Annual Report to Congress

National Taxpayer Advocate

2008 Annual Report to Congress

A Framework for Reforming the Penalty Regime

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Table of Contents

Table of Tables

Executive Summary

The number of civil tax penalties has increased from about 14 in 1954 to more than 130 today.[1] If structured properly, civil tax penalties can potentially increase voluntary tax compliance.[2] If structured improperly, however, penalties can reduce voluntary compliance, potentially endangering collection of the 84 percent of all taxes due that come in timely and voluntarily each year without any direct effort on the part of the government.[3] So, the *sole* purpose of civil tax penalties should be to enhance voluntary compliance.[4] An IRS task force expressly rejected other purposes, such as raising revenue, punishing noncompliant behavior, and reimbursing the government for the cost of compliance programs, because policies designed to fulfill other purposes may conflict with the goal of enhancing voluntary compliance.[5]

Penalties may deter noncompliance for some taxpayers by imposing costs on it. If such deterrence were the only consideration, however, penalty reform would be easy – we could simply increase the severity of all civil tax penalties and work to impose them in every instance of noncompliance. But, severe civil and criminal penalties already apply to intentional tax evasion.[6] Even very high penalties may not improve compliance if the likelihood that the IRS will detect noncompliance and impose the penalty is small.

Moreover, severe penalties that are not well designed could reduce compliance if they provide a disincentive for noncompliant taxpayers to step forward, are so disproportionate or arbitrarily imposed that taxpayers feel they are unjust, or result in protracted disputes that

1 *See* IRM 20.1.1.1.1 (Feb. 22, 2008). For a list of about 130 current law penalties, see Table 4, *The Number of FY 2007 Assessments for Selected Civil Tax Penalties by Internal Revenue Code Section,* Appendix A, *infra.*

2 We use the term "penalty" to refer to civil monetary penalties and "additions to tax," exclusive of interest charges and loss of tax benefits, for violating federal tax rules. For purposes of this report, a penalty does not include an increase in tax liabilities resulting from the failure to satisfy substantive requirements to obtain a tax benefit. For example, it excludes the so-called penalties for premature distributions from annuity contracts or individual retirement accounts. *See, e.g.*, IRC §§ 72(q), (t). This report generally focuses on those penalties with some nexus to the federal income tax.

3 When the IRS last measured compliance, it found that taxpayers voluntarily and timely pay about 84 percent of all federal taxes due each year – about $1.767 trillion out of $2.112 trillion in 2001 – without any action by the government. *See* Internal Revenue Service U.S. Department of the Treasury, *Reducing the Federal Tax Gap, A Report on Improving Voluntary Compliance*, 10 (Aug. 2, 2007), *at* http://www.irs.gov/pub/irs-news/tax_gap_report_final_080207_linked.pdf (last visited Dec. 4, 2008). Only about one percent is collected via enforcement (i.e., $24.3 billion). *Id.*

4 Both Congress and the IRS reached the same conclusion in the late 1980s after extensive study, research, and comment from the public. *See, e.g.*, Executive Task Force for Internal Revenue Commissioner's Penalty Study, *A Philosophy of Civil Tax Penalties* (Discussion Draft), *reprinted in* 111 DTR L-1 1988, 9-10 (June 9, 1988) (hereinafter "IRS Task Force Report I"); H.R. Conf. Rep. No. 101-386 at 661 (1989) (stating in connection with significant civil tax penalty reform, "the IRS should develop a policy statement emphasizing that civil tax penalties exist for the purpose of encouraging voluntary compliance.").

5 *See* IRS Task Force Report I at 9-10.

6 *See, e.g.*, IRC § 6651(f) (fraudulent failure to file); IRC § 6663 (fraudulent underpayment); IRC § 7201 (criminal sanction for willful tax evasion); IRC § 7203 (criminal sanction for willful failure to file, report, or pay).

leave the IRS with few resources to impose them.[7] Even seemingly moderate penalties may be seen as disproportionately severe and arbitrary if they apply (or the IRS proposes them) in situations where taxpayers reasonably believe they have done nothing wrong or have done their best to comply. Therefore, any legislative changes to the penalty regime need to be based on research, rather than a reflexive reaction to the abuse of the day.

Before we begin serious penalty reform, we need better data about whether and how penalties promote voluntary compliance. As early as 1989, Congress recommended that the IRS "develop better information concerning the administration and effects of penalties."[8] In addition, the IRS's official policy is to collect information:

> to determine the effectiveness of penalties in promoting voluntary compliance… [and recommend] changes when the Internal Revenue Code or penalty administration does not effectively promote voluntary compliance…[9]

However, the government still has no significant quantitative data to show how penalties affect voluntary compliance.[10] As Table 4, *The Number of FY 2007 Assessments for Selected Civil Tax Penalties by Internal Revenue Code Section* in Appendix A shows, the IRS either does not assess or does not track assessments of many current penalties, much less study them in a comprehensive manner. As a result, policymakers lack the information they need to structure and administer tax penalties to maximize voluntary compliance or even to accurately estimate the budget effect of changes to the penalty rules.[11]

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7 One survey found that the strongest factors influencing compliance was personal integrity. *See* Roper ASW, *IRS Oversight Board 2005 Taxpayer Attitude Survey* 7 (Feb. 21, 2006), *at* http://www.ustreas.gov/irsob/releases/2006/02212006.pdf (last visited Dec. 4, 2008) (finding that for 95 percent of the respondents personal integrity was somewhat of an influence or a great deal of influence on their compliance decision). *Accord* Marjorie E. Kornhauser, *Tax Compliance and the Education of John (and Jane) Q. Taxpayer*, 121 Tax Notes 737 (Nov. 10, 2008) (suggesting personal integrity and tax morale drive voluntary compliance). When a taxpayer feels the government (or the tax system) has become unjust, this sense of personal integrity may no longer require tax compliance – he or she may feel justified in evading the tax rules.

8 H.R. Conf. Rep. No. 101-386, at 661 (1989).

9 Policy Statement 20-1 (June 29, 2004).

10 *See* Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2001-40-069, *Management Advisory Report: Ineffective Administration of the Individual Taxpayer Penalty Program Creates Inequity* 9 (Apr. 2001) (stating "[T]he IRS does not know if the individual taxpayer penalty program is achieving its objective of encouraging voluntary compliance;" and finding that the IRS lacked systems to assess whether it was assessing and abating penalties consistently or following up on recommended improvements).

11 Revenue generated directly from new penalties can be taken into account in connection with the federal budget "scoring" process, but any resulting effect on voluntary compliance can probably not be taken into account given the lack of quantitative research in this area. Because the scoring process takes the IRS's tendency not to enforce an unduly harsh penalty into account, a focus on budget scoring may provide an incentive for legislators to enact penalties that cannot be waived by the IRS even if such penalties might ultimately reduce voluntary compliance and tax revenues in ways that are difficult to measure. *See* Joint Committee on Taxation, JCX-1-05, *Overview of Revenue Estimating Procedures and Methodologies Used by the Staff of the Joint Committee on Taxation* (Feb. 2, 2005) (stating, "the effectiveness of the applicable penalty regime and the IRS enforcement posture (*i.e.*, whether the IRS routinely waives penalties for a particular issue and how frequently they audit an issue) that would be associated with a proposal are also taken into account."). However, as one commentator has observed: "[t]he best penalties are those that don't raise any revenue [directly] because they encourage the conduct that the penalty is designed to encourage." Jeremiah Coder, *Tax Shelter Penalties Are Unclear and Weakly Enforced, Panelists Say*, 2008 TNT 145-3 (July 28, 2008) (quoting N. Jerold Cohen).

Recommendations

Our primary recommendation is for Congress to have the IRS (1) collect and analyze more detailed penalty data on a regular basis, and (2) conduct an empirical study to quantify the effect of each penalty on voluntary compliance. This quantitative research should also identify changes to penalty laws and penalty administration that would improve voluntary compliance. Congress should appropriate additional funds for this research, as necessary.

Without such research, any penalty analysis will be somewhat subjective and superficial. Nonetheless, the limited data and analysis that is available suggests the following changes to the major penalty provisions would promote voluntary compliance, as further discussed below:

1. Prevent IRS systems from automatically assessing accuracy-related penalties without considering all of the facts and circumstances;
2. Consider the feasibility of clarifying the definition of a "tax shelter" for purposes of the substantial understatement penalty;
3. Restructure the penalty for failure to file a "reportable transaction" information disclosure;
4. Improve the proportionality and effectiveness of the failure to file penalty for those who are more than six months late;
5. Reduce the penalty for late filers who timely pay within a period of extension;
6. Reduce the number of failure to pay penalty rates and eliminate interaction with the failure to file penalty;
7. Simplify the prior year estimated tax payment safe harbor and encourage taxpayers to use it;
8. Simplify the estimated tax penalty computation and provide an automatic waiver of *de minimis* estimated tax penalties;
9. Allow the IRS to abate estimated tax penalties for first-time estimated tax payers who have reasonable cause;
10. Make the Trust Fund Recovery Penalty more effective by clarifying that it covers third party payers; and
11. Reduce the penalty for failure to make tax deposits in the prescribed manner.

