impact overall compliance. Data show that compliance is greatest for sources of income, such as wages and salaries, which are reported to the IRS by employers and other payers, and for which taxes are withheld by third parties. Noncompliance is greatest for income, including self-employment

[35] In fiscal year 2019, the IRS received more than 3.5 billion third-party information returns, 89.6 percent of which were filed electronically. In addition, individual income tax withheld totaled $1.35 trillion out of $1.98 trillion of individual income tax collected, before refunds. See Internal Revenue Service, *Data Book 2019*, Publication 55-B, Washington, DC, June 2020, Tables 1 and 22.

[36] For further discussion of these categories, see III.A below.

[37] Joel Slemrod, Brett Collins, Jeffrey Hoopes, Daniel Reck, and Michael Sebastiani, "Does Credit-Card Information Reporting Improve Small-Business Tax Compliance?" *Journal of Public Economics*, vol. 149, 2017, pp. 1-19.

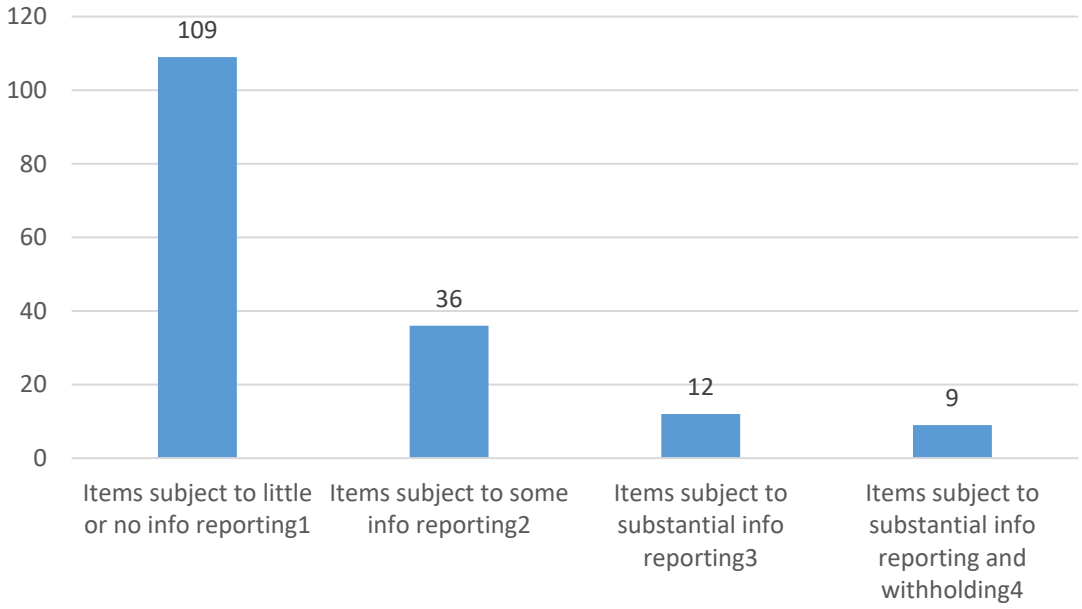
See also, for example, Mark D. Phillips, "Individual Income Tax Compliance and Information Reporting: What Do The U.S. Data Show?" *National Tax Journal*, vol. 67, 2014, pp. 531-568; Kleven, Henrik, Martin Knudsen, Claus Kreiner, Soren Pedersen, and Emmanuel Saez, "Unwilling or Unable to Cheat? Evidence From a Tax Audit Experiment in Denmark," *Econometrica*, vol. 79, no. 3, 2011, pp. 651-692.

[38] Christian A. Vossler, Michael McKee, David M. Bruner, "Behavioral Effects of Tax Withholding on Tax Compliance: Implications for Information Initiatives," *Journal of Economic Behavior and Organization*, vol. 183, March 2021, pp. 301-319.

income, for which third-party information is not separately reported to the IRS and is not visible to the IRS or not easily accessed by taxpayers.

As shown in Figure 3, in 2011-2013, the amount of individual income tax underreported was $109 billion for income that is subject to little or no information reporting. In contrast, it was $12 billion for income that was subject to substantial information reporting with no withholding and an additional $9 billion for income that was subject to substantial information reporting together with withholding.

Figure 3.− Individual Income Tax Underreporting by Visibility of Income, 2011-13 (Billions) (Nominal dollars)



Source: Internal Revenue Service, *Tax Gap Estimates for Tax Years 2011–2013*, September 2019.

Notes: [1]Includes nonfarm proprietor income, other income, rents and royalties, farm income, Form 4797 income;[2] Includes partnership and S corporation income, capital gains, alimony income; [3]Includes pensions and annuities, unemployment compensation, dividend income, interest income, taxable Social Security benefits; [4]Includes wages and salaries.

Math error authority

When an error is detected on a tax return, the IRS may generally correct the error by starting an audit process. However, in certain limited cases, the IRS is authorized to

automatically correct mathematical and clerical errors (collectively known as "math errors") and recalculate tax liability on returns without an audit.[39]

In fiscal year 2019, the IRS sent 1.87 million notices for 1.89 million math errors on returns for tax year 2018, and 312,379 notices for 413,484 errors on returns for tax years prior to 2018.[40] Table 4 shows that for returns filed in 2018, the greatest number of math errors were calculation errors, constituting 50 percent of all math errors for returns in that year. The number of errors associated with the standard versus itemized deduction, the earned income tax credit ("EITC"), the child tax credit ("CTC"), and the number and amount of exemptions were also significant in returns filed in tax years 2018, 2017, and earlier.

Table 4.–Math Errors on Individual Income Tax Returns, by Type of Error, Fiscal Year 2019

	Tax year 2018 returns		Tax year 2017 and prior year returns	
	Number of errors	Percentage of total	Number of errors	Percentage of total
Total math errors	1,894,550	100.0%	413,484	100.0%
Tax calculation	956,528	50.5%	78,263	18.9%
Standard/itemized deduction	189,947	10.0%	29,925	7.2%
Earned Income Tax Credit	132,400	7.0%	42,128	10.2%
Child Tax Credit	47,520	2.5%	41,687	10.1%
Exemption number/amount[1]	40,478	2.1%	116,019	28.1%
Other	527,677	27.9%	105,462	25.5%

Source: Internal Revenue Service, *Data Book 2019*, Publication 55-B, Washington, DC, June 2020, Table 23.

Note: [1]The personal exemption deduction was suspended beginning with tax year 2018. As a result, the number of errors associated with this category decreased significantly.

IRS audits

A taxpayer's perceived probability of audit is an important component of the taxpayer's decision to comply with a requirement to pay tax.[41] To the extent that actual audit rates affect

[39] For a discussion of the trade-offs regarding an expansion of math error authority, see III.B.2 below.

[40] Internal Revenue Service, *Data Book 2019*, Publication 55-B, Washington, DC, June 2020, Table 23.

[41] See for example, Michael Chirico, Robert P. Inman, Charles Loeffler, John MacDonald, and Holger Sieg, "An Experimental Evaluation of Notification Strategies to Increase Property Tax Compliance: Free-Riding in the City of Brotherly Love," *Tax Policy and the Economy*, vol. 30, no. 1, 2016, pp. 129-161.

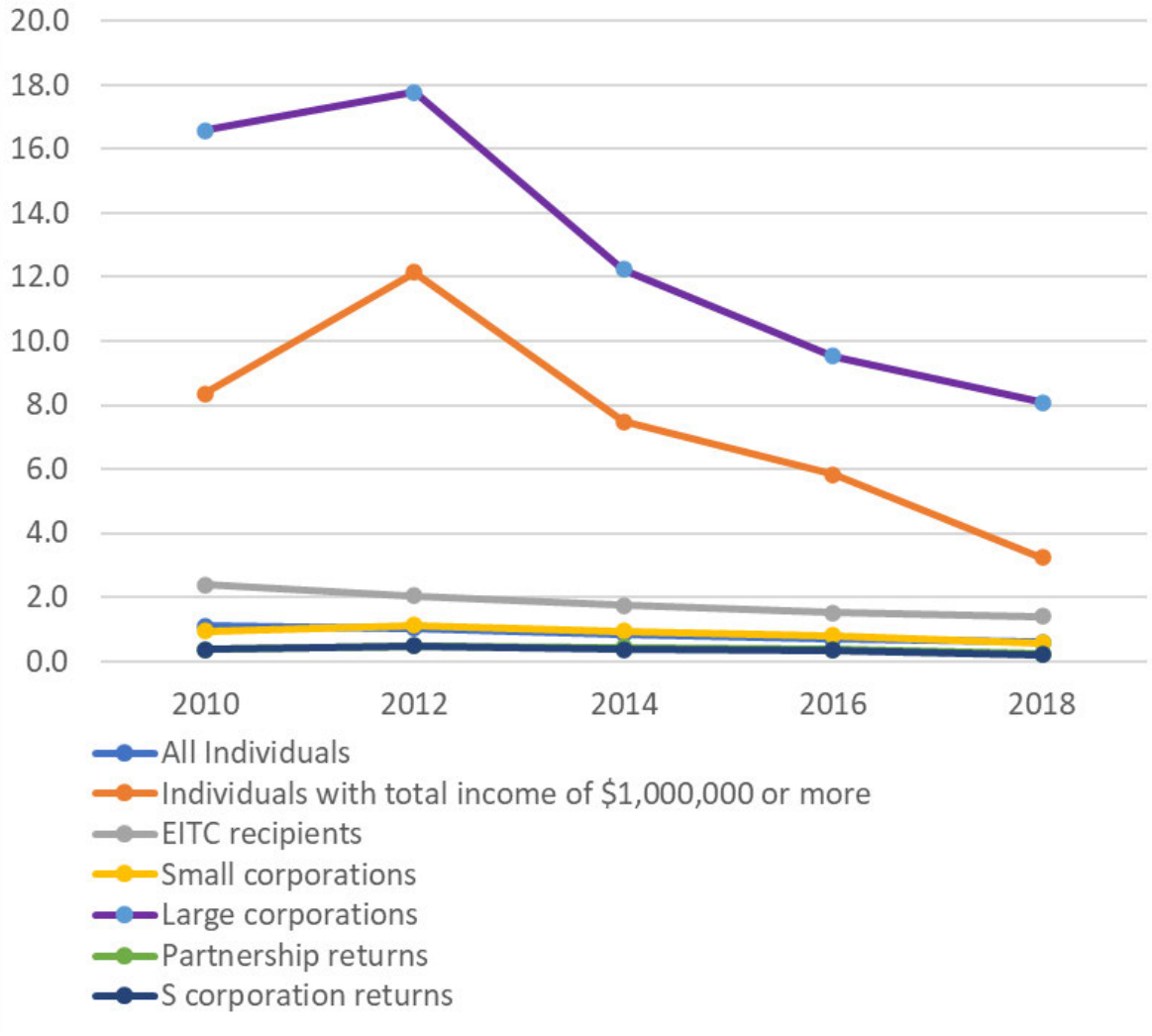
taxpayer perceptions, these rates may be an important deterrent to noncompliance. In addition to the effect of perceived probability of audit, there is a specific deterrence effect of audits on the audited. Individuals generally appear to alter their perceived probability of audit upwards in the few years following an actual audit, increasing reported wages, self-employment income, and other types of income for three to four years following the audit.[42] In addition, Danish research indicates that threat-of-audit letters have some effect on self-reported income in subsequent years, perhaps by altering the individual taxpayer's perceived probability of audit.[43]

Figure 4 shows the percent of returns subject to IRS audit by type of taxpayer over the period 2010 to 2018. These audit rates are the returns examined in a given fiscal year for a given subset of taxpayers, divided by the total number of returns filed in that subset in the preceding calendar year, as reported by the IRS. Large corporations and individuals with total income of $1 million or more are more likely to be audited than are other types of taxpayers, such as individuals with less than $1 million of income, EITC recipients, or small corporations. However, large corporations and individuals with total income of $1 million or more have also seen the largest declines in audit rates in recent years.

[42] Jason DeBacker, Bradley T. Heim, Anh Tran, and Alexander Yuskavage, "Once Bitten, Twice Shy? The Lasting Impact of IRS Audits on Individual Tax Reporting," *Journal of Financial Economics,* vol. 117, no. 1, 2015, pp. 22-138.

[43] In 2008, some Danish taxpayers were randomly selected to receive letters from the Danish tax collection agency ("SKAT") stating, "SKAT has selected a group of taxpayers, including you, for a special investigation. For (half the) taxpayers in this group, the upcoming tax return for 2007 will be subject to a special tax audit…" Researchers find these threat-of-audit letters have some effect on self-reporting of income for this group in future years. See Henrik Kleven, Martin Knudsen, Claus Kreiner, Soren Pedersen, and Emmanuel Saez, "Unwilling or Unable to Cheat? Evidence from a Tax Audit Experiment in Denmark," *Econometrica,* vol. 79, no. 3, 2011, pp. 651-692.

Figure 4.–IRS Audit Rates Over Time By Type of Filer, Fiscal Years 2010-2018 (percent)



Sources: Internal Revenue Service, *Data Book 2018*, Publication 55-B, Washington, DC, May 2019, Table 9a; Internal Revenue Service, *Data Book 2016*, Publication 55-B, Washington, DC, March 2017, Table 9a; Internal Revenue Service, *Data Book 2014*, Publication 55-B, Washington, DC, March 2015, Table 9a; Internal Revenue Service, *Data Book 2012*, Publication 55-B, Washington, DC, March 2013, Table 9a; Internal Revenue Service, *Data Book 2010*, Publication 55-B, Washington, DC, March 2011, Table 9a.

Note: [1]The category "Individuals" includes individuals with total income of $1,000,000 or more, and EITC recipients.

Table 5 provides further detail on audit rates over time. IRS audit rates were highest, as a percentage of type of filer, for estates and large corporations, followed by individuals with greater than $1 million of income. Of these three groups, large corporations and individuals with greater than $1 million of income experienced the largest decreases in audit rates between 2010 and 2018 (a 51 percent decrease and a 61 percent decrease, respectively).

Table 5.–IRS Audit Rates Over Time By Type of Filer, Fiscal Years 2010-2018

	2010	2012	2014	2016	2018	Percent decline, 2010 to 2018
All filers	0.93	0.89	0.73	0.604539	0.51	-45.4%
All Individuals[1]	1.11	1.03	0.86	0.699448	0.59	-46.3%
Individuals with total income of $1,000,000 or more	8.36	12.14	7.50	5.83	3.23	-61.4%
EITC recipients	2.39	2.05	1.74	1.53	1.41	-41.1%
Corporate	1.39	1.64	1.35	1.12	0.88	-36.5%
Small corporations	0.94	1.12	0.95	0.80	0.57	-39.1%
Large corporations	16.58	17.78	12.23	9.53	8.08	-51.2%
Partnership returns[2]	0.36	0.47	0.43	0.38	0.22	-38.9%
S corporation returns[2]	0.37	0.48	0.36	0.34	0.22	-41.0%
Employment tax returns	0.21	0.23	0.19	0.18	0.14	-33.6%
Estates	10.12	29.90	1.50	8.82	8.60	-15.0%

Sources: Internal Revenue Service, *Data Book 2018*, Publication 55-B, Washington, DC, May 2019, Table 9a; Internal Revenue Service, *Data Book 2016*, Publication 55-B, Washington, DC, March 2017, Table 9a; Internal Revenue Service, *Data Book 2014*, Publication 55-B, Washington, DC, March 2015, Table 9a; Internal Revenue Service, *Data Book 2012*, Publication 55-B, Washington, DC, March 2013, Table 9a; Internal Revenue Service, *Data Book 2010*, Publication 55-B, Washington, DC, March 2011, Table 9a.

Note: [1]The category "All individuals" includes all individuals including those with total income of $1,000,000 or more, and EITC recipients. [2] These are audits of returns filed for entities that generally do not have a tax liability but pass through any profits and losses to the underlying owners, who include these profits or losses on their income tax returns.

According to the data in Table 6, when they are audited, individual taxpayers with income less than $1 million are more likely to undergo audit by correspondence, as opposed to in-person. The same is true for individuals with income less than $200,000, including individuals receiving the EITC.

Table 6.–Audit Rates by Type of Filer, Fiscal Year 2019

	Total returns audited in fiscal year 2019	Percent of returns audited in fiscal year 2019	Percent of audited returns that are in-person	Percent of audited returns that are by correspondence
Individuals	680,543	0.45	19.59	80.39
Individuals w/income greater than $1 million	13,946	2.40	71.94	28.06
Individuals w/income between $200,000 and $1 million	44,137	0.56	52.94	47.06
Individuals w/positive income less than $200,000[1]	619,411	0.43	15.71	84.29
EITC recipients	301,180	1.13	5.88	94.12
Corporations	13,472	0.72	97.78	2.22
Small corporations[2]	8,500	0.49	98.29	1.71
Large corporations[3]	4,775	6.22	97.60	2.41
Partnership returns	7,478	0.18	84.19	15.81
S corporation returns	10,065	0.20	94.94	5.06

Source: Internal Revenue Service, *Data Book 2019*, Publication 55-B, Washington, DC, June 2020, Table 17b.

Notes: [1]Includes a total of 301,180 returns selected for examination on the basis of an EITC claim.[2,3] Small and large corporations include returns other than Forms 1120-C, 1120-F, and 1120-S. Small corporations are those with less than $10 million in assets, large corporations are those with $10 million or more in assets.

Penalties

Penalties are an important policy tool in standard economic models of deterrence. For example, a penalty for the failure to timely file tax returns or information returns may foster

compliance in meeting these deadlines.[44] A penalty increases the cost of evasion to the taxpayer, which should motivate compliance. However, if for various reasons taxpayers do not fully optimize their behavior by weighing costs and benefits, this may dampen the full deterrence effect of a penalty regime.

Table 7 shows the amounts of penalty assessment for various groups of taxpayers. In fiscal year 2019, a total of nearly $40.5 billion of penalties were assessed on more than $40 million taxpayers. Civil penalties of greater than $14 billion were assessed on nearly 33 million individual, estate, and trust income taxes, and over 600,000 corporate income tax returns showed penalties assessed for a total amount of greater than $4 billion.

Table 7.– Civil Penalties Assessed
(money amounts in thousands of dollars)
Fiscal Year 2019

	Penalties Assessed	
	Number of Taxpayers	**Dollar Amounts**
Individual, estate, and trust income taxes	32,828,655	$14,169,849
Partnership income taxes	297,813	$1,095,337
Corporation income taxes	644,683	$4,117,192
S corporation income taxes	402,019	$572,735
Employment taxes	4,995,424	$13,681,459
Excise taxes and tax-exempt organizations and trusts	696,467	$381,961
Estate and gift taxes	5,263	$203,126
Nonreturn penalties[1]	291,001	$6,264,551
Total	40,161,325	$40,486,209

Source: Internal Revenue Service, *Data Book 2019*, Publication 55-B, Washington, DC, June 2020, Table 26.
Note: [1]These include various penalties assessed for a wide range of noncompliant behaviors, such as noncompliance related to tax return preparers and to information returns (*e.g.* Forms 1099, W-2, 3520-A, 8027, and 8300), as well as aiding and abetting; frivolous return filings; and misuse of dyed fuel. Also includes trust fund recovery penalties. Withheld income and employment taxes, including Social Security taxes, railroad retirement taxes, or collected excise taxes, are collectively called trust fund taxes because employers actually hold the employee's money in trust

[44] Currently, the failure to file penalty in the Code applies to all returns required to be filed under subchapter A of Chapter 61 (relating to income tax returns of an individual, fiduciary of an estate or trust, or corporation; self-employment tax returns, and estate and gift tax returns), subchapter A of chapter 51 (relating to distilled spirits, wines, and beer), subchapter A of chapter 52 (relating to tobacco, cigars, cigarettes, and cigarette papers and tubes), and subchapter A of chapter 53 (relating to machine guns and certain other firearms).

until they make a Federal tax deposit in that amount. Trust fund recovery penalties are assessed when these employment taxes are not collected, accounted for, and paid timely.

Interactions between penalties and other enforcement tools

When considering how to set optimal levels of tax penalties, policymakers may weigh the ineffective deterrent effects of penalties that are too low against the possible unintended effects of penalties that are too high.[45] One additional consideration is the interaction between penalty and other enforcement regimes. That is, in addition to choosing the level of penalties for misrepresenting information on wealth or income, policymakers must set the probability of detecting the misrepresentation, as well as the probability of an audit. These multiple factors simultaneously determine economically optimal enforcement.

If there is little or no information reporting for certain types of income so that the probability of detecting the offense is low or zero, the optimal penalty amounts will differ from settings in which information reporting is high and therefore income is highly visible and the probability of detecting any misrepresentations is high. Similarly, if audit rates (whether in-person or by correspondence) are high for certain types of income, the optimal penalties for misrepresentation of these types of income should differ from misrepresentation of certain types of income for which audit rates are low.[46]

[45] The Code provides for both civil and criminal penalties to ensure complete and accurate reporting of tax liability and to discourage fraudulent attempts to defeat or evade tax. The majority of delinquent taxes and penalties are collected through the civil process. For further discussion of penalties, see III.B.3 below.

[46] A. Mitchell Polinsky, "Optimal fines and auditing when wealth is costly to observe," *International Review of Law and Economics*, vol. 26, no. 3, September 2006, pp. 323-335.

III. OVERVIEW OF FEDERAL INCOME TAX COMPLIANCE MEASURES RELEVANT TO THE TAX GAP

Over the past 15 years, the IRS Tax Gap reports have shown that a substantial portion of the gap is attributable to individual noncompliance, both failure to file and the underreporting of individual income.[47] During that time, various legislative efforts have been made in an effort to address such noncompliance. Because noncompliance may be attributable to actions ranging from unintentional taxpayer errors to intentional fraud, the initiatives enacted have included changes affecting all phases of the preparation and filing of returns, as well as post-filing administration and enforcement by the IRS.

The following discussion provides an overview of the key legislative tools available to the IRS and how they have changed in recent years. Part A discusses initiatives to prevent underreporting and improve the preparation and filing of returns. Part B discusses measures that enhance the ability of the IRS to administer and enforce the Code with respect to returns after they are filed, such as the reform of partnership audit procedures, expansion of math error assessment authority, and penalties.

A. Measures to Prevent Underreporting and Improve Compliance: Pre-Filing

Efforts to improve the visibility of income-producing activities to the IRS have been numerous. Legislative action to fill gaps in information reporting and withholding at the source are summarized below. An overview of the scope of information reporting related to individual income determination is provided, as well as a more detailed discussion of certain provisions. The government efforts to improve information regarding offshore income or cross-border activities are summarized. Finally, the current state of legislative authority to regulate return preparers is described.

1. Information reporting and withholding

Information reporting is intended to assist taxpayers in receipt of such reports to prepare their income tax returns as well as to help the IRS determine whether such returns are correct and complete. The reporting of most relevance to the determination of individual income generally falls under one of two types. First, there are reports and disclosures required from taxpayers about themselves.[48] Second are the provisions requiring reporting with respect to transactions with other persons, including employers, known as third-party reporting.[49] Persons required to

[47] Compare, Figure 1, Internal Revenue Service, *Tax Gap Estimates for Tax Years 2011-2013,* (Pub. 1415) September 2019; Internal Revenue Service, *Tax Gap Estimates for Tax Years 2008–2010*, May 2016; and Internal Revenue Service, *Overview of the Tax Gap for Tax Year 2006*, January 2012, all available at https://www.irs.gov/statistics/irs-the-tax-gap.

[48] Secs. 6031 through 6040.

[49] Secs. 6041 through 6060.

submit such reports generally must do so electronically if they prepare 250 reports or more in a taxable year.[50]

Self-reporting and disclosure by taxpayers

In the first category, entities that are themselves not subject to Federal income tax, such as partnerships, trusts and estates, certain foreign persons and tax-exempt organizations, but whose payees may be U.S taxpayers, file information returns rather than income tax returns. With few exceptions, these provisions were first enacted well before the Tax Reform Act of 1986. For example, the requirement that partnerships report their income was based on a provision first enacted in 1938.[51] Nevertheless, these provisions have required tightening from time to time, as demonstrated in the following summary of amendments to these provisions since 1986.

Table 8.–Selected Changes to Information Reporting by Persons Subject to Special Provisions (Sections 6031-6039J) [52]

Code section, Title of Provision and related forms	Highlight of Change Since 1986	Year of Enactment
Section 6031 Return of Partnership Income (Form 1065, Sch. K-1)	Added subsection (d). Any partnership regularly carrying on a trade or business must provide information to its partners necessary for each partner to compute their share of income or loss.	1988
	Added subsection (e). Foreign partnerships excluded from reporting requirements unless income is gained within the United States.	1997
	Added subsection (f). Any electing investment partnership must provide information to its partners necessary to determine the extent to which the disallowance of built-in losses under section 743(e) with respect to a transfer of partnership property may affect the basis or distributive share of losses of a partner.	2004

[50] Sec. 6011(e)(5) (for taxable year 2020, persons required to file 250 returns or reports were required to do so electronically. For 2021, the threshold for mandatory e-filing is 100 reports. https://www.irs.gov/forms-pubs/e-filing-thresholds-remain-unchanged-until-further-notice.

[51] Section 6031, requiring income reporting by partnerships, is based on 52 Stat. at Large p. 522, ch.289, sec. 187 (May 28, 1938), which was included in the first codification of revenue statutes the following year, in the Internal Revenue Code of 1939 ("1939 Code").

[52] Not all forms that may be relevant to the items noted in Tables 8 and 9 are identified.

Code section, Title of Provision and related forms	Highlight of Change Since 1986	Year of Enactment
Section 6033 **Returns by Exempt Organizations** **(Forms 990, 990-T, 990-EZ, 990-PF and related schedules).**	Added subsection (g). In general, political organizations under section 527 shall file a return containing information sufficient to identify the extent to which income of the organization constitutes exempt function income.	2000
	Added subsections (h-l). Controlling, sponsoring, and supporting organizations are required to file returns. Subsection (j) details the loss of exemption status for failure to file returns or notices.	2006
	Added subsection (m). Co-op insurers are required to report on their returns the amount of reserves required by each State and the amount of reserves on hand.	2010
	Added subsection (n). Exempt organizations required to report under 6033 must do so in electronic form.	2019
Section 6034 **Returns by Certain Trusts** **(Form 706)**	Amended section 6034. Split interest trusts are not exempt from filing requirements.	2006
Section 6034A **Information to Beneficiaries of Estates and Trusts**	Added subsection (c). Beneficiary's return must be consistent with estate or trust return or Secretary notified of inconsistency.	1997
Section 6035 **Basis Information to Persons Acquiring Property from Decedent**	Added section 6035. The executor of an estate must file returns with the Secretary and to anyone receiving any property from a decedent identifying the value of the property.	2015
Section 6037(c) **Return of S Corporation** **(Forms 1120-S and 1040)**	Added subsection (c). The shareholder’s return must be consistent with corporate return or Secretary notified of inconsistency.	1996
Section 6038 **Information Reporting with Respect to Certain Foreign Corporations and Partnerships** **(Form 8865)**	Changed language within the section from “foreign corporation” to “foreign entity.”	1997

Code section, Title of Provision and related forms	Highlight of Change Since 1986	Year of Enactment
Section 6038A **Information with Respect to Certain Foreign-Owned Corporations** **(Form 5472)**	Added subparagraph (b)(2). A reporting corporation must include information necessary to determine the base erosion minimum tax amount, base erosion payments, and base erosion tax benefits for purposes of section 59A.	2017
Section 6038B(b) **Notice of Certain Transfers to Foreign Persons** **(Form 926)**	Added subsection (b). Limits the reporting requirements of subsection (a)(1)(B) as applied to transfers to foreign partnerships to transfers by a U.S. person at least a 10-percent interest in a foreign partnership or the value of the property transferred within a 12-month period exceeds not $100,000.	1997
Section 6038C **Information with Respect to Foreign Corporations Engaged in U.S. Business** **(Form 5472)**	Added section 6038C. Details the requirements for information and reporting by foreign corporations operating in the United States.	1990
Section 6038D **Information with Respect to Foreign Financial Assets** **(Form 8938)**	Added section 6038D. Details the information required by any individual who holds foreign financial assets which exceed $50,000 (or such higher dollar amount as the Secretary may prescribe) in aggregate.	2010
Section 6038E **Information with Respect to Assignment of Lower Rates or Refunds by Foreign Producers of Beer, Wine, and Distilled Spirits**	Added section 6038E. Foreign producers of alcohol must provide information if they make an assignment under sections 5001(c), 5041(c), or 5051(a).	2020
Section 6039(b) **Returns Required in Connection with Certain Options**	Added subsection (b). When a corporation reports transfer of stocks to an individual under subsection (a), it must provide a written statement to that individual.	2006
Section 6039F **Notice of Large Gifts Received from Foreign Persons** **(Form 3520)**	Added section 6039F. U.S. persons who receive gifts that exceed $10,000 in aggregate from a foreign entity must file such information with the Secretary.	1996

Code section, Title of Provision and related forms	Highlight of Change Since 1986	Year of Enactment
Section 6039G **Information on Individuals Losing United States Citizenship**	Added section 6039G. Details the information to be reported to the Secretary when a U.S. person loses U.S. citizenship.	1996
Section 6039H **Information with Respect to Alaska Native Settlement Trusts and Native Corporations** **(Form 1041-N)**	Added section 6039H. Details reporting requirements for Alaska Native settlement trusts and corporations.	2001
Section 6039I **Returns and Records with Respect to Employer-Owned Life Insurance Contracts** **(Form 8925)**	Added section 6039I. Details reporting requirements for policyholders owning one or more employer-owned life insurance contracts.	2006
Section 6039J **Information Reporting with Respect to Commodity Credit Corporation Transactions**	Added section 6039J. Details reporting requirements for the Commodity Credit Corporation to be filed through the Secretary of Agriculture according to the forms and regulations prescribed by the Secretary of the Treasury.	2008

As noted in the summary of amendments in the table above, the amendments to existing provisions sometimes relate to changes in the underlying tax obligations of the subject of the report. For example, the changes described with respect to section 6038A were made contemporaneous with the enactment of the base erosion anti-avoidance tax under section 59A.

The only entirely new provision among these amendments to the Code is the relatively recent addition of information reporting by estates to accompany a substantive change to the rules for determination of basis of property received from a decedent.[53] In 2015, section 1014 was amended to require consistency between the estate tax value of property and basis of property acquired from a decedent. If the value of the property has been finally determined for estate tax purposes, the basis in the hands of the recipient can be no greater than the value of the property as finally determined. If the value of such property has not been finally determined for estate tax purposes, then the basis in the hands of the recipient can be no greater than the value reported in a required statement. To enforce the mandatory consistency, lack of consistency was added as a basis for imposition of the accuracy related penalty, and the new information reporting requirement for both the estate and certain beneficiaries was added. An executor or

[53] Sec. 6035; Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, Pub. L. No. 114-41, sec. 2004, July 31, 2015.

beneficiary of a decedent's estate that is required to file an estate tax return[54] is required to report the value of each interest in property included in the gross estate to both the recipient and the IRS.

Third-party reporting overview

Most individual taxpayers in the United States are likely familiar with one or more forms of third-party reporting, unlike the self-reporting described above. These taxpayers use such forms to compute their annual gross income (generally, reported on one of the forms in the Form 1099 series or a W-2). Less frequently, information reports assist in confirming potential deductions based on expenses incurred or eligibility for certain credits (Form 1098 series). As discussed in Part I, income subject to information reporting tends to be more accurately reported on income tax returns.[55]

Based on Joint Committee staff analysis of data contained in the Information Returns Master File, which is part of the IRS Compliance Data Warehouse, the most commonly-issued third-party information reports are the Forms W-2 reflecting wages earned. Employers issued such forms to over 163 million individual employees in taxable year 2019.[56] Similarly, Forms 1099-INT that document interest paid were sent to over 81 million individual account holders.[57] The most commonly issued form relating to potential deductions is the Form 1098, documenting mortgage interest paid by the taxpayer to the issuer of the report, sent to over 57 million individuals.[58] Various other types of income are subject to information reporting, including social security benefits (Form 1099-SSA), retirement benefits (Form 1099-R), dividends (Form 1099-DIV), and gross proceeds from brokered transactions (such as a sale of stock) (Form 1099-B). Over 47 million individuals received reports of dividend income, and almost 31 million received reports on proceeds from brokered transactions.[59]

Development of third-party information reporting

As with the first type of information reporting, the third-party information reporting rules had predecessors in early tax statutes. The first third-party reporting requirement in the Code is a

[54] Sec. 6018(a) and (b).