Introduction

Penalty reform in the late 1980s

The number of civil tax penalties has increased from about 14 in 1954 to more than 130 today.[12] By 1987, stakeholders were complaining that penalties were enacted in an *ad hoc* fashion; they were sometimes used as a revenue source in lieu of substantive tax provisions; they were increasingly complex; multiple penalties could apply to the same infraction as a result of "stacking;" and the magnitude of the penalty (or penalties) sometimes bore no relation to the severity of the infraction.[13] In response to these concerns, the Joint Committee on Taxation issued a report and an IRS task force issued three more (collectively the "IRS Task Force Reports").[14]

The IRS Task Force Reports concluded that tax penalties should exist solely to encourage voluntary compliance by (1) helping taxpayers understand what conduct is acceptable, (2) deterring noncompliance by imposing costs, and (3) establishing the fairness of the tax system.[15] Based on extensive interviews with stakeholders, the task force developed four broad principles for evaluating whether penalties encourage voluntary compliance: fairness, comprehensibility, effectiveness, and ease of administration, summarized below.[16]

Perception of "fairness"

According to the IRS Task Force Reports, the perception that the tax system is fair promotes voluntary compliance.[17] They discussed three main components of fairness: horizontal equity, proportionality, and procedural fairness.

Horizontal equity – "treating similarly situated taxpayers similarly"

Horizontal equity requires that similarly situated taxpayers be treated similarly. It does not require that we blindly apply the same penalty to all taxpayers who fail to comply because

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12 *See* IRM 20.1.1.1.1 (Feb. 22, 2008). Table 4, *The Number of FY 2007 Assessments for Selected Civil Tax Penalties by Internal Revenue Code Section*, in Appendix A, lists about 130 provisions.

13 *See, e.g.*, Laurence Keiser, *IRS Penalty Reform Under the 1989 Act (The Revenue Reconciliation Act of 1989)*, The CPA Journal Online (June 1990).

14 *See* IRS Task Force Report I; Executive Task Force for the Commissioner's Penalty Study, *Report on Civil Tax Penalties* (Working Draft of Chapters 1-4 and 8), *reprinted in* 237 DTR L-10 (Dec. 9, 1988) (hereinafter "IRS Task Force Report II"); Executive Task Force for the Commissioner's Penalty Study, *Report on Civil Tax Penalties*, *reprinted in* 89 TNT 45-36 (Feb. 27, 1989) (hereinafter "IRS Task Force Report III"); Joint Committee on Taxation, JCS-9-88, Description of Tax Penalties (Mar. 24, 1988). *See also* Thomas R. Hoffman, *Studies of the Code's Tax Penalty Structure: A Fitful Step Toward Reform*, 43 Tax. Law. 201 (Fall 1989); Internal Revenue Service Commissioner Lawrence Gibbs' Prepared Statement on Civil Tax Penalties, Including Executive Summary of Report by IRS Task Force on Civil Penalties, Hearing Before the House Ways and Means Oversight Subcommittee (Feb. 21, 1989), *reprinted in* 34 DTR L-18, 1989 (Feb. 22, 1989).

15 The IRS incorporated these principles into Policy Statement P-1-18 (Aug. 20, 1998).

16 The discussion in this section is drawn, in large part, from the IRS Task Force Reports.

17 *See, e.g.*, Task Force Report III at 13. Various studies support this conclusion. *See, e.g.*, Kim M. Bloomquist, *Income Inequality and Tax Evasion: A Synthesis*, Second Edition of the OECD Jan Francke Tax Research Award (Mar. 20, 2003) (citing studies suggesting that growing dissatisfaction with the tax system and the perception of unfair treatment may be causes of noncompliance).

not everyone is similarly situated.[18] Rather, a horizontally equitable penalty does not apply to a taxpayer who puts forth the expected level of effort to comply, even if he or she did not actually succeed. Horizontal equity may require the IRS to evaluate factors such as the willfulness of the noncompliance, and the taxpayer's level of sophistication and prior compliance history, to determine if a penalty should apply.

These types of inquiries (*e.g.*, exceptions for "reasonable cause") are more important for more severe penalties. For example, the government does not inquire about mitigating circumstances or a person's state of mind before imposing a minor parking fine to the same extent that it does before sending the person to prison. These inquiries may also become more important when the substantive rules are so complex that the taxpayer could have unintentionally violated them without being negligent.[19]

Proportionality – "the punishment should fit the crime"

A fundamental constitutional principle, which also contributes to perceptions of fairness, is the concept of proportionality.[20] A proportionate penalty bears some relation to the culpability of the taxpayer and the harm caused by the infraction. Even if courts do not strike down a civil tax penalty on the grounds that it is disproportionate, the public is likely to regard a disproportionate penalty as unfair.[21]

Procedural fairness – don't "shoot first and ask questions later"

Even moderate penalties are perceived as unfair, arbitrary, or disproportionate when proposed against taxpayers that have not done anything wrong. Procedural fairness, thus, requires the government to avoid asserting penalties against taxpayers that have not violated

18 In 1998, when Congress urged the IRS to use its authority to compromise tax liabilities more liberally, allowing some taxpayers who failed to comply with the law to pay less tax than other taxpayers, it reiterated the belief that such compromises "enhance taxpayer compliance." H.R. Conf. Rep. 105-599, at 288-89 (1998) (stating that "[t]he Senate amendment provides that the IRS will adopt a liberal acceptance policy for offers-in-compromise to provide an incentive for taxpayers to continue to file tax returns and continue to pay their taxes.... The conferees believe that the ability to compromise tax liability ... enhances taxpayer compliance.").

19 *Accord* Restatement (Second) of Torts § 328D (2008) (permitting an inference of negligence in a civil context under the doctrine of *Res Ipsa Loquitur,* if among other things, the "event is of a kind which ordinarily does not occur in the absence of negligence ... [and] other responsible causes... are sufficiently eliminated by the evidence").

20 In a criminal context, the Eighth Amendment prohibition on cruel and unusual punishment prohibits sentences that are disproportionate to the crime. *See, e.g., Harmelin v. Michigan*, 501 U.S. 957 (1991) (recognizing limits on disproportionate sentences). In a civil context, courts also may strike down or reduce disproportionate punitive damages on due process grounds. *See, e.g., State Farm v. Campbell*, 538 U.S. 408 (2003). A fine may also violate the Excessive Fines Clause if it is "punishment" and grossly disproportionate when compared to the gravity of the offense. *See, e.g., United States v. Bajakajian*, 524 U.S. 321 (1998). Although the Supreme Court has suggested that it is very difficult for a penalty denominated as "civil" to rise to the level of a punishment, it may not have entirely closed the door on the possibility. *Compare United States v. Halper*, 490 U.S. 435, 447-48 (1989) (holding that a disproportionate civil penalty imposed after a conviction for the same conduct can constitute "punishment" in the context of double jeopardy) *with Hudson v. U.S.* 522 U.S. 93 (1997) (abrogating *Halper* on the basis that it "bypassed the traditional threshold question whether the legislature intended the particular successive punishment to be 'civil' or 'criminal' in nature;" the *Hudson* court placed more weight on whether the penalty was denominated as civil or criminal).

21 Even relatively high civil tax penalties have been upheld on constitutional grounds. *See, e.g., Helvering v. Mitchell*, 303 U.S. 391, 398-401 (1938) (concluding that the civil fraud penalty was not intended as punishment but as a remedial exaction to reimburse the government for the heavy expense of investigation and loss resulting from the taxpayer's fraud); *United States v. Alt*, 83 F.3d 779 (6th Cir. 1996) (same).

the rule.[22] Procedural fairness may sometimes require an IRS decision maker to communicate with the taxpayer and consider any mitigating facts and circumstances before assessing the penalty.[23] It may also require the IRS to provide taxpayers with an effective process for administratively appealing penalty assessments.[24]

Comprehensibility

To promote voluntary compliance, taxpayers of varying levels of education and limited amounts of time must be able to understand what conduct is expected, and how to compute the penalty for failure to meet the expectation.[25] The applicability of more than one penalty to the same conduct (*i.e.*, "stacking") can multiply any complexity. Penalties cannot promote voluntary compliance if taxpayers do not understand them.

Effectiveness

To be effective, a penalty must be severe enough to eliminate the noncompliance without being so severe as to be difficult to enforce or perceived as disproportionate or unfair. For some taxpayers, a nominal penalty is sufficient because of the social, personal, or moral stigma attached to a penalty of any magnitude. The possibility of triggering an audit or criminal investigation may provide additional deterrence in some cases. For other taxpayers, the penalty may need to impose costs that eliminate the expected economic benefits of noncompliance. In some cases, the potential for penalties may help tax advisors convince clients not to engage in aggressive transactions. For this group of taxpayers, a larger penalty may be needed if the noncompliance may go undetected. Regardless of a penalty's severity, it is likely to be more effective in encouraging remedial action if it is graduated (or reduced) based on the taxpayer's efforts to correct any initial noncompliance, provided such graduations do not produce excessive complexity.

Ease of administration

A penalty is administrable if it is easy for the IRS to determine when it should be imposed while still allowing the IRS to exercise discretion in determining whether to waive it. Such

22 *See* IRS Task Force Report II at L-18 (noting "the Task Force believes that, at the fringes, penalizing those who should not be penalized creates more negative attitudes and more problems than providing a slight tilt toward allowing some taxpayers who have violated a standard of behavior to avoid penalties").

23 As early as 1989, Congress recommended: "In the application of penalties, the IRS should make a correct substantive decision in the first instance rather than mechanically assert penalties with the idea that they will be corrected later." H.R. Conf. Rep. No. 101-386, at 661 (1989).

24 *See* IRS Task Force Report II at L-19 and L-20; IRS Task Force Report III at 13-15. According to the Supreme Court: "taxes are the lifeblood of government, and their prompt and certain availability an imperious need. Time out of mind, therefore, the sovereign has resorted to more drastic means of collection… [therefore] the statutes, in a spirit of fairness, invariably afford the taxpayer an opportunity at some stage to have mistakes rectified." *Bull v. U.S.*, 295 U.S. 247, 259-260 (1935).

25 Comprehensibility may also improve effectiveness, fairness, and ease of administration. For example, in a criminal context, due process requires that a penal statute define a criminal offense with sufficient definiteness that "ordinary people can understand what conduct is prohibited and in a manner that does not encourage arbitrary and discriminatory enforcement." *Kolender v. Lawson*, 461 U.S. 352, 357 (1983). The Supreme Court explained: "It would certainly be dangerous if the legislature could set a net large enough to catch all possible offenders, and leave it to the courts to step inside and say who could be rightfully detained, and who should be set at large. This would, to some extent, substitute the judicial for the legislative department of government." *Id.* at 358 n.7 (quoting *United States v. Reese*, 92 U.S. 214, 221 (1875)).

discretion is most important when the rule is complicated or the penalty is severe.[26] Overly detailed guidance or rigid rules regarding the assertion or waiver of a severe penalty may be difficult to administer or cause the IRS (or the judiciary) to use strained interpretations to reach a reasonable result in a given case. As a practical matter, IRS employees may find reasons not to enforce penalties perceived to be unfairly harsh. Such penalties are also difficult to administer, in part, because they lead to controversy, which drains IRS resources, limiting the number of taxpayers the IRS will be able to impose the penalty against.

The IRS Task Force Reports recognized that these four principles – fairness, comprehensibility, effectiveness, and ease of administration – were not always consistent with one another. Nonetheless, because the IRS had no quantitative data on the characteristics of penalties that best promote voluntary compliance, the reports applied these principles, which were developed with input from stakeholders, to identify improvements to the major civil tax penalties. In 1989, after extensive hearings,[27] Congress reformed information reporting penalties, accuracy-related penalties, preparer, promoter, and protester penalties, and penalties for failure to file, pay, withhold, and make timely tax deposits.[28]

Penalty reform efforts in the late 1990s

In 1998, Congress required the Joint Committee on Taxation (JCT) and the Secretary of the Treasury to obtain comments from the public and make legislative and administrative recommendations to simplify penalty and interest provisions, reduce taxpayer burden, and ensure the provisions promote voluntary compliance.[29] These analyses were based on many of the same principles established by the IRS Task Force Reports. Congress held

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26 A small strict liability penalty may be appropriate when the rule is simple, a violation is easy to identify, and the penalty is proportionate to the harm caused by the violation. For example, some banks automatically charge a nominal penalty when a customer bounces a check.

27 *See, e.g., Review of the Civil Penalty Provisions Contained in the Internal Revenue Code, Hearings Before the Subcommittee on Oversight of the Committee on Ways and Means*, 100th Cong., 2nd Sess. (Mar. 31, 1988); *Review of the Civil Penalty Provisions Contained in the Internal Revenue Code, Hearings Before the Subcommittee on Oversight of the Committee on Ways and Means,* 100th Cong., 2nd Sess. (July 28, 1988); *Recommendations for Civil Tax Penalty Reform and H.R. 2528 to Revise the Civil Penalty Provisions of the Internal Revenue Code of 1986, Hearings Before the Subcommittee on Oversight of the Committee on Ways and Means*, 101st Cong., 1st Sess. (Feb. 21, 1989); *Recommendations for Civil Tax Penalty Reform and H.R. 2528 to Revise the Civil Penalty Provisions of the Internal Revenue Code of 1986, Hearings Before the Subcommittee on Oversight of the Committee on Ways and Means*, 101st Cong., 1st Sess. (June 6, 1989).

28 *See* Omnibus Budget Reconciliation Act of 1989 (OBRA), Pub. Law No. 101-239 §§ 7701-7743 (Dec. 19, 1989). OBRA incorporated penalty reform legislation entitled the "Improved Penalty Administration and Compliance Tax Act" (IMPACT). *See* H.R. Conf. Rep. No. 101-386 at 647-55 (1989).

29 Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98), Pub. L. No. 105-206 (1998); H.R. Conf. Rep. No. 105-599 at 323 (1998) (requiring the reports to examine "whether the current penalty and interest provisions encourage voluntary compliance."). *See also* Notice 99-4, 1999-1 C.B. 318; Department of Treasury, Office of Tax Policy, *Report to the Congress on Penalty and Interest Provisions of the Internal Revenue Code* 13 (Oct. 1999) (hereinafter "Treasury Study"); Department of Treasury, *The Problem of Corporate Tax Shelters Discussion, Analysis and Legislative Proposals* (July 1999) (incorporated into the Treasury Study by reference); Joint Committee on Taxation, JCS-3-99, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1988 (Including Provisions Relating to Corporate Tax Shelters)* 3-9 (July 22, 1999) (hereinafter "JCT Study"). For a comparison of Treasury and Joint Committee recommendations, see Joint Committee on Taxation, JCX-79-99, *Comparison of Joint Committee Staff and Treasury Recommendations Relating to Penalty and Interest Provisions of the Internal Revenue Code* (Nov. 5, 1999).

hearings to discuss penalty recommendations, but did not enact sweeping reform as it had in 1989.[30]

Penalty philosophy in the early 2000s – a shift from voluntary compliance to economic deterrence

In the early 2000s, as the government redoubled its efforts to curb tax shelter activities, build up enforcement actions, and reduce the tax gap, its approach to penalties shifted. The IRS's policy of using penalties solely to enhance voluntary compliance, in part by "helping taxpayers understand" the proper standards of conduct, was replaced by a policy of ensuring that penalties are always developed and applied, especially if "a significant purpose" of the transaction was the avoidance or evasion of federal tax, as shown on the following table.

Table 1, A Comparison of IRS Penalty Policy Statements

Policy Statement P-1-18 (Aug. 20, 1998)	Policy Statement 20-1 (June 29, 2004)
Penalties support the Service's mission **only** if penalties enhance voluntary compliance. (Emphasis in original).	Penalties are used to enhance voluntary compliance.
... the Service will design, administer, and evaluate penalty programs **solely** on the basis of whether they do the best possible job of encouraging compliant conduct. (Emphasis added).	In order to make the most efficient use of penalties, the Service will design, administer, and evaluate penalty programs based on how those programs can most efficiently encourage voluntary compliance.
In the interest of an effective tax system, **the Service uses penalties to encourage voluntary compliance by**: (1) **helping taxpayers understand that compliant conduct is appropriate and that non-compliant conduct is not**; (2) deterring noncompliance by imposing costs on it; and (3) establishing the fairness of the tax system by justly penalizing the non-compliant taxpayer. (Emphasis added).	Penalties encourage voluntary compliance by: (1) demonstrating the fairness of the tax system to compliant taxpayers; and (2) increasing the cost of noncompliance.
	... examiners and their managers **must consider** the elements of each potentially applicable penalty and then fully develop the facts ... (Emphasis added).
	...Consistent development and proper application of ... [various penalties] in **abusive transaction** cases will help curb this activity by imposing tangible economic consequences.... An abusive transaction is one where a **significant purpose** of the transaction is the avoidance or evasion of Federal tax. (Emphasis added).
	...The Service **will fully develop accuracy-related or fraud penalties in all cases** where an underpayment of tax is attributable to a listed transaction.... (Emphasis added).
	In limited circumstances where doing so will promote **sound and efficient tax administration**, the Service may approve a reduction of otherwise applicable penalties or penalty waiver for a group or class of taxpayers as part of a Service-wide resolution strategy to **encourage efficient and prompt resolution of cases** of noncompliant taxpayers. (Emphasis added).[31]

30 *See, e.g., Hearing Before the House Ways and Means Subcommittee on Oversight on the Penalty and Interest Provisions in the Internal Revenue Code*, 106th Cong., 2nd Sess. (Jan. 27, 2000); *Hearing Before the House Ways and Means Committee on Corporate Tax Shelters*, 106th Cong. 1st Sess. (Nov. 10, 1999); *Hearing Before the Senate Finance Committee on Penalty and Interest Provisions in the Internal Revenue Code*, 106th Cong. 1st Sess. (Mar. 8, 2000), *at* http://www.senate.gov/~finance/w3-8-0.htm (last visited Dec. 16, 2008).

Because many tax practitioners believe every transaction that could benefit from tax advice involves "a significant purpose" of tax avoidance (as further discussed below), the IRS's current policy statement could encourage IRS employees to seek to impose penalties in more situations where taxpayers believe they have done nothing wrong.[32] During the same period, Congress enacted a number of new penalty provisions to address abusive transactions.[33] Given the recent shift in focus from voluntary compliance to deterrence, the enactment of new penalties, and the time that has elapsed since the last major penalty review, it may be helpful to reevaluate the penalty regime in light of the way in which the IRS is now administering penalties and principles set forth above.

Where does the data suggest we should focus penalty reform efforts today?

Other than looking at new or recently revised penalties, such as the substantial understatement penalty and the penalty for failure to properly report certain transactions to the IRS office of tax shelter analysis, it may be difficult to identify areas in need of reform without additional data on how penalties affect voluntary compliance.[34] Nonetheless, we do have some potentially relevant data, as discussed below.

Tax gap data

The largest parts of the tax gap result from taxpayers who:

- Underreport their income, accounting for $285 billion or about 83 percent of the gap;
- Do not pay taxes reported as due, accounting for $33.3 billion or about ten percent of the gap; and
- Do not pay amounts associated with unfiled returns, accounting for $27 billion or about eight percent of the gap.[35]

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31 Interestingly, one internal memo suggests that in the absence of express statutory authority to abate a penalty, any penalty abatement must be based on the IRS's determination that the abatement would promote voluntary compliance, rather than "sound and efficient tax administration" or an "efficient and prompt resolution of cases." Authority of the Commissioner to Waive/Abate Civil Tax Penalties (Mar. 1999).