[55] See Figure 3, above, and Department of the Treasury, *Agency Financial Report, Fiscal Year 2020*, p. 192, available at https://home.treasury.gov/about/budget-financial-reporting-planning-and-performance/agency-financial-report. A table at page 192 shows various components of individual income and estimated misreporting attributable to each. The estimates range from one-percent for wages subject both information reporting and withholding was estimated to a misreporting rate of 61-percent for farm income subject to little or no information reporting and no withholding.

[56] Sec. 6051 (requires that employers who are required to withhold tax from wages must report wages and withheld tax for each employee).

[57] Sec. 6049 (requires reports on interest payments aggregating $10 or more to a single payee).

[58] Sec. 6050H (Mortgage interest received in the course of a trade or business from an individual).

[59] Secs. 6042 (dividends) and 6045 (broker reporting) and the Treasury regulations thereunder.

successor to an almost identical provision in the 1939 Code,[60] as is the provision requiring reporting of dividends and corporate earnings and profits.[61] Third-party information reporting has expanded significantly since then, addressing numerous specific types of payments. These include reporting with respect to medical and health care payments;[62] gross proceeds paid to an attorney;[63] substitute payments in lieu of dividends or tax-exempt interest;[64] and payments by a Federal executive agency for services.[65] It continues to expand, reflecting the importance of IRS access to reliable and objective third-party verification of income in detecting noncompliance.

Despite the addition of numerous specific reporting requirements, section 6041 serves as an important residuary requirement. It requires that every person engaged in a trade or business who makes payments aggregating $600 or more in any taxable year to a single payee in the course of that trade or business report those payments to the IRS. The provision covers fixed or determinable payments of income as well as nonemployee compensation, generally reported on either Form 1099-MISC or Form 1099-NEC. However, reporting does not extend to payments for goods or certain enumerated types of payments that are subject to other specific reporting requirements, such as provisions covering dividends, interest and royalties.[66] Treasury regulations generally provide further exceptions from reporting of payments to corporations, exempt organizations, governmental entities, international organizations, or retirement plans.[67]

The regulatory carveout and narrow scope of reporting applicable to proceeds from sales of property was believed to leave significant income outside the scope of third-party reporting. That perceived gap was addressed by the attempt to expand information reporting under section 6041 in 2010. The explicit override of the regulatory carveout of payments to corporations,

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[60] Sec. 6041(a); Treas. Reg. secs. 1.6041-1 and 1.6041-2. Section 6041 is the successor to section 147(b)(2) of the 1939 Code. Joint Committee on Taxation, *Derivations of Code Sections of the Internal Revenue Codes of 1939 and 1954,* (JCS-1-92), January 21, 1992.

[61] Sec. 6042 (Form 1099-DIV); 1939 Code sec. 148

[62] Sec. 6050T.

[63] *Ibid.*

[64] Sec. 6045(d).

[65] Sec. 6041A(d)(3).

[66] Sec. 6041(a) generally excepts from its scope most interest, royalties, and dividends, which are instead covered by present law sections 6049, 6050N and 6042, respectively. Under the 1939 Code, dividends were also under a separate provision, section 148(a) through (c).

[67] Treas. Reg. sec. 1.6041-3. Certain for-profit health provider corporations are not covered by this general exception, including those organizations providing billing services for such companies.

broadened categories of property from which proceeds were reported and requirement to report passive rental income were enacted in 2010.[68] None were implemented before repeal in 2011.[69]

In addition to amendments to existing provisions, multiple new provisions have been added in recent years, as shown in the summary of such amendments since 1986, below.

Table 9.–Selected Changes to Third-Party Information Reporting Provisions (Sections 6041-6053)

Code Section, Title of Provision and Related Forms	Highlight of Change Since 1986	Year of Enactment
Section 6041 **Information at Source** **(Form 1099-MISC)**	Added subsection (f). Exempts certain health arrangements from the general requirement that payments of $600 or more to a single payee in the course of the payor's trade or business are reportable; particularly to medical care paid for under a flexible spending arrangement or a health reimbursement arrangement.	2003
	Added subsection (g). Details what nonqualified deferred compensation that subsection (a) will not apply to.	2004
	Amended subsection (d) to include gross proceeds paid in consideration of any form of property. Added subsection (h) to require recipients of rental income from real property to report such income, regardless of whether engaged in a trade or business. Added subsection (i) to override regulatory carveout.	2010 (repealed in 2011)
Section 6043(c) **Liquidating, Etc., Transactions** **(Form 1099-CAP)**	Added subsection (c). Details the reporting requirements for when there is a change in control or a recapitalization of a corporation.	1989

[68] The Patient Protection and Affordable Care Act, Pub. L. No. 111-148, sec. 9006, March 23, 2010; Small Business Jobs Act of 2010, Pub. L. No. 111-240, sec. 2101, Sept. 27, 2010.

[69] Comprehensive 1099 Taxpayer Protection and Repayment of Exchange Subsidy Overpayments Act of 2011, Pub. L. No. 112-9, secs. 2 and 3, April 14, 2011.

Code Section, Title of Provision and Related Forms	Highlight of Change Since 1986	Year of Enactment
Section 6043A **Returns Relating to Taxable Mergers and Acquisitions** **(Form 5310-A)**	Added section 6043A. Details the returns and reporting requirements for taxable mergers and acquisitions.	2004
Section 6045 **Returns of Brokers** **(Form 1099-B)**	Added subsection (f). Details the requirements for returns in the case of payments made to attorney.	1997
	Added subsections (g-h). Details additional reporting requirements for brokers required to report gross proceeds of securities transactions or options on securities transactions to facilitate basis reporting.	2008
Section 6045A **Information Required in Connection with Transfers of Covered Securities to Brokers**	Added section 6045A. Details reporting requirements for when securities are transferred to a broker.	2008
Section 6045B **Returns Relating to Actions Affecting Basis of Specified Securities** **(Form 8937)**	Added section 6045B. Details reporting requirements for actions affecting the basis of specific securities as defined in section 6045(g)(3).	2008
Section 6046A **Returns as to Interests in Foreign Partnerships** **(Form 8865, Sch. P)**	Added subsection (d). The interest in a foreign partnership triggering a reporting requirement is 10 percent.	1997
Section 6047 **Information Related to Certain Trusts and Annuity Plans** **(Form 1098-Q)**	Added subsection (e). Directs the Secretary to require reporting with regard to employee stock ownership plans by either the employer maintaining such plan, the plan administrator (under section 414(g)), or both, if such plan holds stock with respect to which dividends paid would be subject to section 414(k).	2001
	Added subsection (g). Section 6047 does not apply to any information also required to be reported under section 6050Y.	2017

Code Section, Title of Provision and Related Forms	Highlight of Change Since 1986	Year of Enactment
Section 6050H **Returns Relating to Mortgage Interest Received in Trade or Business from Individuals** **(Form 1098)**	Added subparagraphs 6050H(b)(2)(D), (E) and (F) to require that report on debt secured by real property include (i) the amount of outstanding principal on the mortgage as of the beginning of the calendar year, (ii) the loan origination date, and (iii) the address of the property.	2015
	Added subsection 6050H(h). Details the reporting requirements of any individual who receives in aggregate $600 or more in mortgage insurance premiums.	2006
Section 6050I **Returns Relating to Cash Received in Trade or Business, Etc.**	Added subsection (f). Extends the general rule requiring reporting of cash transactions of $10,000 or more to transactions structured to evade the reporting threshold of section 6050I.	1988
	Added subsection (g). Extends reporting requirements to Federal and State criminal courts which receive more than $10,000 in cash as bail for any individual charged with crimes listed in subsection (g)(3).	1994
Section 6050L **Returns Relating to Certain Donated Property** **(Form 1098-C)**	Amended subsection (a) to increase the length of time between receipt of donated property and its disposition by the donee from two years to three years before triggering a return requirement.	2006
Section 6050M **Returns Relating to Persons Receiving Contracts from Federal Executive Agencies**	Added subsection (e). Section 6050M reporting requirements generally do not apply to confidential or classified contracts.	1988
Section 6050P **Returns Relating to The Cancellation of Indebtedness by Certain Entities** **(Form 1099-C)**	Added section 6050P. Details the reporting requirements of applicable entities which discharge the indebtedness of any person in whole or in part. Applicable entities are defined in subsection (c)(2), but generally include government agencies and financial institutions.	1993
	Added subsection (e). Details an alternative reporting procedure for those entities required to report under section 6050P.	1996

Code Section, Title of Provision and Related Forms	Highlight of Change Since 1986	Year of Enactment
Section 6050Q **Certain Long-Term Care Benefits** **(Form 1099-LTC)**	Added section 6050Q. Details reporting requirements for any person who provides long-term care benefits.	1996
Section 6050R **Returns Relating to Certain Purchases of Fish** **(Form 1099-MISC)**	Added section 6050R. Details the reporting requirements for those that are involved in the trade or business of purchasing fish for resale from catchers of fish and makes payments to such a person of $600 or more.	1996
Section 6050S **Returns Relating to Higher Education Tuition and Related Expenses** **(Forms 1098-E and 1098-T)**	Added section 6050S. Details reporting requirements for educational institutions, insurers engaged in a trade or business of making payments as reimbursements or refunds of qualified tuition and related expenses, or persons receiving student loan interest of $600 or more in the course of their trade or business.	1997
Section 6050T **Returns Relating to Credit for Health Insurance Costs of Eligible Individuals**	Added section 6050T. Details reporting requirements for individuals receiving payments under section 7527 regarding advance payments of the credit for health insurance costs of eligible individuals.	2002
Section 6050U **Charges or Payments for Qualified Long-Term Care Insurance Contracts Under Combined Arrangements**	Added section 6050U. Details reporting requirements for individuals making charges against the cash value of an annuity contract or life insurance contract which is excludable from gross income under section 72(e)(11).	2006
Section 6050V **Returns Relating to Applicable Insurance Contracts in Which Certain Exempt Organizations Hold Interests**	Added section 6050V. Details the reporting requirements for exempt organizations as defined in subsection (d)(3) which acquires an applicable insurance contract as defined in subsection (d)(1).	2006

Code Section, Title of Provision and Related Forms	Highlight of Change Since 1986	Year of Enactment
Section 6050W **Returns Relating to Payments Made in Settlement of Payment Card and Third-Party Network Transactions** **(Form 1099-K)**	Added section 6050W. Details reporting requirements for payment settlement entities. As defined in subsection (b)(1), payment settlement entities are merchant acquiring entities and third-party settlement organizations.	2008; amended 2021
Section 6050X **Information with Respect to Certain Fines, Penalties, And Other Amounts** **(Form 1098-F)**	Added section 6050X. Details reporting requirements for officials of any government or certain regulatory entities involving a suit or settlement agreement.	2017
Section 6050Y **Returns Relating to Certain Life Insurance Contract Transactions** **(Forms 1099-LS and 1099-SB)**	Added section 6050Y. Details reporting requirements for any person which acquires a life insurance contract or any interest in a life insurance contract.	2017
Section 6053 **Reporting of Tips**	Added subsection 6053(c)(8). Details the reporting requirements that certified professional employer organizations provide reporting on work-site employees to the customer with respect to whom the employee provides services.	2014

Because gross proceeds constitute income only to the extent that they exceed the seller's adjusted basis, reliable record-keeping of original basis and necessary adjustments are required. In 2008, the reporting requirements for brokers were revised to provide that every broker that is required to file a return under section 6045(a) reporting the gross proceeds from the sale of a covered security must include in the return (1) the customer's adjusted basis in the security and (2) whether any capital gain or loss with respect to the security is long-term or short-term.[70] Specific rules for determining a customer's adjusted basis are provided. In order to enable brokers to comply with these requirements, new section 6050A provides for broker-to-broker reporting under which a broker that transfers to a broker a security that is a covered security when held by that transferor broker must furnish to the transferee broker a written statement that allows the transferee broker to satisfy the provision's basis and holding period reporting

[70] Sec. 1222 (gain or loss from sale or exchange of a capital asset is short-term if the asset was held no more than one year, and long-term if the asset was held one year or more).

requirements, while section 6050B requires the issuer to inform the transferee broker of any organizational action (such as a stock split or a merger or acquisition) that affects the basis of the specified security, the quantitative effect on the basis of that specified security, and any other information required by the Secretary.

Most of the statutory provisions requiring third-party reporting predate the advent of cryptocurrency market, and do not explicitly address it. In its annual list of proposed guidance projects, the IRS identified broker reporting under section 6045 for virtual currency as one of its priorities.[71] The scope of reporting encompasses brokers of a variety of transactions, including securities, real estate and barter transactions, but to date, regulations have not been issued to address transactions involving cryptocurrency. However, in its initial published guidance dealing with cryptocurrency, the IRS referred to the need for reporting on a Form 1099-MISC if cryptocurrency with a fair market value of $600 or more is paid in the course of business, paraphrasing section 6041 and the regulatory guidance thereunder that provides that payments made in property rather than money must be reported by including the fair market value of the property paid.[72] As the use of cryptocurrency has developed, the G-7 Finance ministers have committed to develop common standards and principles to guide the public policy and regulatory issues, while recognizing the potential benefits of the market.[73]

Reporting and withholding tax at the source

In addition to reporting information with respect to payments to others, certain payments are subject to withheld income tax at the time of payment and remitted to the IRS. Present law provides for withholding at the source wages, and has so provided continuously for wages[74] since 1943, when the need for revenue to fund the war effort was met with changes in the tax laws that both broadened the base of the income tax and increased the rates. As a result, the number of persons subject to the income tax grew from four million in 1940 to 42 million in 1943.[75] Employers who are required to deduct and withhold tax from employees' income are subject to information reporting requirements.[76] In addition, any service recipient engaged in a

[71] Rev. Rul. 2019-24, 2019-44 I.R.B. 1004, October 29, 2019; Office of Tax Policy and IRS, "2020-2021 Priority Guidance Plan," September 30, 2020. Plan available at https://www.irs.gov/pub/irs-utl/2020-2021_pgp_initial.pdf.

[72] Treas. Reg. sec. 1.6041-1(g); Notice 2014-21, 2014-16 I.R.B. 938, April 14, 2014.

[73] Department of the Treasury press release, "G-7 Finance Ministers and Central Bank Governors' Communique," pars. 17 and 18, June 5, 2021, available at https://home.treasury.gov/news/press-releases/jy0215

[74] Sec. 3402, a successor to 1939 Code secs.1622(a) through (d) and (g) to (k).

[75] The Current Tax Payment Act of 1943, Pub. L. No. 78-068, ch. 120, sec. 2(a), June 9, 1943. Income tax withholding was modeled on the employer withholding that had been implemented several years earlier to collect the employee contribution to Social Security system. See Anuj Desai, "What a History of Tax Withholding Tells Us About the Relationship between Statutes and Constitutional Law," Northwestern Univ. Law Review, vol. 108, 2014, pp. 859, 889-896.

[76] Sec. 6051(a), successor to 1939 Code sec. 1633.

trade or business and paying for services is required to make a return when the aggregate of payments is $600 or more.[77]

Withholding has been extended to many nonwage payments, including pensions,[78] gambling proceeds,[79] Social Security and other specified Federal payments,[80] and unemployment compensation benefits.[81] Certain reportable payments such as dividends and interest are subject to backup withholding.[82]

Government entities are not otherwise currently required to withhold tax from governmental payments made to contractors providing services. A three-percent withholding tax on payments by governmental entities to persons providing certain goods and services to those entities was enacted in 2006.[83] The provision was to be effective for payments made after calendar year 2012 on any payments of $10,000 or more on a payment-by-payment basis.[84] The withholding provision for government contractors was repealed in 2011 before it became effective.[85]

In addition, non-business income paid to foreign persons from U.S. sources is generally subject to tax on a gross basis at a rate of 30 percent, which is collected by withholding at the source of the payment. The income subject to the 30-percent tax is limited to U.S.-source income that is "fixed or determinable annual or periodical gains, profits, and income" ("FDAP

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[77] Sec. 6041A.

[78] Payors of pensions are required to withhold from payments made to payees, unless the payee elects no withholding. Withholding from periodic payments is at variable rates, parallel to income tax withholding from wages, whereas withholding from nonperiodic payments is at a flat 10-percent rate. Secs. 3405(a) and (b). Withholding at a rate of 20 percent is required in the case of an eligible rollover distribution that is not directly rolled over. Sec. 3405(c).