32 *See, e.g.*, Nathan Giesselman, *A Significant Problem Defining a 'Significant Purpose' and the Significant Difficulties that Result*, 111 Tax Notes 1119 (June 5, 2006); Sheryl Stratton, *Lawyers Discuss Postshelter Assault on Privilege,* 2005 TNT 71-5 (Apr. 13, 2005).

33 For example, the American Jobs Creation Act of 2004 (AJCA), Pub. L. No. 108-357, 118 Stat. 1578 (Oct. 22, 2004), enacted or strengthened a number of penalties, such as the new penalties applicable to reportable transactions, and revisions to the accuracy-related penalty, among others. *See, e.g.*, IRC §§ 6707A, 6708, 6700, 6662A, 6662(d)(2)(C), and 6717. In addition, Pub. L. No. 110-28, Title VIII, § 8247(a), 121 Stat. 204 (2007) recently added IRC § 6676.

34 *See, e.g.*, IRC §§ 6707A, 6662(d)(2)(C).

35 *See* IRS, *Tax Gap Map for Year 2001* (Feb. 2007), *at* http://www.irs.gov/pub/irs-utl/tax_gap_update_070212.pdf (last visited Dec. 4, 2008) (providing estimates of the tax gap). These percentages do not equal 100 due to rounding. About 63 percent of all returns were signed by paid tax preparers in tax year 2006. IRS, *Tax Year 2006 Taxpayer Usage Study* (Aug. 24, 2007), *at* http://www.irs.gov/taxstats/article/0,,id=96629,00.html (last visited Dec. 4, 2008). These statistics may suggest that a focus on the tax gap may also require a focus on preparer penalties. However, this document does not focus on preparer penalties because of recent revisions to the preparer penalty rules. *See, e.g.*, Small Business and Work Opportunity Tax Act of 2007, Pub. L. No. 110-28 § 8246 (2007) (codified as amended at IRC § 6694); Tax Extenders and Alternative Minimum Tax Relief Act of 2008, Pub. L. No. 110-343 § 506 (2008) (same). *See also* NPRM REG-129243-07, 73 Fed. Reg. 34,560 (June 17, 2008) (rendered partially obsolete by Pub. L. No. 110-28). For prior recommendations in this area, see, *e.g.*, National Taxpayer Advocate 2003 Annual Report to Congress 270 (Key Legislative Recommendation, *Federal Tax Return Preparer Oversight and Compliance*).

This data may suggest penalty reform should focus on penalties for underreporting (called "accuracy-related" penalties), failure to pay, and failure to file.[36] However, it may be difficult to improve these or other penalties without additional information about whether and how they are effective in promoting voluntary compliance.

Litigation data

The following penalties are among the top ten most litigated tax issues in 2008:

- The accuracy-related penalty was the fifth most litigated issue, accounting for about nine percent of the cases.
- Failure to file and estimated tax penalty issues were the seventh most litigated issue, accounting for about seven percent of the cases; and
- The frivolous issues penalty was the ninth most litigated issue, accounting for about five percent of the cases.[37]

Notably, taxpayers prevailed, in whole or in part, in about 43 percent of the accuracy-related penalty cases when they were represented (more than in any other category) and in 17 percent of the cases when they were *pro se* (without counsel).[38]

Although penalties may be the frequent subject of litigation for many different reasons, the most successful penalties – those that deter noncompliance – should not need to be proposed or litigated very often. Frequent litigation could be a sign that taxpayers are not satisfied with the fairness of a penalty. Alternatively, the litigation may simply reflect frequent assessments (*e.g.*, the failure to file penalty) or assessments against taxpayers who often litigate (*e.g.*, frivolous issues penalty or accuracy-related penalties). Moreover, some penalties that need improvement may rarely be the subject of litigation because they are either too low to be a priority or too harsh for the government to enforce.

Assessment and abatement data

As shown in Table 4, *The Number of FY 2007 Assessments for Selected Civil Tax Penalties by Internal Revenue Code Section* in Appendix A, many penalties are rarely assessed. However, this data does not show whether they are really rarely imposed on a relative basis or how many transactions could have been subject to the penalty. Even if a penalty is rarely assessed on a relative basis, it may be difficult to determine if this is because taxpayers are complying with the rules or because the IRS is not enforcing them.

The ten most frequently assessed penalties, which are also frequently abated, are shown in the following table.

36 *See, e.g.*, IRC §§ 6662, 6651.

37 *See* Introduction to Most Litigated Issues, *supra*.

38 *Id.*

Table 2, Top Ten Civil Penalties Assessed During FY 2003-2005 and Abated as of March 2008[39]

	Assessed		Abated		Percent abated	
	Number	Amount ($1,000s)	Number	Amount ($1,000s)	Number	Amount
Failure to pay (§ 6651(a)(2), (3))	47,337,508	$11,001,879	5,877,006	$3,209,028	12%	29%
Failure to file (§ 6651(a)(1))	14,161,272	$12,570,853	1,873,190	$5,108,146	13%	41%
Failure to deposit (§ 6656)	7,742,953	$12,325,807	1,135,163	$7,780,072	15%	63%
Estimated tax – individual (§ 6654)	6,066,799	$1,761,347	388,184	$383,270	6%	22%
Bad check (§ 6657)	863,262	$115,642	45,766	$64,148	5%	55%
Accuracy-related (§ 6662)	729,808	$2,419,503	82,609	$906,309	11%	37%
Trust Fund Recovery (§ 6672)[40]	628,359	$6,050,255	313,896	$2,242,780	50%	37%
Failure to file info. returns (§ 6721)[41]	416,165	$7,295,919	162,688	$6,284,441	39%	86%
Estimated tax – corporate (§ 6655)	251,665	$382,596	25,243	$244,161	10%	64%
Daily delinquency (§ 6652(c))[42]	246,689	$712,338	179,686	$599,266	73%	84%
Other	86,879	$1,821,397	16,251	$1,206,338	19%	66%

It is difficult to draw conclusions from these figures alone, however. Although penalties that the IRS frequently assesses are not so severe or complicated that the IRS avoids proposing them, the frequency with which the IRS assesses a penalty is not necessarily meaningful unless it is adjusted to take into account the number of transactions that could potentially have been subject to the penalty and the number of transactions in which the IRS considered a penalty. Even if the IRS assesses a penalty frequently on a relative basis, however, it could still be too severe or too complicated for taxpayers who are inadvertently

39 IRS Enforcement Revenue Information System (ERIS) (Mar. 2008). Because additional abatements may be granted for FY 2003-2005 assessments after March 2008, these figures may understate the actual abatement rate.

40 According to the IRS, many of the Trust Fund Recovery Penalty abatements – 82 percent in FY 2006 – are actually adjustments to accounts because of payments on related responsible persons' assessments or on the underlying corporate trust fund liability. National Taxpayer Advocate 2007 Annual Report to Congress 404 (IRS response to Most Serious Problem, *Assessment and Processing of the Trust Fund Recovery Penalty*).

41 About 75.8 percent of these information return penalties are imposed pursuant to IRC § 6721(e) for intentional failures (*i.e.*, a continuing failure after a letter from the IRS) to file correct Forms W-2. IRS, ERIS (Sept. 2008). We do not discuss the information return penalty in the text below because it is largely an administrative problem resulting from the difficulty in tying information reported on employment tax forms such as Form 941, *Employer's Quarterly Federal Tax Return*, with similar information reported to employees and the Social Security Administration on Forms W-2 and W-3. For further discussion of this problem, see Most Serious Problem, *Inefficiencies in hte Administration of the Combined Annual Wage Reporting Program Impose Substantial Burden on Employers and Waste IRS Resources, supra.*

42 We do not discuss the "daily delinquency" penalty – the penalty for failure of an exempt organization to file an information return – in the text below because the IRS has recently taken a number of steps to address the problem. The National Taxpayer Advocate recommended legislation to establish a voluntary compliance program in her 2007 report. *See* National Taxpayer Advocate 2007 Annual Report to Congress 537 (Key Legislative Recommendation, *Require the IRS to Establish a Voluntary Compliance Program for Exempt Organizations*). The IRS agreed to do so and recently circulated draft procedures. *See* IRS, *FY 2008 Exempt Organizations Implementing Guidelines* 9 (Dec. 13, 2007); Fred Stokeld, *EO Division Close To Completing Voluntary Compliance Program*, 2008 TNT 179-14 (Sept. 12, 2008). In her 2006 report, the National Taxpayer Advocate also recommended increasing the EO information return filing threshold from $25,000 to $50,000. *See* National Taxpayer Advocate 2006 Annual Report to Congress 483-95 (Key Legislative Recommendation, *Increase the Exempt Organization Information Return Filing Threshold*). The IRS announced in December 2007 that it would raise the information return filing threshold to $50,000 beginning with the 2010 tax year. IRS News Release IR-2007-204, *IRS Releases Final 2008 Form 990 for Tax-Exempt Organizations, Adjusts Filing Threshold to Provide Transition Relief* (Dec. 20, 2007). In addition, recent changes to Form 990, *Return of Organization Exempt from Income Tax*, may affect daily delinquency penalty assessments and abatements.

violating the rule. Moreover, if taxpayers frequently violate the rule, the penalty may not be promoting voluntary compliance very effectively.

Penalties that the IRS frequently abates may benefit from reform, but high abatement rates are not conclusive evidence of a problem with the penalty. Frequent abatements could be evidence that the IRS is properly allowing taxpayers to demonstrate that they have a reasonable cause for violating the rule. Alternatively, the IRS may abate some penalties frequently if it is frequently abating underlying tax assessments. Thus, frequent penalty abatements could reflect a problem in the underlying tax assessment process.

On the other hand, some penalties the IRS frequently abates may need to be modified to promote more efficient administration and avoid burdening taxpayers and the IRS with unnecessary assessments. Frequent abatements could also be evidence that the IRS has difficulty determining when a taxpayer has violated a rule, or is taking shortcuts when making assessments.

When the IRS assesses and then abates a penalty, a taxpayer generally must produce factual information to justify the abatement, which the IRS must evaluate on a case-by-case basis. The data in Table 2, *Top Ten Civil Penalties Assessed During FY 2003-2005 and Abated as of March 2008*, above, show the percentage of dollars abated is generally higher than the percentage of penalties abated, suggesting that taxpayers more often obtain abatements when larger dollar amounts are at stake, perhaps because they are willing to expend more resources to do so. This data may suggest that taxpayers chose to pay small penalties rather than produce the documentation needed to obtain abatements, even if they would otherwise be eligible for them. If true, these penalties (or the IRS's administration of them) may violate notions of horizontal equity and procedural fairness.

However, an alternative explanation may be that larger entities, which would be more likely to trigger larger penalties, are more likely have a reasonable cause to excuse the violation than smaller taxpayers who are likely to have fewer resources devoted to tax compliance. If that is the case, perhaps we should be looking for ways to make compliance easier for small businesses and individuals.

Because we have no better data by which to measure the effect of penalties on voluntary compliance, this document focuses on selected penalties that rank highly based on these measures (*i.e.*, data on assessments, abatements, litigation, and the tax gap) and others that practitioners have identified as problematic. Our recommendations are summarized below.

Specific Recommendations

1. Prevent IRS systems from automatically assessing accuracy-related penalties without considering all of the facts and circumstances.

Problem[43]

IRS systems sometimes automatically assess certain accuracy-related penalties. Any apparent administrative efficiencies of this automated process may be illusory because of the downstream consequences and rework they often require. This rework drains resources that the IRS (and taxpayers) could use more productively. Consistently imposing a penalty may generally increase economic deterrence. However, the process of automatically imposing a penalty without sufficient inquiry and then abating it after receiving more information is unlikely to foster voluntary compliance.

While there may be instances where automatically assessing a penalty could be appropriate, such as when a taxpayer fails to pay amounts he or she reported as due, the negligence penalty requires a deeper inquiry into the taxpayer's specific facts and circumstances, as further described below. Indeed, an IRS employee generally may not assess a penalty unless his or her supervisor personally pre-approves the penalty in writing.[44] However, an IRS employee may assess certain penalties "automatically calculated through electronic means," such as those for the failure to file and pay without managerial approval.[45] The IRS interprets this exception as allowing its computers to automatically compute and propose the negligence penalty in connection with its Automated Underreporter (AUR) Program.[46]

Accuracy-related penalties may require a facts and circumstances inquiry

The accuracy-related penalty for negligence applies when a taxpayer fails to make a reasonable attempt to comply with the tax law.[47] Negligence generally involves the failure to use reasonable care by taking a position on a return which does not have a reasonable basis.[48] Negligence also arises if the taxpayer carelessly, recklessly, or intentionally disregards a rule

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43 For a more detailed description of the problem, including administrative recommendations, see National Taxpayer Advocate 2007 Annual Report to Congress 275.

44 IRC § 6751.

45 IRC § 6751(b)(2)(B). *See also* IRC § 6751(b)(2)(A) (providing that supervisory approval is not required before assessing the penalties for failure to file, failure to pay, failure by an individual to pay estimated income tax, or failure of a corporation to pay estimated income tax).

46 Memorandum from Martha Sullivan, Deputy Director, Compliance Policy, *Revision to Memorandum (Aug. 14, 2000) Restructuring and Reform Act of 1998 (RRA 98) Section 3306 – Managerial Approval and Notice Requirements of Penalties* (Apr. 24, 2001).

47 IRC § 6662(c); Treas. Reg. § 1.6662-3(b). There are a number of accuracy-related penalties. *See* IRC § 6662(b). However, because the negligence and substantial understatement penalties generate much more controversy than the other accuracy-related penalties, they are the focus of our discussion. *See* Most Litigated Issue, *Accuracy-Related Penalty Under Internal Revenue Code Sections 6662(b)(1) and (2), supra.*

48 IRC § 6662(c); Treas. Reg. § 1.6662-3(b)(3) ("negligence includes any failure to make a reasonable attempt to comply with the provisions of the internal revenue laws or to exercise ordinary and reasonable care in the preparation of a tax return....[It] also includes any failure by the taxpayer to keep adequate books and records or to substantiate items properly.").

or regulation without reasonable cause.[49] These determinations are based on the taxpayer's specific facts and circumstances.[50]

Automated processes do not consider all relevant facts and circumstances.

As part of the AUR program, IRS systems compare income reported by third parties on information returns (*e.g.*, Form 1099, *U.S. Information Return*) to the income reported by taxpayers on tax returns.[51] These systems send notices to taxpayers, explaining the discrepancy between the information provided by the taxpayer and the information reflected on a third party's information return. If the taxpayer fails to respond to the notice and has a mismatch (*e.g.*, failure to report income shown on an information return) in more than one year (*e.g.*, a prior year and the current year), the AUR program automatically assesses a negligence penalty (after sending a notice of deficiency) without evaluating any other facts or circumstances.[52]

Mismatches are poor indicators of negligence.

These mismatches occur fairly frequently in situations where no penalty is warranted. Most taxpayers respond to the notice and provide documentation sufficient to demonstrate to the IRS that the penalty does not apply. In FY 2007, the IRS actually assessed only about 37 percent of the accuracy-related penalties initially proposed through the AUR program because taxpayers provided such documentation.[53]

Automated penalty assessments need to be abated more often than manual penalty assessments. In FY 2007, the IRS abated about 16 percent of the accuracy-related penalty assessments it made using the automated AUR program, compared to only approximately three to six percent of assessments it made using less automated processes.[54] This data may suggest AUR systems propose unjustified accuracy-related penalties more frequently than IRS employees, in contravention of the principles of procedural fairness and efficiency described above.[55] Further, when represented taxpayers disputed the accuracy-related penalty in court, they prevail, at least in part, in about 43 percent of the cases decided during the

49 Treas. Reg. § 1.6662-3(b)(2).

50 *See, e.g.*, Treas. Reg. § 1.6664-4(b)(1).

51 *See* IRM 4.19.3.1 (Sept. 1, 2008).

52 *See generally* IRM 4.19.3.16.7 (Sept. 1, 2008) (noting that the AUR program automatically computes the negligence penalty); IRM 4.19.7.8.22.18 (Sept. 1, 2007) (same); IRM 4.19.3.20.1.4(3) (Sept. 1, 2008) (explaining that the penalty is automatically imposed without managerial review if the taxpayer does not explain an information reporting discrepancy occurring in more than one year). *See also* National Taxpayer Advocate 2007 Annual Report to Congress 275-86 (further describing the automated AUR processes).

53 IRS response to TAS information request (Oct. 20, 2008) (providing SB/SE data for tax year 2005 which corresponds to FY 2007, the most recent period for which full-year data is available); IRS response to TAS information request (Oct. 17, 2008) (providing similar W&I data).

54 IRS response to TAS information request (Oct. 20, 2008); IRS response to TAS information request (Oct. 17, 2008). About three percent of the assessments resulting from field examinations and about six percent of the assessments resulting from correspondence examinations were abated. *Id.* These are less automated processes than AUR.

55 This process seems inconsistent with conference report to the 1989 OBRA, quoted above, which recommended the IRS "make a correct substantive decision in the first instance rather than mechanically assert penalties with the idea that they will be corrected later." H.R. Conf. Rep. No. 101-386, at 647-65 (1989).

period beginning on June 1, 2007 and ending on May 31, 2008.[56] In addition, the resources required to manually correct unjustified computer assessments and, if necessary, litigate them in court, reduce the resources the IRS can use to assess penalties in instances where they are justified.

Example[57]

For two years, a taxpayer who was experiencing financial difficulties negotiated with lenders to cancel certain debts. The lenders reported the cancelled debts on Form 1099-C in both years. Because of certain technical rules, the taxpayer was not required to report the cancellations as income.[58] However, the IRS's AUR program detected the two mismatches and sent the taxpayer a letter proposing additional tax as well as the negligence penalty. Because of his financial difficulties, the taxpayer moved and did not receive the AUR notice. IRS computers automatically assessed additional tax and the 20 percent accuracy-related penalty.

Recommendation

Amend IRC § 6751 to prevent the IRS from automatically assessing accuracy-related penalties without managerial review. This change would apply the same rule to accuracy-related penalties that applies to penalties that are not "automatically calculated through electronic means."[59]

2. Consider the feasibility of clarifying the definition of a "tax shelter" for purposes of the substantial understatement penalty.

Problem

For purpose of the substantial understatement penalty rules, a "tax shelter" is broadly defined to include any partnership, entity, investment plan or arrangement having "a significant purpose" of tax avoidance or evasion.[60] Prior to 1997, a "tax shelter" had to have

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56 Most Litigated Issue, *Accuracy-Related Penalty Under Internal Revenue Code Section 6662(b)(1) and (2), supra.*

57 This is a hypothetical example is drawn from the IRS's procedures for handling information returns that reflect cancellation of indebtedness income. For a more complete discussion of these issues, see National Taxpayer Advocate 2007 Annual Report to Congress 13 (Most Serious Problem, *Understanding and Reporting the Tax Consequences of Cancellation of Debt Income).*

58 *See generally* IRC § 108.

59 *See* IRC § 6751(b)(2)(B).