[79] Certain gambling proceeds are subject to withholding obligations which vary depending on the form of wager or game. Secs. 3402(q)(1) through (3).

[80] Voluntary withholding applies to specified Federal payments which include Social Security payments, certain payments received as a result of destruction or damage to crops, certain amounts received as loans from the Commodity Credit Corporation, and other payments.

[81] Withholding is at a flat 10-percent rate. Sec. 3402(p)(2).

[82] A variety of payments (such as interest and dividends) are subject to backup withholding if the payee has not provided a valid taxpayer identification number ("TIN"). Withholding is at a flat rate based on the fourth lowest rate of tax applicable to single taxpayers. Sec. 3406.

[83] Sec. 3402(t), added by the Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, sec. 511, May 17, 2006. As originally enacted, its provisions were to be effective for payments made after December 31, 2010. The effective date was delayed until payments made after December 31, 2011, American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, sec. 1511, February 17, 2009.

[84] Treas. Reg. sec. 31.3402(t)-1(d).

[85] Three Percent Withholding Repeal and Job Creation Act, Pub. L. No. 112-56, sec. 102, November 21, 2011.

income") that is not effectively connected with the conduct of a U.S. trade or business.[86] The items enumerated in defining FDAP income are illustrative; the common characteristic of types of FDAP income is that taxes with respect to the income may be readily computed and collected at the source, in contrast to the administrative difficulty involved in determining the seller's basis and resulting gain from sales of property. Withholding on FDAP payments to foreign payees is required unless the withholding agent,[87] *i.e.*, the person making the payment to the foreign person receiving the income, can establish that the beneficial owner of the amount is eligible for an exemption from withholding or a reduced rate of withholding under an income tax treaty.[88]

2. Recent expansion of information reporting to credit cards and electronic payments

In general

One of the more recent information reporting requirements is on so-called "payment settlement entities." It was enacted in 2008, with a delayed effective date of 2012 (for payments received in 2011).[89]

Payment settlement entities are required to report the following on Form 1099-K: (1) all payments made in settlement of payment card transactions, such as credit cards and (2) payments in settlement of third party network transactions if certain requirements are met. For calendar years beginning after December 31, 2021, a third party settlement organization must report if gross payments to a participating payee, in the aggregate, exceed $600. For calendar years beginning prior to that date, the test is two-pronged. A third party settlement organization must report if gross payments to a participating payee exceed $20,000 and there are more than 200 transactions with the participating payee.

Payment settlement entities are required to report the gross amount of payments made in settlement of reportable payment transactions to the IRS and to payees that receive these payments. Specifically, the statute requires any payment settlement entity making a payment to a participating payee in settlement of reportable payment transactions to report annually to the IRS and to the participating payee the gross amount of such reportable payment transactions, as

[86] Secs. 871(a), 881. If the FDAP income is also ECI, it is taxed on a net basis, at graduated rates, and generally is not subject to withholding, unless it reflects gain from sale or exchange of either U.S. real property interests, or of an interest in a foreign partnership engaged in a U.S. trade or business. Secs. 1445 and 1446.

[87] Withholding agent is defined broadly to include any U.S. or foreign person that has the control, receipt, custody, disposal, or payment of an item of income of a foreign person subject to withholding. Treas. Reg. sec. 1.1441-7(a).

[88] Secs. 871, 881, 1441, 1442; Treas. Reg. sec. 1.1441-1(b). In addition to statutory exemptions, the 30-percent withholding tax with respect to interest, dividends or royalties may be reduced or eliminated by a tax treaty between the United States and the country in which the recipient of income otherwise subject to withholding is resident.

[89] Sec. 6050W; Pub. L. No. 110–289, sec. 3091(a), July 30, 2008 (effective for returns for calendar years beginning after Dec. 31, 2010).

well as the name, address, and TIN of the participating payees. A "reportable payment transaction" means any payment card transaction and any third party network transaction.

A "payment settlement entity" means, in the case of a payment card transaction, a merchant acquiring entity and, in the case of a third party network transaction, a third party settlement organization. A "participating payee" means, in the case of a payment card transaction, any person who accepts a payment card as payment and, in the case of a third party network transaction, any person who accepts payment from a third party settlement organization in settlement of such transaction. A "person" includes a governmental unit, although, generally, not someone with a foreign address.

Returns relating to payments made in settlement of payment card transactions

For purposes of the reporting requirement, the term "merchant acquiring entity" means a bank or other organization with the contractual obligation to make payment to participating payees in settlement of payment card transactions. A "payment card transaction" means any transaction in which a payment card is accepted as payment.[90] A "payment card" is defined as any card (*e.g.*, a credit card or debit card) which is issued pursuant to an agreement or arrangement which provides for: (1) one or more issuers of such cards; (2) a network of persons unrelated to each other, and to the issuer, who agree to accept such cards as payment; and (3) standards and mechanisms for settling the transactions between the merchant acquiring entities and the persons who agree to accept such cards as payment. Thus, under the provision, a bank that enrolls a business to accept credit cards and contracts with the business to make payment on credit card transactions is required to report to the IRS the business's gross credit card transactions for each calendar year on a Form 1099-K, *Payment Card and Third Party Network Transactions*. The bank also is required to provide a copy of the information report to the business.

Returns relating to payments made in settlement of third party network transactions

The statute also requires reporting on a third party network transaction. The term "third party network transaction" means any transaction which is settled through a third party payment network. "Third party payment network" is defined as any agreement or arrangement: (1) that involves the establishment of accounts with a central organization by a substantial number of persons (*e.g.*, more than 50) who are unrelated to such organization, provide goods or services, and have agreed to settle transactions for the provision of such goods or services pursuant to such agreement or arrangement; (2) that provides for standards and mechanisms for settling such transactions; and (3) that guarantees persons providing goods or services pursuant to such agreement or arrangement that such persons will be paid for providing such goods or services.

In the case of a third party network transaction, the payment settlement entity is the third party settlement organization, which is defined as the central organization which has the contractual obligation to make payment to participating payees of third party network transactions. Thus, an organization generally is required to report if it provides a network

[90] For this purpose, the acceptance as payment of any account number or other indicia associated with a payment card also qualifies a payment card transaction.

enabling buyers to transfer funds to sellers who have established accounts with the organization and have a contractual obligation to accept payment through the network. However, an organization operating a network which merely processes electronic payments (such as wire transfers, electronic checks, and direct deposit payments) between buyers and sellers, but does not have contractual agreements with sellers to use such network, is not required to report. Similarly, an agreement to transfer funds between two demand deposit accounts will not, by itself, constitute a third party network transaction.

A third party payment network does not include any agreement or arrangement that provides for the issuance of payment cards as defined by the provision. In addition, there is an exception for *de minimis* payments that applies to payments made by third party settlement organizations but not to payments made by merchant acquiring entities. As initially enacted, a third party settlement organization is not required to report unless the aggregate value of third party network transactions with respect to a taxpayer for the year exceeds $20,000 and the aggregate number of such transactions with respect to a taxpayer exceeds 200.[91] If a payment of funds is made to a third party settlement organization by means of a payment card (*i.e.*, as part of a payment card transaction), the $20,000 and 200 transaction *de minimis* rule continues to apply to any reporting obligation with respect to payment of such funds to a participating payee by the third party settlement organization made as part of a third party network transaction.

So, for example, if a business that provides a web-based rental platform for short-term travelers is considered a third party settlement organization, it does not have to provide a Form 1099-K to property owners participating on its web-based site who have received payments of $20,000 or less.[92] On the other hand, if that company is considered a merchant acquiring entity, it would have to issue a Form 1099-K to all payees participating on its platform who have received payments of any amount starting with the first dollar.

However, that the threshold below which a third party settlement organization is not required to report payments to participants in its network was recently lowered and modified.[93] Effective for returns for calendar years beginning after December 31, 2021, for any calendar year, a third party settlement organization is required to report third party network transactions with any participating payee that exceed a minimum threshold of $600 in aggregate payments. The threshold requirement for number of thresholds was removed. In addition, effective on the date of enactment, Congress clarified that third party network transactions only include

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[91] Sec. 6050W(e).

[92] Note that, for calendar years beginning after December 31, 2021, for any calendar year, a third party settlement organization is required to report third party network transactions with any participating payee that exceed a minimum threshold of $600 in aggregate payments, regardless of the aggregate number of such transactions. Pub. L. No. 117-2, sec, 9674(a), March 11, 2021. Pub. L. No. 117-2, sec. 9674(b), March 11, 2021.

Thus, the business in this example would have to provide a Form 1099-K to property owners participating on their site who have received payments greater than $600.

[93] Sec. 6050W(e). Pub. L. No. 117-2, sec, 9674(a), March 11, 2021. Pub. L. No. 117-2, sec. 9674(b), March 11, 2021.

transactions for the provision of goods or services (*e.g.*, personal gifts, charitable contributions, and reimbursements are not included, and reporting is not required on these transactions).

There are also reporting requirements on intermediaries who receive payments from a payment settlement entity and distribute such payments to one or more participating payees. Such intermediaries are treated as participating payees with respect to the payment settlement entity and as payment settlement entities with respect to the participating payees to whom the intermediary distributes payments. Thus, for example, in the case of a corporation that receives payment from a bank for credit card sales effectuated at the corporation's independently-owned franchise stores, the bank is required to report the gross amount of reportable payment transactions settled through the corporation (notwithstanding the fact that the corporation does not accept payment cards and would not otherwise be treated as a participating payee). In turn, the corporation, as an intermediary, would be required to report the gross amount of reportable payment transactions allocable to each franchise store. The bank would have no reporting obligation with respect to payments made by the corporation to its franchise stores.

Another rule provides that if a payment settlement entity contracts with a third party facilitator to settle reportable payment transactions on behalf of the payment settlement entity, the third party facilitator is required to file the annual information return in lieu of the payment settlement entity.[94]

The payment settlement entity is required to file the information return with the IRS on or before February 28th (March 31st if filing electronically) of the year following the calendar year for which the return must be filed.[95]The statements are required to be furnished to the participating payees on or before January 31st of the year following the calendar year for which the return was required to be made.[96]

The Secretary has exercised authority under these rules to issue guidance to implement the reporting requirement, including rules to prevent the reporting of the same transaction more than once.[97] The reportable payment transactions subject to information reporting generally are subject to backup withholding requirements.

3. Enhanced visibility of cross-border activity: FATCA, modernized treaties and international cooperation.

In the aftermath of whistleblower disclosures and a summons proceeding in 2008 involving the Swiss bank, UBS, evasion of U.S. tax by U.S. persons through the use of offshore

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[94] Treas. Reg. sec. 1.6050W-1(d)(2)

[95] Treas. Reg. sec. 1.6050W-1(g). Taxpayers that file these information returns that report reportable payment transactions are entitled to a 30-day automatic extension of time to file. Treas. Reg. sec. 1.6081-8(a) (effective for requests for extension of time to file certain information returns due after December 31, 2016).

[96] Sec. 6050W(f); Treas. Reg. sec. 1.6050W-1(h).

[97] Treas. Reg. sec. 1.6050W-1(a)(4)(ii).

accounts in certain low-tax or no-tax jurisdictions[98] was the focus of multiple hearings before the Senate Permanent Subcommittee on Investigations, Senate Finance Committee, and House Committee on Ways and Means. As a result, the new withholding and reporting regime with respect to foreign account tax compliance and cross-border transactions was enacted in 2010, commonly referred to as FATCA.[99]

FATCA

FATCA imposes a withholding tax equal to 30 percent of the gross amount of withholdable payments[100] to a foreign financial institution unless the foreign financial institution meets certain requirements. Specifically, withholding is generally required on withholdable payments unless the foreign financial institution enters into an information reporting agreement with the Secretary of the Treasury (the "Secretary") and is in compliance with the terms of that agreement. Under such agreements, the institutions agree to obtain information necessary to determine whether any account at such institution are held or owned by U.S. individuals and are within the scope of FATCA,[101] as well as to report annually with respect to any such financial accounts, in addition to seeking waivers of local law that would otherwise bar reporting to the United States and complying with other requirements that the Secretary may determine are needed. A foreign financial institution must report with respect to a U.S. account (1) the name, address, and taxpayer identification number of each U.S. person holding an account or a foreign entity with one or more substantial U.S. owners holding an account; (2) the account number; (3) the account balance or value; and (4) except as provided by the Secretary, the gross receipts, including from dividends and interest, and gross withdrawals or payments from the account.[102]

Many foreign financial institutions noted that they faced domestic legal barriers in complying with the terms of FATCA, such as the inability to satisfy information exchange

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[98] For a discussion of the private banking scandals, see Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Switzerland* (JCX-31-11), pp. 23-38, May 20, 2011.

[99] The Hiring Incentives to Restore Employment ("HIRE") Act, Pub. L. No. 111-147. Subtitle A of Title V of the HIRE Act, entitled "Foreign Account Tax Compliance," was based on legislative proposals in the Foreign Account Tax Compliance Act ("FATCA"), a bill introduced in both the House and Senate on October 27, 2009, as H.R. 3933 and S. 1934, respectively. FATCA added new Chapter 4 to Subtitle A of the Code.

[100] Section 1473(1) broadly defines "withholdable payments" to include FDAP and gross proceeds from sales of property that produces interest or dividend, except to the extent otherwise provided by the Secretary. Proposed regulations would remove gross proceeds from the scope of "withholdable payment." Prop. Treas. Reg. sec. 1.1473-1(a), REG-132881-17, 83 F.R. 64757, December 18, 2018. Although not final, the preamble provides that taxpayers may rely upon the exclusion in the proposed regulation.

[101] A United States account is any financial account held by one or more specified United States persons or United States owned foreign entities. Sec. 1471(d). Depository accounts are not treated as United States accounts for these purposes if (1) each holder of the account is a natural person and (2) the aggregate value of all depository accounts held (in whole or in part) by each holder of the account maintained by the financial institution does not exceed $50,000. Sec. 1471(d)(1)(B).

[102] Sec. 1471(c). Prop. Treas. Reg. sec. 1.1473-1(a) (indicating that gross proceeds will no longer be within the scope of "withholdable payments."

requirements due to privacy laws of the jurisdiction in which the foreign financial institution is resident. In 2012, the United States began negotiations for a series of bilateral intergovernmental agreements ("IGAs") are under the authority of its various tax treaties and agreements to exchange tax information to obviate such legal impediments. These agreements conform to one of two types. Model 1 is a bilateral agreement with another jurisdiction which allows a foreign financial institution to fulfill its FATCA reporting obligations by reporting information about U.S. accounts directly to their domestic tax authority rather than to the IRS. The information is then the subject of an automatic exchange of information on a government-to-government basis between the two jurisdictions. IGAs based on Model 2 require that foreign financial institutions report specified information directly to the IRS and may be supplemented by a government-to-government exchange of information on request. The United States has entered into such agreements with over 100 jurisdictions, enabling the government to implement FATCA widely.[103]

The information to be reported for U.S. accounts includes (1) the name, address, and taxpayer identification number of each U.S. person or a foreign entity with one or more substantial U.S. owners holding an account, (2) the account number, (3) the account balance or value, and (4) except as provided by the Secretary, the gross receipts and gross withdrawals or payments from the account.[104] FATCA also limited the ability to use bearer bonds, by repealing provisions that had permitted "foreign targeted obligations" to be considered to be in compliance with registration requirements for income taxes purposes and Title 31.[105] In addition, FATCA treats certain dividend equivalent payments received by foreign persons as U.S. source dividends for withholding tax purposes, and modifies certain rules in respect of foreign trusts.

In addition to the added responsibilities of foreign financial institutions, Congress also enacted new disclosure requirements for U.S. individuals with foreign financial assets. Such individuals must disclose on their federal income tax returns their foreign financial assets and foreign financial accounts if the aggregate value of such assets exceeds $50,000.[106] To the extent required by regulations, any domestic entity that such individuals used to hold such assets, directly or indirectly, must also report.[107] Failure to do so results in both a failure to disclose penalty as well as an increase in any otherwise applicable accuracy-related penalty. The normal three-year limitations period for assessment of additional tax is extended to six years for

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[103] A complete list of jurisdictions and links to the relevant agreements is available on the U.S. Department of the Treasury website, https://home.treasury.gov/policy-issues/tax-policy/foreign-account-tax-compliance-act.

[104] Sec. 1471(c).

[105] A foreign targeted obligation is any obligation satisfying the following requirements: (1) there are arrangements reasonably designed to ensure that such obligation will be sold (or resold in connection with the original issue) only to a person who is not a United States person; (2) interest is payable only outside the United States and its possessions; and (3) the face of the obligation contains a statement that any United States person who holds this obligation will be subject to limitations under the U.S. income tax laws.

[106] Sec. 6038D.

[107] Treas. Reg. sec. 1.6038D-6(a) defines specified domestic entities that must report foreign financial assets.

taxpayers who do not comply with the foreign financial asset disclosure obligations or significantly under-report income associated with foreign assets.

Multilateral efforts toward transparency

In addition to domestic legislative measures such as FATCA, the United States worked to develop a new international consensus on exchange of information as a member of the Organization for Economic Cooperation and Development ("OECD"). The resulting standards regarding exchange of information upon request have since been widely accepted. The standards generally require that countries maintain adequate information on cross-border transactions and financial accounts, including information on beneficial ownership of financial accounts. In addition, tax administrators must have access to such information for use in their exchange of information programs. The information requested to be exchanged need only be "foreseeably relevant" to the administration and enforcement of the domestic laws of a requesting State, without any restrictions on exchange caused by otherwise applicable bank secrecy laws in the jurisdiction receiving the request or lack of a domestic tax interest in the information. Finally, the standards require strict confidentiality as to the information exchanged and are monitored for compliance by periodic peer reviews.[108]

The United States agreed to be one of the first jurisdictions subjected to peer review for compliance with the new standards on exchange of information. That process quickly identified a major shortcoming in the ability of the United States to retrieve and exchange information about beneficial ownership of financial accounts, resulting in a "largely compliant" rating in 2011 and an admonishment to improve its ability to provide beneficial ownership information. The failure to do so resulted in a rating of only "partially compliant" with respect to the ownership and identity information measures in the second round of reviews in 2018.[109]

The inability to comply with requests for information about foreign persons believed to have an interest in financial accounts maintained in the U.S stems from the fact that State law controls the formation of legal entities and the record keeping required of those entities. Although banks are required to exercise due diligence *(i.e.,* "know your customer" rules) when opening an account, that does not necessarily result in maintenance of adequate information to identify ultimate owners. No uniform system of determining the identity of owners of an interest in a U.S. entity is available to the Federal authorities, impairing enforcement of U.S. tax law as

[108] The OECD work on international transparency and international tax evasion was undertaken at the request of the G-20 in 2008 and 2009, leading directly to publication of the standards as "terms of reference" for members of the OECD and formation of the Global Form on Transparency and Exchange of Information for Tax Purposes ("Global Forum"). The OECD has since updated the standards to reflect automatic exchange of information standards. The Global Forum oversees and conducts the peer reviews for adherence to the standards. For an overview of the work of the Global Forum and the standards, see Global Forum, *Transparency and Exchange of Information for Tax Purposes: Multilateral Cooperation Changing the World 10th Anniversary Report*, November 2019, available at https://www.oecd.org/tax/transparency/documents/global-forum-10-years-report.pdf. For updates, see https://www.oecd.org/tax/transparency.

[109] A chart displaying the specific categories and ratings assigned the United States in each peer review can be found at https://www.oecd.org/tax/transparency/documents/exchange-of-information-on-request-ratings htm.

well as precluding reciprocity in exchanges of information with the many countries that do maintain such information at the national level.

The inclusion of the Corporate Transparency Act in the National Defense Authorization Act in 2020 may alleviate this barrier to piercing bank secrecy and address the U.S. short comings identified in the peer review reports, depending on how the new legislation is implemented. The legislation establishes a standard for determining beneficial ownership and requires creation of a Federal database to which businesses will report their beneficial ownership information.[110] The Secretary has published an advance notice of proposed rulemaking for implementation of the standard and solicited public comments on the new database.[111]

Concurrently with development of the OECD standards, the U.S. Treasury pursued modernization of the exchange of information articles in several bilateral treaties to which the United States is a party to ensure that exchange of information was required without regard to countries' domestic bank secrecy laws.[112] The United States signed protocols to each of the bilateral tax treaties with Luxembourg and Switzerland in 2009 that are illustrative of this effort. Both protocols expanded the scope of information exchange authorized between the treaty countries and limited the grounds for refusal to exchange information based on domestic law. A requested treaty country may no longer decline to provide information held by financial institutions, information that is not relevant to a domestic tax issue, or information about conduct that would not constitute a crime under domestic law. Those protocols were ratified and entered into force in 2019.[113]

4. Regulation of paid return preparers

Tax assessment and collection in the United States depends heavily on the voluntary compliance of taxpayers. Every year, large numbers of taxpayers discharge their duty to prepare accurate and timely tax returns by seeking the advice and assistance of an adviser to prepare the return. An important element in achieving accurate and complete returns is in turn dependent on

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[110] National Defense Authorization Act for Fiscal Year 2021, Title LXIV, Pub. L. No. 116- 283, January 1, 2021; Conference Report to Accompany H.R. 6395, H.R. Rep. 116-617, p. 4458.

[111] Treasury's Financial Crimes Enforcement Network (FinCEN) will create and maintain the new database. See FinCEN, "Beneficial Ownership Information Reporting Requirements," ANPRM, 86 Fed. Reg. 17557, 31 CFR Part 1010, April 5, 2021.

[112] U.S. Treasury Press Release, TG-143, May 21, 2009.

[113] "Protocol Amending the Convention between the Government of the United States of America and the Government of the Grand Duchy of Luxembourg for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital," signed on May 20, 2009, at Luxembourg, and a related agreement effected by the exchange of notes also signed on May 20, 2009 (entered into force on September 9, 2019); "Protocol Amending the Convention between the United States of America and the Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income," signed at Washington on October 2, 1996, signed on September 23, 2009, at Washington, as corrected by an exchange of notes effected November 16, 2010 and a related agreement effected by an exchange of notes on September 23, 2009, (entered into force September 20, 2019). U.S. Department of the Treasury Press Release, September 20, 2019, available at https://home.treasury.gov/news/press-releases/sm781.

the competence and professionalism of the advisers whose assistance taxpayers seek in preparing a tax return.

Approximately 50 percent of persons claiming refundable credits, such as the earned income tax credit, employ others to prepare their returns. In many cases, those preparers are neither licensed by their States as accountants or lawyers nor recognized as an enrolled agent for purposes of representing a taxpayer before the Department of the Treasury. Of those returns, the Secretary reports a higher error rate compared to those returns prepared by taxpayers themselves or other tax professionals.[114]

Background of regulation of practice before the Department of the Treasury

The Department of the Treasury has authority to establish standards for and regulate conduct of persons representing others before any office or agency of the Secretary.[115] The original grant of authority to regulate persons appearing before the Secretary was added to an 1884 appropriations measure.[116] The authority included explicit authority to disbar from further practice any person, agent, or attorney for incompetence or misconduct, due to concerns that the Secretary lacked authority to declare any agent ineligible to represent claimants, despite evidence of the agent charging unfair fees or misleading their clients.[117] The statutory provision has remained substantively unchanged and is now codified in Title 31.[118] It has been supplemented by Treasury Department Circular No. 230 ("Circular 230").[119]

The original Circular 230 in 1921 established ethical standards for conduct before an executive agency and a committee on enrollment and disbarment.[120] It prescribed an applications process for enrollment of all persons wishing to appear before the Department of the Treasury as either an enrolled attorney or an enrolled agent and included a nonexclusive list of causes warranting disbarment and prescribed procedures for substituting representatives or revocation of authorization to an agent. A supplement to Circular 230 published later the same year bars a former Department of the Treasury employee from appearing in a matter as to which

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[114] Department of the Treasury, Agency Financial Report, Fiscal Year 2020, p. 195.

[115] 31 U.S.C. sec. 330 *et seq*.

[116] Act of July 7, 1884, ch. 334, 23 Stat. 236, 258-59.

[117] For example, on the House floor, Mr. Townsend of Illinois stated, "Let a word be now said on behalf of the soldiers victimized by the sharks that lie around this city and who make their living by practicing deception on soldiers living hundreds--in some instances thousands--of miles away. … The officers of the Department have done their duty in endeavoring to guard the interests of claimants against these claim agents, but they have been unable to do so because no law authorized them to disbar the disreputable claim agents from practice. I know there are honest and upright men engaged in the business, and they can not [*sic*] object to a law which will protect the soldier from the disreputable class of attorneys to whom I have referred." 15 Cong. Rec., 1884, p. H5222.

[118] 31 U.S.C. secs. 330(a) and 330(b).

[119] 31 C.F.R. Part 10; Treasury Circular 230 (Rev. 6-2014) available at https://www.irs.gov/pub/irs-pdf/pcir230.pdf.

[120] Circular 230, 1921 C.B. 4-1600A, February 15, 1921.

the employee had personal knowledge or responsibility in an official capacity, thus establishing post-employment conflict of interest as a basis for disbarment.[121] Over the years, Circular 230 was revised to clarify and expand classes of persons eligible under the regulations, allowing certain persons, such as attorneys or certified public accountants, to qualify on the basis of maintaining licenses or professional credentials issued by a state or governmental entity, while allowing others to qualify as "enrolled agents" on the basis of successful completion of educational requirements and testing prescribed by the Department of the Treasury. Despite numerous revisions over time, regulating return preparation was not generally within the scope of Circular 230, other than an oblique reference in 1937.[122]

In 2010, Treasury proposed expansion of Circular 230 to include registered tax return preparers among the specified classes of representatives who may be enrolled based on successful testing. The revisions defined "tax return preparer" to be consistent with use of that term in the Code and required a valid preparer tax identification number (PTIN). By including registered tax return preparers, the proposal established standards of conduct for previously unenrolled tax return preparers, including minimum educational and competence requirements to be eligible to prepare and sign a return as a paid tax return preparer and sanctions for failure to comply with the regulations. The regulations were finalized in 2011, effective as of August 2, 2011.[123]

Tax return preparers under the Code

Under the Code, the term "tax return preparer" is broadly defined as any person who prepares for compensation, or who employs other people to prepare for compensation, all or a substantial portion of a tax return or claim for refund.[124] Regulations thereunder provide that a person who prepares a substantial portion of a return is treated as having prepared such return, regardless of whether or not the person signs the return.[125] The regulations do not prescribe specific educational or professional credentials required to be subject to the rules applicable to tax return preparers.[126] Persons whose duties are merely mechanical or clerical (such as keying

[121] 1921 C.B. 4-1600B 414, June 7, 1921.

[122] F.R. Doc. 37-2747; Fed. Reg. 1842, September 15, 1937. The regulation requiring a specific disclosure of contingent fees on executed powers of attorney was amended to state that "This requirement shall not be applicable to powers of attorney wherein the authority granted is limited to the filing of tax or information returns."

[123] T.D. 9501, 75 Fed. Reg., 60309, September 30, 2010 (proposed revisions); T.D. 9527, 76 Fed. Reg. 32286, June 3, 2011 (final regulations).

[124] Sec. 7701(a)(36)(A). The term as originally added in 1976 was "income tax return preparer," and thus did not encompass those persons who prepared other statements or returns required by the Code. Tax Reform Act, Pub. L. No. 94-455, sec. 1203(a), October 4, 1976. The prefatory word "income" was deleted from the term in 2007. The Small Business and Work Opportunity Tax Act of 2007, Pub. L. No. 110-28, sec. 8246(a)(1)(A), May 25, 2007.

[125] Treas. Reg. sec. 301.7701-15(b).

[126] Treas. Reg. sec. 301.7701-15(d).

in data, typing schedules, or printing or producing copies) are excepted from the definition of tax return preparers, as are IRS officials in the course of their official duties and certain volunteers.

The status as tax return preparer triggers certain duties for tax return preparers and persons who employ tax return preparers and potential sanctions for failure to conform to those duties. These duties include furnishing copies of the completed return or statement to the client and retaining copies for his own records,[127] providing the identification number required by the IRS,[128] and, depending on the volume of a preparers' business, submitting returns electronically.[129] Tax return preparers are subject to civil penalties for failure to comply with the foregoing duties, for negotiating checks issued to their clients by the IRS with respect to taxes, or for failing to comply with due diligence standards with respect to certain refundable credits or eligibility for head of household filing status claimed on the client's return.[130] Tax return preparers may also be subject to civil or criminal penalties for the disclosure or use of a client's tax return information.[131] In addition, persons who employ tax return preparers are subject to specific recordkeeping requirements.[132]

Additional civil penalties may also apply based on an understatement of tax on a client's return or claim for refund that results from an unreasonable position. The penalty varies depending on the nature and amount of the understatement as well as the unreasonableness of the position. An understatement that is due to an unreasonable position may result in a penalty of at least $1,000 (increasing to $5,000 in the case of willful or reckless conduct) or 50-percent of the income derived by the return preparer with respect to that return.[133] Whether the position is unreasonable may depend on the existence of reasonable authority for the position, the reasonable beliefs of the preparer and disclosure of the position.[134] If the position taken meets the definition of a tax shelter[135] the preparer must have a reasonable belief that the position would more likely than not be sustained on its merits.

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[127] Sec. 6107.

[128] Sec. 6109; Treas. Reg. sec. 1.6109-2. Beginning in 1998, the IRS provided PTINs upon request, but the use of such numbers was formalized in regulations in 2010, requiring periodic renewal as well as prescribing user fees, application fees for the education programs. The regulations were published contemporaneously with revision to Circular 230 that first included tax return preparers. See T.D. 9503, 75 Fed. Reg. 60316, September 30, 2010.

[129] Sec. 6011(e)(3).

[130] Sec. 6695.

[131] Secs. 6713 and 7216.

[132] Sec. 6060.

[133] Sec. 6694(b)

[134] Secs. 6694(a)(1) and (a)(2). To be reasonable, the preparer must have a reasonable basis for the position and disclose the position on the return, or have substantial authority for the position, determined by whether the authority in favor outweighs authority against the position taken.

[135] Sec. 6662(d)(2)(B)(ii)(I)), or a listed or reportable transaction as referenced in 6662A.

Challenges to authority to regulate tax return preparers

The inclusion of tax return preparers in the revisions to Circular 230 issued in 2011 was questioned on its necessity, its cost and its ability to achieve the stated goal of limiting fraud and malfeasance that is aided and/or committed by preparers.[136] Challenges to the enforcement of the regulations followed, with mixed results.

The imposition of user fees were challenged in *Brannen v. United States.*[137] A certified public accountant challenged the user fee required to be paid to obtain the preparer taxpayer identification number, arguing that there was no explicit authorization for imposition of a user fee, although, he conceded the existence of the Department of the Treasury's authority to require registration and use of a unique identification number referred to as a PTIN.[138] The government successfully defended the imposition of user fees. In rejecting the challenge and upholding imposition of the user fee, the Eleventh Circuit noted the general authorization for user fees in Title 31, the standards under which such fees may be imposed, and the explicit regulations under the Code requiring use of a PTIN.[139] Subsequently, the user fees were challenged, claiming that the collection of PTIN fees violated the Independent Offices Appropriations Act ("IOAA"). In *Steele v. Commissioner*, the district court held that the fees were in violation of IOAA, and permanently enjoined collection of the fees. However, *Steele v. Commissioner* was reversed by the appellate court in 2019, holding that IOAA did authorize the IRS and that such PTINs were not arbitrary and capricious. [140] In 2020, the Secretary finalized regulations requiring the PTIN and user fees, allowing the IRS to resume collection of PTIN user fees.[141]

In *Loving v. Internal Revenue Service,*[142] litigation culminated in the Court of Appeals for the D.C. Circuit, which concluded that return preparation is not tantamount to representation of the taxpayer and affirmed a permanent injunction that precluded enforcement of the broadened Circular 230.

At the trial level, plaintiffs sought an injunction against enforcement of the Circular 230 regulations and the IRS registered tax return preparer program. The U.S. district court granted

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[136] Patrick E. Tolan, Jr., "It's About Time: Registration and Regulation Will Boost Competence and Accountability of Paid Tax Preparers," *Virginia Tax Review*, vol. 31, Winter, 2012, p. 471.

[137] 682 F.3d 1316 (11th Cir. 2012).

[138] Since 1976, Code sec. 6109(a)(4) has authorized the Secretary to require preparers to use of a number other than a social security number, although the Secretary did not do so until 2010.

[139] See 31 U.S.C. 9701; Treas. Reg. sec. 1.6109-2(d).