60 IRC § 6662(d)(2)(C).

"the principal purpose" of tax avoidance or evasion.[61] Given the government's subsequent experience with these rules and legislative responses to abuses that it has identified, the government should evaluate whether it is now feasible to provide additional guidance about what constitutes a tax shelter, especially given the consequences of existing uncertainty, as further described below.

Unlike the negligence penalty, the substantial understatement penalty may apply even if the taxpayer makes a reasonable attempt to comply if he or she fails by a significant margin.[62] If the IRS finds an understatement of sufficient magnitude, the penalty generally applies unless the understatement is attributable to (1) undisclosed tax positions for which there was "substantial authority,"[63] or (2) disclosed positions with respect to which there was a "reasonable basis."[64] These exceptions provide an incentive for taxpayers to ensure that with respect to every position on their returns, they either have substantial authority or make a special disclosure to the IRS.

These exceptions, however, do not apply to "tax shelters."[65] Therefore, the substantial understatement penalty does not provide the same good incentives for taxpayers to find substantial authority for or disclose transactions the IRS might characterize as tax shelters.

61 The Taxpayer Relief Act of 1997, Pub. L. No. 105-34 § 1028(c)(2) (Aug. 5, 1997) substituted the phrase "a significant purpose" for "the principal purpose." This change was made to conform the definition of tax shelter in the accuracy-related penalty rules with a new definition provided in the "reportable" transaction rules – transactions subject to special reporting requirements. H.R. Conf. Rep. No. 105-220, at 541-42 (1997). To be treated as a tax shelter under the reportable transaction rules, however, a transaction also had to be offered to potential participants under conditions of confidentiality and the promoter had to receive fees in excess of $100,000. IRC § 6111(d) (before amendment in 2004 by Pub. L. No. 108-357). Congress later eliminated specific reference to transactions with "a significant purpose" in the reportable transaction rules. The American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 815(a) (Oct. 22, 2004) defined tax shelters for purposes of the reportable transaction rules by reference to "reportable" transactions under new IRC § 6707A(c), which now simply cross references Treasury regulations under IRC § 6011. Those regulations do not use the term "a significant purpose." *See* Treas. Reg. § 1.6011-4. However, both the accuracy-related penalty applicable to "reportable" transactions and the regulations governing practitioners (called Circular 230) now also use the phrase "a significant purpose" of tax avoidance, without providing any clarifying guidance as to its meaning. *See* IRC § 6662A; Treasury Department Circular No. 230 § 10.35 (Rev. 4-2008).

62 It applies when the amount of tax that the taxpayer reported differs by the greater of $5,000 or ten percent from the correct amount of tax that the taxpayer should have reported. IRC § 6662(d). If the IRS establishes that a taxpayer was both negligent and substantially understated the tax, the maximum accuracy-related penalty is capped at 20 percent of the understated tax. IRC § 6662(a).

63 According to regulations:

> The substantial authority standard is less stringent than the more likely than not standard (the standard that is met when there is a greater than 50-percent likelihood of the position being upheld), but more stringent than the reasonable basis standard ... the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment." Treas. Reg. § 1.6662-4(d)(2).

These regulations specifically identify the types of authorities that can establish substantial authority.

64 IRC § 6662(d)(2). By "undisclosed," we do not mean the position was unreported. It may have been plainly reflected on the face of the return. Rather, we use the term "undisclosed" to refer to situations where the taxpayer did not take additional steps to make a special disclosure. *See, e.g.*, Treas. Reg. § 1.6662-4(f). According to regulations:

> Reasonable basis is ... significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. If a return position is reasonably based on one or more of the authorities set forth in § 1.6662-4(d)(3)(iii) (taking into account the relevance and persuasiveness of the authorities, and subsequent developments), the return position will generally satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard.... Treas. Reg. § 1.6662-3(b)(3).

65 IRC § 6662(d)(2)(C).

As noted above, "tax shelters" are broadly defined as any partnership, entity, investment plan, or arrangement having "a significant purpose" of tax avoidance.[66] Since tax minimization (or avoidance) is the point of most tax advice, the term "a significant purpose" of tax avoidance does not help taxpayers identify transactions that can reasonably be called tax shelters. Articles in the press suggest that the tax practitioner community is confused.[67] As a result, the tax shelter exception dilutes the good incentives created by the substantial understatement penalty for all taxpayers. Well-advised taxpayers may decide there is no point in paying an advisor to determine if there is "substantial authority" for their return positions, or to disclose questionable transactions to the IRS, if penalties may apply in any event. Any incentive for these taxpayers to flag questionable issues for the IRS in order to avoid a penalty will decline if taxpayers and their advisors believe such disclosures may increase the risk of an audit without reducing the risk that a penalty will apply.

Other taxpayers have no idea they have engaged in transactions that could be considered tax shelters and are likely to feel unfairly penalized, especially if they had substantial authority for a position ultimately determined to be a tax shelter. The definition of a tax shelter should not be so broad that taxpayers become tax shelter investors by reason of claiming tax benefits that Congress intended them to have. A taxpayer should not have to wonder if he or she will be accused of participating in a tax shelter by reason of hiring an independent contractor, deducting a contribution to charity, opening an IRA, or buying a house and deducting the interest. Thus, additional guidance might improve the substantial understatement penalty's effectiveness by encouraging appropriate disclosures and also reduce the potential for arbitrary enforcement against taxpayers who have no idea the IRS might conclude they have invested in tax shelters.

The idea that we should subject tax shelters to heightened standards of conduct, but define them vaguely to deter taxpayers from taking any aggressive positions, has superficial appeal. However, vague standards do not provide appropriate guidance for unsophisticated taxpayers and are also difficult for IRS employees to administer. As a result, penalties for

66 IRC § 6662(d)(2)(C). A taxpayer must also determine the meaning of this phrase to identify the level of certainty required to avoid a penalty with respect to a "reportable" transaction – a type of transaction identified by the IRS as having the potential for tax avoidance – because a separate accuracy-related penalty may apply to reportable transactions that have "a significant purpose" of tax avoidance. IRC § 6662A(b)(2). In addition, the reasonable cause and good faith defense is not applicable to reportable transaction understatements unless the taxpayer made special disclosures with respect to them, had substantial authority for the position, and reasonably believed that his or her position was more likely than not correct. IRC § 6664(d)(2).

67 *Compare Nathan Giesselman, A Significant Problem Defining a 'Significant Purpose' and the Significant Difficulties that Result*, 111 Tax Notes 1119 (June 5, 2006) (voicing confusion about the meaning of "a significant purpose" after analyzing its meaning in various code and regulation sections, and concluding that it could be interpreted broadly) Sheryl Stratton, *Lawyers Discuss Postshelter Assault on Privilege*, 2005 TNT 71-5 (Apr. 13, 2005) (reporting one practitioner as stating that "[o]ne of the most troublesome aspects of defining a tax shelter [which is carved out of the accountant's privilege under IRC § 7525 by cross reference to IRC § 6662(d)] as any transaction that has as a significant purpose the avoidance of tax is that all meetings with tax advisers have a significant purpose of tax avoidance"), *and* Gregory M. Fowler, *The Valero Cases: New Meaning for 'Significant Purpose' Definition?*, 121 Tax Notes 677 (Nov. 10, 2008) (noting that more "prudent boundaries" would be helpful) *with* Kip Dellinger, *Circular 230: How Broad Is the Scope of 'Significant Purpose'?* 111 Tax Notes 1503 (June 26, 2006) (speculating that practitioners may be overreacting because the phrase "a significant purpose" could be interpreted narrowly, at least in the context of Circular 230). As the administration's 2009 budget proposal acknowledges, "the determination as to whether a transaction has a significant purpose of tax avoidance or evasion is inherently subjective to the taxpayer…" Treasury Department, *General Explanations of Revenue Proposals in Administration's Fiscal Year 2009 Budget* 93 (Feb. 2008), *at* http://www.treas.gov/offices/tax-policy/library/bluebk08.pdf (last visited Dec. 16, 2008).

failing to meet a vague standard are more likely to be enforced inconsistently. If these penalties are enforced, taxpayers are likely to feel they are being singled out and unfairly and disproportionately penalized, which may reduce respect for the tax system and increase costly litigation. An overly broad definition may also eliminate any stigma associated with the term "tax shelter."

Example

A small business taxpayer hired workers under terms that it believed caused them to be treated as independent contractors rather than employees for federal income tax purposes.[68] An IRS examiner might reasonably believe "a significant purpose" of the "arrangement" was to "avoid" taxes. As a result, an examiner could take the position that the arrangement is a "tax shelter" for purposes of the substantial understatement penalty, and that any substantial authority for the taxpayer's position and any special disclosure to the government could not be used as a defense.[69]

This interpretation would reduce the incentive for taxpayers to disclose positions for which they are unsure. Moreover, another examiner might view a similar arrangement implemented by a competitor as one that does not have "a significant purpose" of tax avoidance because there is little guidance regarding the meaning of "significant," especially if the tax purpose of the arrangement could be viewed as insignificant when compared to the non-tax business purposes. Such inconsistent enforcement would violate horizontal equity principles.

Recommendation

Consider the feasibility of defining "tax shelter" (or "a significant purpose" of tax avoidance) more specifically.[70]

3. Restructure the penalty for failure to file a "reportable transaction" information disclosure.[71]

Problem

Every taxpayer that has participated in a "reportable" transaction and who is required to file a tax return must file a Form 8886, *Reportable Transaction Disclosure Statement,* with the return and send a copy to the IRS Office of Tax Shelter Analysis.[72] The definition of a reportable transaction includes transactions that are not necessarily aggressive, such as transactions that result in significant losses, are subject to conditions of confidentiality, or

68 For a discussion of the difficulties in making the determination regarding whether a worker is an employee or an independent contractor and recommendations for reform, see Legislative Recommendation, *Worker Classification, supra.*

69 To qualify for abatement, the taxpayer would need to demonstrate that the reasonable cause and good faith exception applied. IRC § 6664(c).