[140] *Steele v. Commissioner*, 260 F. Supp. 3d 52 (D.D.C. 2017), rev'd and remanded under the name *Montrois v. United States*, 916 F.3d 1056 (D.C. Cir. 2019).

[141] T.D. 9903, Treas. Reg. 1.6109-2, 85 Fed. Reg. 4344, July 17, 2020.

[142] Loving v. Internal Revenue Service, 742 F.3d 1013 (D.C. Cir. 2014) (Loving III), affirming Loving II, 920 F. Supp. 2d 108 (D.D.C. 2013), in which the District Court had narrowed an earlier granted injunction in Loving I, 917 F.2d. 67 (D.C.C. 2013).

summary judgment for the plaintiffs and permanently enjoined the IRS from enforcing its the education, testing and registration program for preparers in *Loving I.* The district court held that the general authority of the Secretary to regulate conduct before the Department of the Treasury was unambiguous and could not be construed to include tax return preparation within its scope. In concluding that the text unambiguously precluded the regulation of return preparers, the court determined that the statute is not silent as to the issue to be decided, rendering moot consideration of whether the regulation presented a permissible interpretation of the statute. In doing so, the court rejected IRS arguments that the statute is silent as to return preparation, and that the regulations are accordingly entitled to deference as a permissible interpretation that is not contrary to the statutory intent, under the two-step analysis outlined by the U.S. Supreme Court.[143]

In *Loving II*, the district court addressed the government's motion for stay of the injunction. The court modified the injunction to clarify that the IRS need not suspend its PTIN program entirely, and instead permitted the IRS to collect a user fee from applicants for PTINs or renewals of PTINs. It also modified the injunction against the continuing education and testing program. However, it provided that the IRS cannot require attendance or collect fees with respect to the testing and education programs, nor can it impose penalties for failure to participate.

In *Loving III*, the D.C. Circuit affirmed *Loving II*, after reviewing the trial court's statutory interpretation de novo, as well as examining the IRS administrative practices regarding assessment of taxes and recognizing persons authorized to speak for or on behalf of taxpayers during audits, etc.

Since then, the IRS has attempted to operate the program on a voluntary basis as permitted by the modified injunction. Under its Annual Filing Season program, the IRS provides education and testing to otherwise unregulated return preparers. The participants who successfully complete the program receive a Record of Completion and are included in a roster of unenrolled agents available on the IRS website. In addition, they have a limited right to represent a taxpayer before the IRS.[144]

The American Institute of Certified Public Accountants ("AICPA") challenged the authority of the IRS to conduct such a program, claiming that the IRS was in violation of the *Loving III* opinion and had waived its right to argue that section 330 authorized any portion of the program. After extensive litigation over whether the AICPA had constitutional standing, a trial court dismissed the case based on lack of statutory standing. On appeal, the Circuit Court disagreed with the lower court regarding statutory standing. Instead, in the absence of factual issues and the parties having fully briefed the legal issues, the Court proceeded to the merits and held in favor of the IRS, rejecting the AICPA claims in full, holding that the IRS had adequate

[143] See *Chevron U.S.A. Inc. v. Natural Res. Def. Council Inc.*, 467 U.S. 837 (1984) and *Mayo Foundation for Medical Education and Research v. United States*, 131 S. Ct. 704 (2011).

[144] Rev. Proc. 2014-42, 2014-29 I.RB. 192, June 30, 2014.

authority under Title 31 to conduct the voluntary program and authority under the Code to publicize the results of the program.[145]

[145] American Inst. of Certified Public Accountants v. IRS, 746 Fed. Appx. 1 (D.C. Cir. 2018).

B. Measures Focused on Post-Filing Controversy, Corrections

1. Reform of partnership audit procedures

As discussed in Part I, underreporting income by passthrough entities is a contributor to the tax gap. Partnerships are a persistent challenge to effective tax administration. Unlike sole proprietorships, inadequacy of information reporting is not *per se* the barrier to "visibility" of partnership income. Rather, the flow-through nature of the partnerships and the frequently multi-tiered structure of partnerships (*i.e.*, partnerships holding interests in other partnerships) renders it difficult to determine whether income has been properly reported by the ultimate beneficial owner of the income. The most recent attempt to address the barriers to identifying underreporting by partners is the centralized audit regime, enacted as part of the Bipartisan Budget Act of 2015 ("BBA"), effective for partnership taxable years beginning after 2017.[146] This section provides a brief overview of the background and issues that led to the new partnership regime and the regime itself.

Nature of partnership for Federal tax purposes

A partnership is defined in the Code generally as a group, syndicate, joint venture or other organization through which any business or venture is carried on, other than a corporation, trust or estate.[147] For Federal income tax purposes, partnerships have historically been treated as conduits rather than as taxable entities, depending on the specific characteristics of the entity. Under the case law and guidance in effect until the mid-1990's, a purported partnership could be taxable at the entity level as if it were a corporation if it possessed features in its foundational documents and operations that were characteristic of corporations, on the basis of presence or absence of four characteristics indicative of status as a corporation: continuity of life, centralization of management, limited liability, and free transferability of interests. An entity that possessed three or more of these characteristics was treated as a corporation; if it possessed two or fewer, then it was treated as a partnership. Classification of the entity was often a threshold issue in Federal tax audits and often required examination of relevant State law before addressing the Federal income tax issues.

As the formation of limited liability companies ("LLCs") under State laws began to allow business owners to create customized entities that possessed a critical common feature—limited liability for investors—as well as other corporate characteristics the owners found desirable, classification became essentially elective. The "check-the-box" regulations adopted in 1997[148] simplified the entity classification process for both taxpayers and the IRS by making the entity classification of unincorporated entities explicitly elective in most instances.[149] Whether an

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[146] The Bipartisan Budget Act of 2015 ("BBA"), Pub. L. No. 114-74, sec. 1101, November 2, 2015; Protecting Americans from Tax Hikes Act of 2015 ("PATH Act"), Div. Q, sec. 411, Pub. L. No. 114-113, December 18, 2015.

[147] Secs. 761(a). and 7701(a)(2); former Treas. Reg. sec. 1.7701-2.

[148] Treas. Reg. sec. 301.7701-1, *et seq*.

[149] The check-the-box regulations replaced Treas. Reg. sec. 301.7701-2.

entity is eligible for the election and the breadth of its choices depends upon whether it is a "per se corporation" and its number of beneficial owners.

Prior versions of centralized audit for partnerships

IRS audits relating to partnerships have raised administrative difficulties stemming from the passthrough nature of partnerships. The items of partnership income, deduction, gain, loss, and credit flow through the partnership to its partners, to be taken into account on the partners' income tax returns. To the extent that an item related to the partnership was misreported to or by partners, efforts to redetermine correct partnership income and partner's distributive shares required separate proceedings, both administrative and judicial, for each partner, regardless of the number of partners. Coordination across districts, factual development, and need to ensure consistency in treatment of partners present significant barriers to timely processing of the cases. These difficulties have prompted the development of centralized audit procedures for partnership items.

TEFRA[150]

In 1982, a set of rules coordinating audits of partners was enacted to provide for entity level examination and adjustments of tax treatment of partnership items. These rules were accompanied by enactment of explicit information reporting requirements for partnerships.[151]

TEFRA established unified rules that enabled the IRS to examine and challenge the reporting position of a partnership by conducting a single administrative proceeding with the tax matters partner as the primary representative of the partnership, after certain required notices to partners of the beginning of an administrative proceeding. In that way, all items more appropriately determined at the partnership level than at the partner level, as provided by regulations, could be resolved as "partnership item" issues with respect to all partners.[152] The tax matters partner was a general partner designated by the partnership or, in the absence of designation, the general partner with the largest profits interest at the close of the taxable year.

Partners' rights and obligations, in addition to the general right to notice of the beginning of an examination, included a limited right to participate in the proceeding at the partnership level, and to request an administrative adjustment or a refund for a partner's own separate tax liability. TEFRA mandated consistency between the partners' returns and the reporting positions on the partnership return. Partners who took a position contrary to that of the partnership were required to provide notice to the IRS of that inconsistency. Finally, all partners were entitled to

[150] Tax Equity and Fiscal Responsibility Act ("TEFRA") of 1982, Pub. L. No. 97-248, September 3, 1982. See Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982* (JCS-38-82), December 31, 1982, p. 268.

[151] Sec. 6031.

[152] Former sec. 6231(a)(3). Any item that is affected by a partnership item (for example, on the partner's return) is an "affected item." Affected items of a partner are subject to determination at the partner level. Former sec. 6231(a)(5).

consistent treatment and were bound by settlement agreements with respect to partnership items.[153]

The TEFRA rules did not however, change the process for collecting underpayments attributable to understatements at the partnership level. The resulting deficiencies in tax were collected from each partner separately, along with any additional tax from affected items required to be determined at the partner level. As a result, a special limitations period was provided to ensure that the IRS had at least one year from the final redetermination of adjustments made to the partnership return to pursue assessment against a partner for those deficiencies.[154]

Electing large partnership procedures

In an attempt to ameliorate the difficulty of collecting from numerous partners after completion of a TEFRA audit, an additional centralized examination process was enacted for electing large partnerships introducing both streamlined reporting and centralized audit and collection procedures.[155] Partners were required to report items consistently with the partnership. The provisions define an electing large partnership as any partnership that elects to be subject to the specified reporting and audit rules, if the number of partners in the partnership's preceding taxable year is 100 or more.[156] The rationale stated in 1997 for adding new audit rules for large partnerships was that "[a]udit procedures for large partnerships are inefficient and more complex than those for other large entities. The IRS must assess any deficiency arising from a partnership audit against a large number of partners, many of whom cannot easily be located and some of whom are no longer partners. In addition, audit procedures are cumbersome and can be complicated further by the intervention of partners acting individually."[157] In lieu of passing through an adjustment to its partners, under these rules the partnership was permitted to elect to pay an imputed underpayment.

New centralized audit regime under BBA

The BBA[158] repealed both the TEFRA and the Electing Large Partnership rules and replaced them with new centralized audit procedures, effective generally for partnership taxable

[153] Former sec. 6224(c).

[154] Former secs. 6229(d) and (g).

[155] Secs. 771-777 and secs. 6240-6255, as enacted by the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, August, 5, 1997.

[156] Former sec. 775.

[157] See Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1997* (JCS-23-97), December 17, 1997, p. 363.

[158] Bipartisan Budget Act of 2015, Pub. L. No. 114-74, secs. 1101 *et seq*, November 2, 2015. Technical corrections were made to these audit rules in the Consolidated Appropriations Act, 2018, Pub. L. No 115-141 (Division U), March 23, 2018.

years beginning after December 31, 2017.[159] Borrowing principles developed under TEFRA and the Electing Large Partnership provisions, the BBA system requires appointment of a designated partnership representative, determines most items of income or deductions at the partnership level, and mandates that partners file returns that are consistent with the reporting position of the partnership. The new system varies from TEFRA in that the partnership through its designated representative is responsible for informing partners of the initiation of administrative proceedings and collecting necessary information from partners to determine imputed underpayments. Unlike TEFRA, the new system provides for the collection of at the partnership level if an audit results in underpayments attributable to partnership adjustments.

Administrative proceeding and determination of imputed underpayment

Under the BBA regime, the Secretary may initiate an examination of a partnership by issuing a notice of administrative proceeding to the partnership or its designated representative.[160] Any adjustment to items of income, gain, loss, deduction, or credit of a partnership for a partnership taxable year, and any partner's distributive share thereof, generally is determined at the partnership level.[161] Unlike prior law, distinctions between partnership items and affected items are no longer made. The Secretary is required to notify the partnership and the partnership representative of any proposed partnership adjustment before the Secretary may issue a notice of final partnership adjustment.[162] A notice of proposed adjustment issued to the partnership identifies both the substance of the adjustment and informs the partnership of the amount of any imputed underpayment that results. An imputed underpayment of tax determined as a result of an examination of a taxable year generally is assessed against and collected from the partnership with respect to the partnership taxable year during which the adjustment is finally determined (the adjustment year) rather than the reviewed year. [163]

[159] For years prior to the effective date of the BBA provisions, there remain three sets of rules for tax audits of partners and partnerships. Partnerships with more than 100 partners may elect the electing large partnership audit rules of sections 6240 through 6256. Partnerships with more than 10 partners (and that are not electing large partnerships) are subject to the TEFRA partnership audit rules enacted in 1982, found in sections 6221 through 6234. Under these two sets of rules, partnership items generally are determined at the partnership level under unified audit procedures. All other partnerships (those with 10 or fewer partners that have not elected the TEFRA audit rules) are subject to the audit rules applicable generally to each partner with the tax treatment of an adjustment to a partnership's items of income, gain, loss, deduction, or credit determined for each partner in separate proceedings, both administrative and judicial.

[160] Sec. 6231(a)(1).

[161] Sec. 6221(a).

[162] Secs. 6231(a), 6231(b) and 6235.

[163] For purposes of the centralized system, the reviewed year means the partnership taxable year to which the item being adjusted relates (sec. 6225(d)(1)). The adjustment year means (1) in the case of an adjustment pursuant to the decision of a court (under the centralized system's judicial review provisions), the partnership taxable year in which the decision becomes final; (2) in the case of an administrative adjustment request, the partnership taxable year in which it is made; or (3) in any other case, the partnership taxable year in which the notice of final partnership adjustment is mailed (sec. 6225(d)(2)).

As an alternative to partnership payment of the imputed underpayment, a partnership may elect to furnish a statement of each partner's share of any adjustments (similar to a Schedule K-1) to each reviewed-year partner, who is then required to pay tax attributable to the partnership adjustment.[164] Conforming changes to limitations period and opportunities for judicial review are also made.[165]

An imputed underpayment of tax with respect to a partnership adjustment for any reviewed year is determined by netting all adjustments of items of income, gain, loss, or deduction and multiplying the net amount by the highest rate of Federal income tax applicable either to individuals or to corporations that is in effect for the reviewed year.[166] Any adjustments to items of credit are taken into account as an increase or decrease of the product of this multiplication. Any net increase or decrease in loss is treated as a decrease or increase, respectively, in income. Netting takes into account applicable limitations, restrictions, and special rules under present law.

Modification of an imputed underpayment generally

If the partnership disagrees with the computation of the imputed underpayment during an administrative proceeding, it may seek modification of the computation, subject to the approval of the Secretary.[167] Modification procedures permit redetermination of the imputed underpayment (1) to take into account amounts paid with amended returns filed by reviewed year partners, (2) to disregard the portion allocable to a tax-exempt partner, and (3) to take into account a rate of tax lower than the highest tax rate for individuals or corporations for the reviewed year.

Certain section 469(k) passive activity losses can reduce the imputed underpayment of a publicly traded partnership under the centralized system. The imputed underpayment can be determined without regard to the portion of the underpayment that the partnership demonstrates is attributable to *(i.e.,* would be offset by) specified passive activity losses attributable to a specified partner. The amount of the specified passive activity loss is concomitantly decreased, and the partnership takes the net decrease into account as an adjustment in the adjustment year with respect to the specified partners to which the net decrease relates. In addition, regulations or guidance may provide for additional procedures to modify imputed underpayment amounts on the basis of other necessary or appropriate factors.

[164] Sec. 6226.

[165] Secs. 6226(a)(1) and 6234(a).

[166] Sec. 6225(b)(1).

[167] Sec. 6225(c).

Modifying an imputed underpayment based on applicable highest tax rates

The partnership may seek to modify an imputed underpayment amount by demonstrating that a lower tax rate is applicable to partners.[168] For example, the partnership may demonstrate that a portion of an imputed underpayment is allocable to a partner that is a C corporation, and for that C corporation partner, the highest marginal rate of Federal income tax (21-percent rate in 2021, for example) is lower than the highest marginal rate of Federal income tax for individuals (37-percent rate for individuals in 2021).

Adjudication of disputes concerning partnership items

As under the TEFRA rules, a partnership adjustment can be challenged in the Tax Court, the district court in which the partnership's principal place of business is located, or the Court of Federal Claims. However, only the partnership, and not partners individually, can petition for a readjustment of partnership items.

If a petition for readjustment of partnership items is filed by the partnership, the court with which the petition is filed has jurisdiction to determine the tax treatment of all partnership items of the partnership for the partnership taxable year to which the notice of partnership adjustment relates, and the proper allocation of such items among the partners. Thus, the court's jurisdiction is not limited to the items adjusted in the notice.

2. Expansion of math error authority

In general

The Code provides general authority for the IRS to assess all taxes shown on returns, including assessment of tax computed by the taxpayer.[169] In addition, the IRS may make supplemental assessments within the limitations period whenever it determines that an assessment was imperfect or incomplete.[170] However the IRS's authority to assess additional tax may be subject to certain restrictions on assessment known as deficiency procedures.[171] These deficiency procedures generally assure a taxpayer access to administrative review and a pre-payment judicial forum (*i.e.*, the U.S. Tax Court) for reviewing disputed adjustments proposed by the IRS.

There are several exceptions to the restrictions on assessment of tax.[172] One of the principal exceptions is the IRS's authority to make a summary assessment of tax without

[168] Sec. 6225(c)(4).

[169] Sec. 6201.

[170] Sec. 6204.

[171] Secs. 6211 through 6215.

[172] Section 6213 provides that a taxpayer may waive the restrictions on assessment, permits immediate assessment to reflect payments of tax remitted to the IRS and to correct amounts credited or applied as a result of claims for carrybacks under section 1341(b), and requires assessment of amounts ordered as criminal restitution.

issuance of a notice of deficiency if the error is a result of a mathematical or clerical error, generally referred to as math error authority. Purely mathematical or clerical issues are often identified early in the processing of a return, prior to issuance of any refund; they are not typically identified as a result of an examination of a return.

If the mistake on the return is of a type that is within the meaning of mathematical or clerical error, the IRS immediately assesses the additional tax due as a result of correcting the mistake and sends notice of the math error to the taxpayer. The issuance of a notice of math error begins a 60-day period within which a taxpayer may submit a request for abatement of the math error adjustment, which then requires the IRS to abate the assessment and refer the unresolved issue for examination under the deficiency procedures.

This exception to the restriction on assessment originally was limited to mathematical errors, was expanded to include clerical or transcription errors, and then was further expanded to address various specific cases, to reach the 17 categories of errors within the scope of the exception.[173] Many issues covered by the math error authority relate to rules regarding refundable credits.[174] Math error authority is used to deny a claimed credit, either during initial processing of a return on which the credit is claimed or in an examination of the return after the refund has been issued, and immediately assess any additional tax due as a result without issuing a notice of deficiency. For example, in 2015, the math error authority was expanded to cover situations for which: (1) a taxpayer claimed the earned income tax credit, child tax credit, or the American opportunity tax credit ("AOTC") during the period in which a taxpayer is not permitted to claim such credit as a consequence of having made a prior fraudulent or reckless claim; and (2) there was an omission of information required by the Secretary relating to a taxpayer making improper prior claims of the child tax credit or the AOTC.[175] In 2020 and 2021, math error authority was expanded to cover certain errors related to valid identification numbers and reconciliation of advance payments with respect to the 2020 recovery rebate credit, 2020 additional recovery rebate credit, and the 2021 recovery rebate credit.[176]

Challenges in balancing administrative efficiency and taxpayer protections

Any proposals to expand math error authority present the issue of how to balance the need for efficient allocation of government resources with the need for adequate taxpayer safeguards. Under current law, the IRS has the authority to correct math or clerical errors on a return using summary assessment procedures. When it makes such a summary assessment,

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Assessment is also permitted in certain circumstances in which collection of the tax would be in jeopardy. Secs. 6851, 6852 or 6861.

[173] Secs. 6213(g)(2)(A) through (Q).

[174] Math error authority currently applies to certain errors related to the earned income tax credit, the child tax credit, the American opportunity tax credit, and the recovery rebate credits.

[175] Secs. 6213(g)(2)(K), (P), and (Q). Pub. L. No. 114-113, Div. Q, sec. 208.

[176] Pub. L. No. 116-136, sec. 2201; Pub. L. No. 116-260, Div. N, sec. 272; Pub. L. No. 117-2, title IX, sec. 9601. See also secs. 6213(g)(2)(L); 6428(e)(1), (g)(4); 6428A(e)(1), (g)(7); 6428B(e)(2)(G), (f)(1).

taxpayers cannot obtain judicial review before satisfying the proposed tax liability unless they respond to an IRS math error notice requesting an abatement.[177]

The efficiency argument reasons that by avoiding time-consuming examination, possible administrative review, and possible judicial review of issues that are readily identified mistakes (*e.g.*, transposition of numbers, addition errors) that a taxpayer cannot reasonably challenge, the IRS conserves its resources. At the same time, certain expansions of math error authority may threaten taxpayer safeguards in that the expansion may be overbroad and may lead to assessment of tax in cases where tax is not due for multiple reasons. For example, with respect to proposals to expand math error authority to include instances where information provided by the taxpayer does not match the information obtained by the government or from third parties, it is not clear that all information obtained by government and from third parties is sufficiently reliable to warrant a conclusion that a mismatch between these sources and information on a tax return should result in an immediate deficiency assessment. Moreover, the premise that a discrepancy between information in a government database obtained by a third party information return and a tax return is adequate grounds on which to permit a summary assessment is contrary to a provision in the Code that suggests that the mere inclusion of information on a third party information return is insufficient to support a potential adjustment to a return.[178]

The expanded scope of math error assessment authority and the manner in which it is used by the IRS has generated discussion among oversight agencies. The National Taxpayer Advocate has identified improper use of math error authority as one of the most serious problems in tax administration[179] and proposes legislative restrictions on its use.[180] The National Taxpayer

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[177] Sec. 6213(b)(2).

[178] See section 6201(d), which requires reasonable verification of information returns in any court proceeding if a taxpayer asserts a reasonable dispute with respect to any item of income on an information return.

[179] National Taxpayer Advocate, *2018 Annual Report to Congress,* vol. 1, pp. 164-169 (Most Serious Problem No. 11: Post-Processing Math Error Authority: IRS Has Failed to Exercise Self-Restraint in Its Use of Math Error Authority, Thereby Harming Taxpayers); National Taxpayer Advocate, *2014 Annual Report to Congress*, vol. 1, pp. 163-171 (Most Serious Problem No. 16: The IRS Does Not Clearly Explain Math Error Adjustments, Making It Difficult for Taxpayers to Understand and Exercise Their Rights); National Taxpayer Advocate, *2011 Annual Report to Congress*, vol. 1, pp. 74-92 (Most Serious Problem No. 4: Expansion of Math Error Authority and Lack of Notice Clarity Create Unnecessary Burden and Jeopardize Taxpayer Rights).

[180] National Taxpayer Advocate, *2021 Purple Book*, pp. 25-27 (Legislative Recommendation No. 11: Continue to Limit the IRS's Use of "Math Error Authority" to Clear-Cut Categories Specified by Statute); National Taxpayer Advocate); National Taxpayer Advocate, *2020 Purple Book*, pp. 28-29 (Legislative Recommendation No. 12: Continue to Limit the IRS's Use of "Math Error Authority" to Clear-Cut Categories Specified by Statute); National Taxpayer Advocate, *2015 Annual Report to Congress*, pp. 329-339 (Legislative Recommendation No. 2: Authorize the IRS to Summarily Assess Math and "Correctable" Errors Only in Appropriate Circumstances) (arguing that Congress should consider expanding math error only in one of the situations described in the Administration's proposal which is where there is no doubt that the taxpayer has claimed amounts in excess of a lifetime limitation based on information shown on the return as could be the case with the American opportunity tax credit).

The National Taxpayer Advocate proposes five factors be weighed before an issue is added to the list for which math error authority is permitted: (i) there is a discrepancy between the return and reliable government data; (ii) the IRS's math error notice clearly describes the discrepancy and how taxpayers may contest the assessment, (iii)

Advocate also notes that the current IRS math error notices do not provide a clear explanation of the alleged error, such that it is difficult for taxpayers to determine what the IRS is proposing to change.[181] By contrast, the Government Accountability Office focuses on the need to avoid erroneous issuance of refunds and proposes that math error authority be expanded to permit better administration of refundable credits.[182] The Treasury Inspector General for Tax Administration similarly has described that without expanded math error authority the IRS is unable to address a significant number of erroneous claims of the refundable earned tax income credit.[183]

The opposing viewpoints regarding expansion of math error authority can be understood as different evaluations of where the balance lies between efficiency gains and possible curtailment of taxpayer protections. The increasing number and complexity of refundable credits and the constraints on IRS access to information needed to verify eligibility for such refunds at the time the return is filed have led to issuance of erroneous refunds, which are difficult to recover. The need to issue refunds promptly in order to avoid paying interest on the refund[184] adds to the pressure to resolve questions during processing in favor of issuing a refund during the filing season.

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the IRS has researched all information in its possession that could reconcile the apparent discrepancy; (iv) the IRS does not have to analyze facts and circumstances or weigh the adequacy of information submitted by the taxpayer to determine if the return contains an error; and (v) the abatement rate for a particular issue or type of inconsistency is low for those taxpayers who respond. See, *e.g.*, National Taxpayer Advocate, *2021 Purple Book*, pp. 25-27 (Legislative Recommendation No. 11: Continue to Limit the IRS's Use of "Math Error Authority" to Clear-Cut Categories Specified by Statute); National Taxpayer Advocate, *2018 Annual Report to Congress*, vol. 1, pp. 164-169 (Most Serious Problem No. 11: Post-Processing Math Error Authority: IRS Has Failed to Exercise Self-Restraint in Its Use of Math Error Authority, Thereby Harming Taxpayers.

[181] National Taxpayer Advocate, *2018 Annual Report to Congress*, vol. 1, pp. 174-197 (Most Serious Problem No. 12: Math Error Notices: Although the IRS Has Made Some Improvements, Math Error Notices Continue to Be Unclear and Confusing, Thereby Undermining Taxpayer Rights and Increasing Taxpayer Burden), vol. 2, pp. 194-210 (Literature Review: Improving Notices Using Psychological, Cognitive, and Behavioral Science Insights) (review how notices can be improved using insights from the available psychological, cognitive, and behavioral science research); Statement of Nina E. Olson, National Taxpayer Advocate, Oversight Subcommittee of the House Committee on Ways and Means, "IRS Reform: Perspectives from the National Taxpayer Advocate," May 19, 2017, available at https://www.irs.gov/pub/foia/ig/tas/Nina-Olson-Testimony-final-5-19-2017-Hearing.pdf.

[182] Government Accountability Office, *2011 Tax Filing: IRS Dealt with Challenges to Date but Needs Additional Authority to Verify Compliance* (GAO 11-481), March 2011. In testimony before the Oversight Subcommittee of the House Committee on Ways and Means, GAO recommended that the IRS be provided math error authority to use prior years' tax return information to ensure that taxpayers do not improperly claim credits or deduction in excess of applicable lifetime limits. Statement of Michael Brostek, Director Strategic Issues, Government Accountability Office, Oversight Subcommittee of the House Committee on Ways and Means, "Enhanced Prerefund Compliance Checks Could Yield Significant Benefits," (GAO-11-691T), May 25, 2011.

[183] Treasury Inspector General for Tax Administration, *Without Expanded Error Correction Authority, Billions of Dollars in Identified Potentially Erroneous Earned Income Credit Claims Will Continue to Go Unaddressed Each Year* (2016-40-036), April 27, 2016.

[184] Sec. 6611(e) (interest otherwise required to be paid on overpayments of tax does not accrue during a 45-day grace period after a return is filed or deemed filed).

As explained above, the restrictions on assessment generally assure a taxpayer access to administrative review and a pre-payment judicial forum (*i.e.*, the U.S. Tax Court) for reviewing disputed adjustments proposed by the IRS. Assessments made in reliance on math error authority bypass those protections unless the taxpayer requests abatement of the assessment within 60 days. The extent to which affected taxpayers understand this relief from the summary assessment is not clear. According to the Treasury Inspector General for Tax Administration, taxpayers seldom challenge math error assessments, but those who do generally prevail. Few cases requesting abatement are subsequently referred to examination.[185] These data support the contention that math error authority is efficient and operates without prejudice to rights of taxpayers. Information developed by the National Taxpayer Advocate, however, suggests the contrary.[186] The failure to challenge a math error adjustment may not signify agreement with the adjustment, but may instead be a result of taxpayers' failure to understand and timely exercise their rights. After reviewing numerous examples of explanatory paragraphs included in IRS notices sent to taxpayers to inform them that math error adjustments had been made to their income tax returns, the National Taxpayer Advocate office determined that many were inadequate. Lack of clarity in the notices, whether as to the substance of the adjustment or the availability of any means of recourse, may lead the recipient to allow his or her rights to lapse, and should not be equated with agreement with the adjustment.

3. Civil tax penalties as a factor in voluntary compliance

The civil penalty regime is one of the staples of tax administration. An understanding of the strengths and weaknesses of the penalty system requires a basic understanding of civil tax administration generally. Accordingly, below is an explanation of the Federal civil assessment process and an overview of Federal civil tax penalties.

Civil assessment process

The Federal income tax system relies upon self-reporting and assessment. A taxpayer is expected to prepare a report of his or her liability[187] and submit it to the IRS with any payment due. The Code provides general authority for the IRS to assess all taxes shown on returns,[188] other than certain Federal unemployment tax and estimated income taxes.[189] The assessment is required to be made by recording the liability in the "office of the Secretary" in a manner

[185] See Treasury Inspector General for Tax Administration, *Some Taxpayer Responses to Math Error Adjustments Were Not Worked Timely and Accurately*, (TIGTA-2011-40-059), July 7, 2011.

[186] National Taxpayer Advocate, *2018 Annual Report to Congress*, vol. 1, pp. 174-196 (Most Serious Problem No. 12: Math Error Notices: Although the IRS Has Made Some Improvements, Math Error Notices Continue to Be Unclear and Confusing, Thereby Undermining Taxpayer Rights and Increasing Taxpayer Burden).

[187] Sec. 6011 and 6012.

[188] See section 6201(a), which authorizes assessment of tax computed by the taxpayer as well as amounts computed by the IRS at the election of the taxpayer, under section 6014.

[189] Sec. 6201(b).

determined under regulations.[190] If the IRS determines that the assessment was materially incorrect, additional tax must be assessed within the limitations period.[191]

The authority to assess the additional tax may be subject to certain restrictions on assessment known as the deficiency procedures.[192] These deficiency procedures generally assure a taxpayer access to administrative review and a pre-payment judicial forum. A deficiency of tax occurs if the amount of certain taxes[193] assessed for a period, after reduction for any rebates of tax, is less than the liability determined under the Code. If the IRS determines that a taxpayer has not fully reported his or her tax liability, the IRS generally first informs the taxpayer by letter. Most discrepancies in liability identified by the IRS are resolved through such "correspondence audits." In fiscal year 2019, for example, the IRS completed examinations of 771,095 returns, of which 568,872 were correspondence audits.[194]

If the taxpayer does not comply after receipt of such a correspondence audit, an examining agent reviews the return and determines whether an adjustment in tax owed is required. The determination by the examining agent that an adjustment to the return is required results in a notice sent to the taxpayer known as the "30 day letter," which provides an opportunity for the taxpayer to invoke rights to an administrative appeal or to agree to the adjustments within 30 days.

The notice is informally referred to as a 30 day letter, because the letter informs the taxpayer that if a response is not provided within 30 days, the case proceeds to the next stage, *i.e.*, either immediate assessment or the issuance of a notice of deficiency. Many cases conclude at this stage because the taxpayer agrees with the adjustments proposed. If the taxpayer responds and disputes the adjustments, the case is referred to an independent administrative appeals officer for review. In most cases, the taxpayer and the IRS agree on the merit or lack of merit of the adjustments proposed, and the cases are closed without issuance of a notice of deficiency. If the parties do not reach agreement administratively, the IRS must issue a formal notice of deficiency to a taxpayer,[195] which begins a period within which a taxpayer may petition the U.S. Tax Court. During that period, as well as during the pendency of any proceeding in Tax Court, assessment of the deficiency is not permitted.[196]

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[190] Sec. 6203.

[191] Secs. 6204.

[192] Secs. 6211 through 6215.

[193] The taxes to which deficiency procedures apply are income, estate and gift and excise taxes arising under chapters 41, 42, or 44. Secs. 6211 and 6213.

[194] Department of the Treasury and Internal Revenue Service, *Internal Revenue Service Data Book, 2019*, Table 17b.

[195] Sec. 6212.