70 The guidance could also clarify the meaning of "a significant purpose" under IRC § 6662A and in Circular 230.

71 A similar recommendation is include in volume I of this report. *See* Legislative Recommendation, *Modify Internal Revenue Code Section 6707A to Ameliorate Unconscionable Impact, supra.*

72 Treas. Reg. § 1.6011-4(a); Treas. Reg. § 1.6011-4(e).

are "listed" – transactions that are the same as or *substantially similar* to one of the types of transactions that the IRS has identified (or "listed") in published guidance.[73] Taxpayers who do not satisfy these information reporting requirements may be subject to penalties ranging from $10,000 to $200,000.[74] Public companies may also be required to report these penalties in any public filings.[75]

Because it is sometimes difficult for taxpayers to determine if one transaction is "substantially similar" to another or otherwise reportable, some taxpayers may be reasonably unaware they are subject to this special information reporting requirement. They may be particularly surprised if they believe they are properly claiming legitimate tax benefits as intended by Congress. Other taxpayers may fail to contemplate that run-of-the-mill transactions properly and fully reported to the IRS on tax return forms designed by the IRS, or otherwise expressly disclosed to the IRS on special disclosure forms for use in avoiding accuracy-related penalties (described above), may be subject to additional reporting requirements, sometimes long after the return is due (*e.g.*, when the IRS "lists" a transaction for the first time).[76] They may also be surprised that no statute of limitations applies to the failure.[77]

In fact, if a transaction correctly reported on a return later becomes a reportable transaction (*e.g.*, because it is substantially similar to a transaction that the IRS decides to "list" or because the transaction ultimately results in a loss of significant magnitude), then the taxpayer is subject to the special reporting requirements at that time.[78] To comply, taxpayers must continually monitor the IRS's list of transactions along with a list of all of the transactions they have participated in to determine if they need to provide the IRS with additional disclosures potentially with respect to run-of-the-mill transactions that were properly reported on a tax return.

The IRS has a policy of fully developing the penalty for failure to comply with these special reporting requirements, and the IRS is not authorized to abate the penalty if it relates to a

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73 Treas. Reg. § 1.6011-4(b). The regulations explain:

> The term substantially similar includes any transaction that is expected to obtain the same or similar types of tax consequences and that is either factually similar or based on the same or similar tax strategy. Receipt of an opinion regarding the tax consequences of the transaction is not relevant to the determination of whether the transaction is the same as or substantially similar to another transaction. Further, the term substantially similar must be broadly construed in favor of disclosure. For example, a transaction may be substantially similar to a listed transaction even though it involves different entities or uses different Internal Revenue Code provisions. Treas. Reg. § 1.6011-4(c)(4).

74 IRC § 6707A. The penalty for failure to report a "listed" transaction is $100,000 for natural persons and $200,000 for other taxpayers. IRC § 6707A(b)(2). In the case of other types of "reportable" transactions, it is $10,000 for natural persons and $50,000 for other taxpayers. IRC § 6707A(b)(1). Reportable transactions may also be subject to greater substantial underpayment penalties of 20 percent for transactions that are properly disclosed and 30 percent for those that are not. *See* IRC § 6662A.

75 IRC § 6707A(e).

76 For example, a taxpayer may specifically disclose positions contrary to administrative guidance on Form 8275, *Disclosure Statement*, and positions contrary to regulations on Form 8275-R, *Regulation Disclosure Statement*. These disclosures do not satisfy the "reportable transaction" disclosure requirements. *See* Treas. Reg. § 1.6011-4(d) (requiring taxpayers to include disclosure on "Form 8886, 'Reportable Transaction Disclosure Statement' (or a successor form)" with the return and also to send a copy to the Office of Tax Shelter Analysis (OTSA)"); Prop. Treas. Reg. § 1.6011-4(e)(2)(iii).

77 *See* IRC § 6501(c)(10); Rev. Proc. 2005-26, 2005-1 C.B. 965.

78 Treas. Reg. § 1.6011-4(e).

listed transaction.[79] So, IRS employees have little discretion in administering the penalty.[80] Moreover, if a taxpayer engaged in a transaction using a flow-through entity such as an S corporation, he or she could be subject to the penalty at both the individual and entity levels.[81]

Example

In 2004, a small business owned by an individual and operated through an entity purchased a life insurance policy. Like many policies, this one was touted as having certain tax benefits, which were worth about $45,000 over three years. Although the taxpayer was reasonably diligent in evaluating the transaction, he was unaware that it was substantially similar to a listed transaction and subject to special reporting requirements. Consequently, he did not file Form 8886, *Reportable Transaction Disclosure Statement*, with his return or send a copy to the IRS Office of Tax Shelter Analysis. On audit, although the IRS did not disallow the tax benefits with respect to the insurance, it determined the transaction was subject to the special reporting requirements applicable to listed transactions. Because he did not file Form 8886, the taxpayer was subject to a $900,000 penalty, consisting of three $200,000 penalties at the entity level and three $100,000 penalties at the individual level.[82] The IRS would like to abate the penalties, but is not authorized to do so.

This penalty is unlikely to promote the ultimate goal of increasing voluntary compliance under the circumstances described above. A $900,000 penalty for a failure to specifically identify a transaction that generated a $45,000 tax benefit and was correctly reported on the taxpayer's return can reasonably be viewed as disproportionate. Not even the 75 percent accuracy-related penalty applicable to tax fraud is this severe.[83]

In addition, after reasonable diligence the taxpayer did not know that the transaction was subject to special information reporting. Because the penalty is not subject to a reasonable cause exception, it does not treat taxpayers who made similar efforts to comply similarly – those who fail through no fault of their own are penalized to the same extent as those who intentionally fail disclose a transaction – arguably failing to achieve horizontal equity.

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79 *See* Policy Statement 20-1 (June 29, 2004) (providing that "examiners and their managers must consider the elements of each potentially applicable penalty and then fully develop the facts to support the application of the penalty, or to establish that the penalty does not apply, when initial consideration indicates that penalties should apply."); Memorandum for all SB/SE Examination Personnel, from Director Examination, SBSE-04-0808-039, *Interim Guidance on Applying §6707A Penalty*, Attachment 1, Processing Procedures for IRC § 6707A Penalty, § III(F)(7) (Sept. 5, 2008) (stating "The § 6707A penalty has no reasonable cause exception and the penalty must be developed wherever it appears legally applicable"); IRC § 6707A(d). *See also* Memorandum for Large and Mid-Size Business Division Executives, Managers, & Examiners from Commissioner, Large and Mid-Size Business Division, *Consideration of Penalties in Listed Transactions and other Abusive Tax Shelter Cases* (instructing that "[i]n all cases in which there is an underpayment attributable to a listed transaction, the Director of Field Operations (DFO) must approve the decision to impose or not to impose the accuracy-related penalty.").

80 The IRS has a process for seeking rescission of the penalty with respect to reportable transactions that are not listed. *See, e.g.*, Temp. Treas. Reg. § 301.6707A-1T; Rev. Proc. 2007-21, 2007-1 C.B. 613.

81 *See, e.g.*, Prop. Treas. Reg. § 1.6011-4(c)(3).

82 The failure to make special disclosures with respect to a "listed transaction" is subject to a $100,000 penalty for individuals and a $200,000 penalty for entities. IRC § 6707A(b)(2). A "listed transaction" is a transaction that is "[t]he same as or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of section 6011." IRC § 6707A(c)(2).

83 *See* IRC § 6663.

Because we are aware of instances in which the IRS is seeking the penalty even against taxpayers who timely filed Form 8886, either because they did not file it in two places or because it did not contain enough specific information about the transaction, there may be little incentive for some taxpayers to file this form in the first instance. Moreover, the penalty provides no relief to taxpayers who inadvertently failed to meet the initial disclosure deadline to file a late disclosure. With no possibility that the failure will be waived on the basis of reasonable cause and no opportunity to mitigate the penalty by filing late, the penalty provides little incentive to do so. Rather, some delinquent taxpayers may simply hope they will not be audited. As a result, the penalty may reduce rather than increase voluntary compliance, especially for taxpayers who inadvertently fail to file a timely reportable transaction disclosure statement or inadvertently fail to file it in two places.

Recommendations

A. Authorize the IRS to waive the penalty under IRC § 6707A for failure to file the special disclosure with respect to listed transactions based on a showing of reasonable cause and good faith or another appropriate standard, at least if the taxpayer is not a publicly traded entity.[84]

B. Consider ways to prevent "stacking" of multiple penalties under IRC § 6707A on closely related taxpayers who fail to report a single transaction on multiple returns for the same reasons. One alternative would be to place a cap on the penalty for failure to report the same transaction, whether the failure is associated with multiple returns of closely related taxpayers or with more than one return reporting period. One option for implementing a cap would be to apply only one penalty for the first year of the failure and then apportion it among the group of related taxpayers rather than applying a separate penalty against each taxpayer for each period. Another option would be to apply a penalty cap to each taxpayer. An appropriate cap might be 75 percent of the underpayment for the year in which an information return was required – the penalty that would apply to a fraudulent failure to file.[85] Any of these changes would help to reduce the type of stacking illustrated above, and make the penalty more proportionate to the noncompliance.