[196] Sec. 6213(a). If a taxpayer wishes to contest the merits in a different court, the taxpayer may agree to assessment of the tax, reserving his or her rights to contest the merits, pay the disputed amount, and pursue a claim for refund reviewable in a suit in Federal district court or Court of Federal Claims.

There are several exceptions to the restrictions on assessment of taxes that are generally subject to the deficiency procedures,[197] including math error authority discussed above in section III.B.2.

Civil tax penalties

Overview of penalties

The Code provides for both civil and criminal penalties to ensure complete and accurate reporting of tax liability and to discourage fraudulent attempts to defeat or evade tax. Civil and criminal penalties are applied separately. Thus, a taxpayer convicted of a criminal tax offense may be subject to both criminal and civil penalties, and a taxpayer acquitted of a criminal tax offense may nonetheless be subject to civil tax penalties. In cases involving both criminal and civil penalties, the IRS generally does not pursue both simultaneously, but delays pursuit of civil penalties until the criminal proceedings have concluded.

The majority of delinquent taxes and penalties are collected through the civil process. In determining whether a penalty applies along with an adjustment to a tax return, the examining agent is constrained not only by the applicable statutory provisions, but also by the written policy of the IRS not to treat penalties as bargaining points but instead to develop facts sufficient to support the decision to assert or not to assert a penalty.[198] The goal is to ensure consistency, fairness and predictability in administration of penalties.

Civil penalties are provided in Chapter 68 of the Code (sections 6651-6751). Some penalties are calculated by reference to the tax liability, such as the penalty for fraud, while others are fixed dollar amounts or fixed percentages, such as the failure to file a tax return or to pay tax. In general, there is a penalty for (i) fraud,[199] (ii) failure to pay or file (referred to as delinquency penalties),[200] (iii) failure to pay estimated tax,[201] (iv) failure to deposit estimated tax

[197] Section 6213 provides that a taxpayer may waive the restrictions on assessment, permits immediate assessment to reflect payments of tax remitted to the IRS and to correct amounts credited or applied as a result of claims for carrybacks under section 1341(b), and requires assessment of amounts ordered as criminal restitution. Assessment is also permitted in certain circumstances in which collection of the tax would be in jeopardy. Secs. 6851, 6852 or 6861.

[198] Policy Statement 20-1, Internal Revenue Manual, sec. 1.2.20.1.1.

[199] Section 6663(a) applies a penalty of 75 percent on any amount of an underpayment attributable to fraud. Fraud differs from negligence in that fraud requires an intent to evade taxes.

[200] Section 6651(a) applies the delinquency penalties. Failing to pay the amount shown as tax will result in a 0.5 percent monthly penalty on the net amount due, increasing to 1 percent monthly in the first month starting after the IRS gives notice and demand for immediate payment. The maximum aggregate penalty is 25 percent. Failing to file a return results in a penalty of 5 percent per month on the tax required to be shown on the return, up to a maximum aggregate penalty of 25 percent.

[201] Section 6654 provides for additions to tax for underpayment of estimated tax for individuals. Section 6655 provides for the additions to tax for underpayment of estimated tax for corporations. In both cases, the additions to tax is computed by applying the underpayment rate under section 6621 to the amount of the

amounts,[202] (v) negligence, substantial understatement, substantial valuation misstatements, substantial overstatement of pension liabilities, substantial estate or gift tax valuation understatement, lack of economic substance, undisclosed foreign financial asset understatements, and understatements with respect to reportable transactions (all of the items in this list are referred to as accuracy related penalties),[203] (vi) not filing or filing incorrect information returns,[204] and (vii) aiding and abetting understatements, taking unreasonable return positions (applied to return preparers), promoting abusive tax shelters, and failing to furnish information regarding tax shelters (referred to collectively as the preparer, promoter, and protestor penalties).[205]

These penalties are categorized into two types: additions to the tax and additional amounts (herein "additions to tax"), and assessable penalties. The additions to tax penalties are generally subject to deficiency proceedings and include delinquency penalties (section 6651), failure by individuals to pay estimated income tax (section 6654), failure by corporations to pay estimated income tax (section 6655), failure to make deposit of taxes (section 6656), accuracy-related penalties (sections 6662 and 6662A), and the fraud penalty (section 6663). Some of these penalties may be waived under certain circumstances, including a showing of reasonable cause under section 6664.

Assessable penalties can be assessed without restrictions (such as the opportunity for preassessment judicial review) applicable in deficiency cases. These penalties are imposed for failure to pay over collected taxes and to file information returns reporting specified information and transactions (section 6671 through 6720C), for failure to comply with certain information reporting requirements, such as failure to file correct information returns (section 6721), failure to furnish correct payee statements (section 6722), and failure to comply with other information reporting requirements (sections 6723 and 6725). These penalties may also be waived under certain circumstances, including a showing of reasonable cause under section 6724.

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underpayment, for the period of the underpayment. Section 6621 applies an interest rate of the federal short-term interest rate plus 3 percent.

[202] Section 6656(a) applies a penalty for failure to deposit of 2 percent if the failure to deposit is 5 days or less, 5 percent if the failure is greater than 5 days but not more than 15 days, and 10 percent if the failure is more than 15 days.

[203] Section 6662 applies a 20 percent penalty to any part of an underpayment attributable to accuracy related errors as listed in section 6662(b). This penalty increases to 40 percent in certain circumstances.

[204] Section 6721 applies a $250 penalty for failure to file a correct information return, up to a maximum of $3 million per year. These amounts are adjusted annually to account for inflation. For tax year 2021, the penalty amount is $260, up to a maximum of $3,193,000 per year. No penalty is imposed if the failure is due to reasonable cause.

[205] Section 6701 applies a penalty of $1,000 on any person who aids in the understatement of tax liability for individuals and $10,000 on any person who aids in the understatement of tax liability for a corporation. Section 6700 applies a penalty of $1,000 against anyone involved directly or indirectly in the sale of an abusive tax shelter. These are not currently adjusted for inflation.

Efforts to address the tax gap through penalties

To encourage taxpayers to timely fulfill their obligations, Congress has increased the amount of certain frequently assessed penalties, including by modifying the way many fixed dollar penalties are indexed for inflation, and has enacted new rules to punish delinquent taxpayers.

Increases in penalty amounts

Over time, Congress has increased the amount of certain fixed dollar penalties. For example, in 2019, Congress amended section 6651 to increase the minimum penalty for failure to file or failure to pay the tax from $300 to $435. Also, in 2019, Congress increased the maximum penalties in many of the penalties under section 6652 by a factor of 10; for example, the maximum penalty in subsection (h) was increased from $5,000 to $50,000.

In 2014, Congress amended the Code to require an annual inflation adjustment to tax penalty amounts for: (1) failure to file a tax return or pay tax, (2) failure to file certain information returns or registration statements, (3) noncompliance of tax return preparers, (4) failure to file partnerships returns, (5) failure to file S corporation returns, (6) failure to file correct information returns, and (7) failure to furnish correct payee statements.[206] This change results in penalty amounts rising over time in line with inflation. In 2017, Congress amended the Code to change the inflation adjustment from tracking the Consumer Price Index ("CPI") to tracking the Chained Consumer Price Index ("C-CPI-U").[207]

Revocation or denial of passport in case of certain unpaid taxes

Although many of the civil penalties in the Code are monetary, one recent example of a newly-imposed civil penalty involves non-monetary penalties. In 2015, Congress enacted a regime in the Code to deny or revoke passports to induce seriously delinquent taxpayers to pay their amount due in full.[208] The Code now requires the Secretary of State to deny a passport (or renewal of a passport) to a seriously delinquent taxpayer and is permitted to revoke any passport previously issued to such person. In addition to the revocation or denial of passports to seriously delinquent taxpayers, the Secretary of State is authorized to deny an application for a passport if the applicant fails to provide a social security number or provides an incorrect or invalid social security number. With respect to an incorrect or invalid social security number, the inclusion of an erroneous number is a basis for rejection of the application only if the erroneous number was provided willfully, intentionally, recklessly, or negligently. Exceptions to these rules are permitted for emergency or humanitarian circumstances, including the issuance of a passport for short-term use to return to the United States by the seriously delinquent taxpayer.

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[206] Pub. L. No. 113-295, sec. 208, Div. B.

[207] Historically, the C-CPI-U has grown more slowly year to year; so, in the context of penalties, this change will result in penalties rising more slowly than they would have under the previous CPI adjustments.

[208] Pub. L. No. 114-94, sec. 32101(a), adding Code sec. 7345, effective December 4, 2015.

The Code authorizes limited sharing of information between the Secretary of State and Secretary of the Treasury. If the Commissioner of Internal Revenue certifies to the Secretary of the Treasury the identity of persons who have seriously delinquent Federal taxes as defined in the statute, the Secretary of the Treasury or his or her delegate is authorized to transmit such certification to the Secretary of State for use in determining whether to issue, renew, or revoke a passport. Certification of a seriously delinquent tax debt under the statute is added to the list of actions for which the time in which the action must be performed may be postponed due to the taxpayer's service in a combat zone.[209] Applicants whose names are included on the certifications provided to the Secretary of State are ineligible for a passport. The Secretary of State and Secretary of the Treasury are held harmless with respect to any certification issued pursuant to the statute.

The statute defines "seriously delinquent tax debt" to include any outstanding Federal tax liability (including interest and any penalties) in excess of $50,000[210] for which a notice of lien or a notice of levy has been filed. With respect to debts for which a notice of lien has been filed, the debt is considered seriously delinquent only if the taxpayer's administrative review rights have been exhausted or lapsed. The $50,000 amount is to be adjusted for inflation annually, similar to other penalties, and is $53,000 for tax year 2021. Even if a tax debt otherwise meets the statutory threshold, it may not be considered seriously delinquent if (1) the debt is being paid in a timely manner pursuant to an installment agreement or offer-in-compromise, or (2) collection action with respect to the debt is suspended because a collection due process hearing or innocent spouse relief has been requested or is pending.

Several measures ensure that the IRS corrects erroneous certifications and considers actions taken by a taxpayer after action has been initiated under the statute if such actions would have the effect of removing the debt from the category of seriously delinquent debt. These measures include limits on the authority of the Commissioner, notification requirements, standards under which the Commissioner may reverse the certification of serious delinquency, and limits on authority to delegate the certification process.

The Commissioner may not delegate the authority to provide certification of a seriously delinquent tax debt except to a Deputy Commissioner for Services and Enforcement, or to a Division Commissioner (the head of an IRS operating division). Neither official may redelegate such authority.

The Commissioner is required to inform taxpayers regarding the procedures in three ways. First, the possible loss of a passport is added to the list of matters required to be included in notices to taxpayers of potential collection activity under section 6320 or 6331. Second, the Commissioner must provide contemporaneous notice to a taxpayer when the taxpayer is included in a certification of serious delinquency to the Secretary of the Treasury. Finally, in instances in which the Commissioner decertifies the taxpayer's status as a delinquent taxpayer, he is required to provide notice to the taxpayer at the same time as the notice to the Secretary of the Treasury.

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[209] Sec. 7508(a).

[210] Sec. 7345(f) cross referencing sec. 1(f)(3).

The decertification process provides a mechanism under which the Commissioner can correct an erroneous certification or end the certification because the debt is no longer seriously delinquent, due to certain events subsequent to the certification. If after certifying the delinquency to the Secretary, the IRS receives full payment of the seriously delinquent tax debt; the taxpayer enters into an installment agreement under section 6159; the IRS accepts an offer in compromise under section 7122; or a spouse files for relief from joint liability, the Commissioner must notify the Secretary that the taxpayer is not seriously delinquent. In each instance, the "decertification" is limited to the taxpayer who is the subject of one of the above actions. In the case of a claim for innocent spouse relief, the decertification is only with respect to the spouse claiming relief, not both spouses. The Commissioner must generally decertify within 30 days of the event that requires decertification.

The Commissioner must provide the notice of decertification to the Secretary of the Treasury, who must in turn promptly notify the Secretary of State of the decertification. The Secretary of State must delete the certification from the records regarding that taxpayer.

The Code allows limited judicial review of a wrongful certification (or failure to decertify) in a Federal district court or against the Commissioner in the U.S. Tax Court. The court which first acquires jurisdiction over such an action will have sole jurisdiction. If the court determines that the certification is erroneous, the court may order the Secretary of the Treasury to notify the Secretary of State of the error. No other relief is authorized.

Legislative and other history of penalties

Below is a brief review of the legislative and other history of tax penalties.

In November 1987, the Commissioner of Internal Revenue created a task force of IRS and Treasury employees to study civil tax penalties and develop a philosophy of penalties. That group published a report in February 1989 that provided several recommendations that were implemented.[211] For example, the IRS adopted a single penalty policy statement recognizing the primary purpose of civil tax penalties as a means of increasing voluntary compliance. The IRS also developed a comprehensive penalty handbook, revised its training programs, and increased communication with taxpayers regarding penalties.

Following the release of the IRS report, Congress undertook a major review of the penalty provisions resulting in the enactment in 1989 of the Improved Penalty Administration and Compliance Tax Act ("IMPACT").[212] The legislation provided changes to Code in an effort to simplify accuracy-related penalties and information reporting penalties. Specifically, Congress rationalized the penalty structure by reorganizing all accuracy-related penalties into a single Code section (section 6662) with a single rate (except for gross valuation

[211] Executive Task Force, Commissioner's Penalty Study, Internal Revenue Service, *Report on Civil Tax Penalties*, February 21, 1989, available at https://books.google.com/books?id=3Ny_S8dimXIC&printsec=frontcover#v=onepage&q&f=false.

[212] Subtitle G of the Omnibus Budget Reconciliation Act of 1989, the Improved Penalty Administration and Compliance Tax Act, Pub. L. No. 101-239, December 19, 1989.

misstatements[213]). The legislation also introduced a reasonable cause exception and created a uniform definition of underpayment.

Since the enactment of IMPACT, Congress has added numerous penalty provisions to the Code.[214] Due to the proliferation of penalties and increase in their complexity, there have been many penalty studies and suggestions provided for possible reform. The studies include reports prepared by the staff of the Joint Committee on Taxation[215] and the Treasury Department[216] (both of which were mandated by the IRS Restructuring Act of 1998),[217] the National Taxpayer Advocate,[218] the Government Accountability Office,[219] Treasury Inspector General for Tax Administration,[220] and two practitioner groups, the American Institute of Certified Public Accountants,[221] and the American Bar Association, Tax Section.[222] In addition to these reports, there have been many articles written about the current shortcomings of the penalty regime and suggestions for reform.[223]

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[213] Increased rates subsequently have been applied to nondisclosed noneconomic substance transactions, undisclosed foreign financial asset understatements, and overstatements of qualified charitable contributions. See sec. 6662(i) through (l).

[214] National Taxpayer Advocate, *A Framework for Reforming the Penalty Regime," Annual Report to Congress*, vol. 2, December 2008, p. 7 (over 130 penalties in 2008) (herein "NTA Report").

[215] 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), vols. I and II, July 22, 1999.

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

[217] IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206, sec. 3801, July 22, 1998. Mandates separate reports by the Joint Committee on Taxation and the Secretary of the Treasury.

[218] NTA Report, p. 2.

[219] Government Accountability Office, *Inflation Has Significantly Decreased the Real Value of Some Penalties* (GAO-07-1062), August 2007 and Government Accountability Office, *IRS Should Evaluate Penalties and Develop a Plan to Focus its Efforts* (GAO-09-567), June 2009.

[220] Inspector General for Tax Administration, Department of the Treasury, *Accuracy-Related Penalties Are Seldom Considered Properly During Correspondence Audits* (TIGTA 2010-30-059), June 4, 2010; Inspector General for Tax Administration, Department of the Treasury, *Significant Revenue Continues to Be Lost Because of Unassessed Failure to Pay Tax Penalties* (TIGTA 2009-30-052), March 24, 2009.

[221] American Institute of Certified Public Accountants, Penalty Reform Task Force, "Report on Civil Tax Penalties: The Need For Reform," April 11, 2013, p. 4 ("Penalties should treat similarly situated taxpayers similarly and have sufficient flexibility to account for differences in the particular facts and circumstances of each case.").

[222] American Bar Association, Section of Taxation, "Statement of Policy Favoring Reform of Federal Civil Tax Penalties," April 21, 2009.

[223] For a summary of the background, problems, and ideas for reform, see Jeremiah Coder, "Achieving Meaningful Civil Tax Penalty Reform and Making it Stick," *Akron Tax Journal*, vol. 27, 2012, pp. 153-186.