C. Reduce or eliminate the IRC § 6707A penalty in cases where the transaction was reported on the taxpayer's return and the IRS does not propose to disallow the tax benefits of the transaction on audit. The failure to file a special disclosure with respect to a transaction that the government does not find abusive is more damaging to the tax

84 The IRS is authorized to rescind the penalty for reportable transactions other than listed transactions if it determines that rescinding the penalty would promote compliance and effective tax administration. *See* IRC § 6707A(d). While horizontal equity principles suggest that no taxpayer with a reasonable cause should be subject to such a severe penalty, we recognize that Congress enacted this strict liability penalty to address abusive tax shelter activity, especially for large publicly traded entities. This goal can be accomplished by retaining the strict liability standard for publicly traded entities. This change should not undercut the effectiveness of the penalty because those non-public taxpayers who are actively playing the "audit lottery" would not have a reasonable cause for failing to disclose reportable transactions. Any willful failure would also remain subject to the penalty for fraud, and possibly even criminal sanctions. *See, e.g.*, IRC § 6651(f) (fraudulent failure to file); IRC § 6663 (fraudulent underpayment); IRC § 7201 (criminal sanction for willful tax evasion); IRC § 7203 (criminal sanction for willful failure to file, report, or pay).

85 *See* IRC § 6651(f).

system than the failure to make such a disclosure with respect to an abusive transaction. This change would also help to make the penalty easier to administer and more proportionate to the seriousness of the noncompliance. It would be unnecessary, however, if we capped the penalty at 75 percent of any underpayment attributable to the transaction, because there would be no underpayment.

4. Improve the proportionality and effectiveness of the failure to file penalty for those who are more than six months late.

Problem

A taxpayer who files late (or not at all) is subject to a penalty equal to five percent of the net amount of unpaid tax for each month that the return is late for up to five months and a maximum of 25 percent.[86] As a result, a taxpayer filing six months late is subject to the same penalty as a taxpayer who files one year late or not at all. About 53 percent of all late filers for tax year (TY) 2006 filed from six to 13 months late, as shown in the following table.

Table 3, Length of Delinquency by TY 2006 Late Filers[87]

Months	Count	Percent[88]
1	216,186	17
2	108,101	8
3	59,328	5
4	59,603	5
5	51,692	4
6	77,562	6
7	71,030	5
8	43,613	3
9	70,612	5
10	71,831	6
11	75,510	6
12	140,447	11
13	142,328	11
14	50,506	4
15	41,801	3
16	24,361	2
Total	**1,304,511**	

86 IRC § 6651(a)(1); IRC § 6651(b)(1) (addressing the net amount computation). If the failure to file is fraudulent, the penalty is increased to 15 percent per month, up to a maximum of 75 percent. IRC § 6651(f). Information returns, estimated tax payments, and partnership returns are subject to separate rules. *See, e.g.*, IRC § 6031(a) (partnership returns); IRC § 6721 (information returns).

87 IRS Compliance Data Warehouse (Oct. 9, 2008) (Tax Year 2006 returns received after April 15, 2007 as of August 2008 that were subject to a failure to file penalty). This data does not include nonfilers.

88 Percentages may not equal 100 due to rounding.

The penalty could be more effective if it provided an incentive for taxpayers who are more than five months late to file a return promptly.[89] Principles of proportionality and effectiveness suggest that longer delinquencies should be penalized more severely than short ones.

One response might be to eliminate the cap on the failure to file penalty. However, increasing the penalty (or the cap) could encourage some late filers to become nonfilers, especially if filing would trigger an assessment that would be difficult to pay. Practitioners have suggested that an inability to pay the tax required to be shown on the return is one reason that some taxpayers avoid filing.[90] Moreover, some taxpayers may have the perception that the IRS is more likely to detect late filing than nonfiling.[91] This perception may increase the incentive for taxpayers to avoid filing returns reflecting assessments they cannot pay. Because the number of nonfilers exceeds the number of late filers by more than six to one, even a small percentage increase in nonfilers could eliminate the benefits of encouraging late filers to file earlier.[92] The challenge is to structure the penalty to provide a continuing incentive for taxpayers to file returns that are more than five months late without increasing the incentive to avoid filing altogether.

Example

Assume a taxpayer with a net amount due of $1,000 does not file a return (or seek a filing extension) within six months after the due date. The failure to file penalty does not increase even if the taxpayer files one year late or never files at all.

Recommendation[93]

Revise the failure to file penalty so that it is more proportionate to the length of the delinquency, without increasing the rate to such an extent that the penalty itself discourages filing. One approach might be to retain the five percent per month penalty for the first three months of the delinquency and then apply a one percent per month rate for the next ten months (rather than five percent per month for the next two months) until reaching the maximum at 13 months. As noted above, most late filers for TY 2006 were from six to 13 months late. This change would provide an incentive for those late filers to file earlier.

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89 The Treasury Department has recommended that the failure to file penalty be reduced to 0.5 percent for the first six months, and one percent a month thereafter, up to a maximum of 25 percent to provide a continuing incentive for taxpayers to file. Department of Treasury, Office of Tax Policy, *Report to the Congress on Penalty and Interest Provisions of the Internal Revenue Code* 67 (Oct. 1999).

90 SB/SE Research, Project 04.01.014.06, *Literature Review and Preliminary Recommendations on Measuring the Impact of Outreach on Non-filers* 10 (Jan. 2006) (internal citations omitted).

91 Some tax researchers refer to nonfilers as "ghosts" because of the IRS's difficulty in identifying them. *See* SB/SE Research, Project 04.01.014.06, *Literature Review and Preliminary Recommendations on Measuring the Impact of Outreach on Non-filers* 8-10 (Jan. 2006) (internal citations omitted).

92 IRS Compliance Data Warehouse (Oct. 9, 2008) (reflecting 1,304,511 late filers for TY 2006 as of August 2008); W&I, Payment Compliance, Response to TAS information request (Oct. 16, 2008) (indicating there were 8,402,579 nonfilers for TY 2006 as of November 2007).

93 The National Taxpayer Advocate previously recommended a one-time abatement of the failure to file and failure to pay penalties for first-time filers and taxpayers with a history of consistent compliance and no countervailing factors, see National Taxpayer Advocate 2001 Annual Report to Congress 188. This recommendation was included in the House-passed Taxpayer Protection and IRS Accountability Act of 2003, but did not become law. *See* H.R. 1528, 108th Cong. § 106 (2003). The IRS recently issued administrative guidance adopting this recommendation with respect to failure to file, failure to pay, and failure to deposit penalties. *See* IRM 20.1.1.3.5.1 (Feb. 22, 2008) (first time abatement (FTA) guidance).

5. Reduce the penalty for late filers who timely pay within a period of extension.

Problem

A late filer may be subject to an unexpected and disproportionate penalty for failure to file if he or she timely pays his or her tax in full on extension (*i.e.,* after the date initially prescribed for payment but within the period of extension). The five percent per month failure to file penalty is generally based on the amount of any net unpaid tax.[94] The net unpaid tax is the amount of tax required to be shown on the return (net of any credit that may be claimed on the return), reduced by the amount paid on or before the "date prescribed for payment."[95] So if a taxpayer timely pays his or her tax in full by the original due date, no failure to file penalty applies. In this way, the failure to file penalty is proportionate to the harm to the tax system of not filing. The failure to file presents more harm to the tax system when the taxpayer has not fully and timely paid all of the tax required to be shown as due. If he or she has fully paid the tax, the failure to file a return is analogous to the failure to file an information return.

However, significantly different rules apply when a taxpayer fully and timely pays the tax required to be shown as due pursuant to a valid extension to pay (as opposed to the original due date).[96] Such a taxpayer is subject to a penalty for failure to file based on the amount unpaid as of the due date of the return, even if he or she timely paid pursuant to a valid extension.

This result – a significantly higher penalty for failure to file applies to taxpayers who fully and timely pay on extension as compared to other taxpayers who timely pay without an extension – belies the intuitive notion that a taxpayer is not penalized for timely and fully paying pursuant to a valid extension. The IRS forms that taxpayers use to request a payment extension do not provide any warning of this counterintuitive result.[97] Even tax professionals sometimes overlook the rule.

Example

After a taxpayer's parents died, as executor of the estate, he estimated and timely paid the estate tax and received an extension of time to file. The taxpayer filed the return more than five months late. Because the failure to file penalty is computed based on the net amount

94 IRC § 6651(a)(1).

95 IRC § 6651(b)(1).

96 According to a longstanding Revenue Ruling, the "date prescribed for payment" in IRC § 6651(b)(1) means the "last day fixed for such payment (determined without regard to any extension of time for paying the tax)." Rev. Rul. 81-237, 1981-2 C.B. 245. *See also* Non-Docketed Service Advice Review 1988 WL 1092648 (July 22, 1988).

97 *See* Form 4768, *Application for Extension of Time to File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes* (July 2008); Form 1127, *Application for Extension of Time for Payment of Tax* (March 1993); Form 1138, *Extension of Time for Payment of Taxes by a Corporation Expecting a Net Operating Loss Carryback* (Dec. 2005).

of any unpaid tax as of the original due date (without regard to any extension), which was zero, the estate was not subject to any significant penalty for failure to file a timely return.[98]

In contrast, a similarly situated taxpayer timely paid the tax in full within the time allotted by an extension to pay. A tax professional incorrectly advised the taxpayer to spend the time to file correctly, even if the return would be late, because no late filing penalty would apply. The estate filed late and was subject to penalty equal to 25 percent of the tax. The tax professional's bad advice did not constitute "reasonable cause" to excuse the late filing.[99]

Recommendation

Modify IRC § 6651(b)(1) so the failure to file penalty is based on the net unpaid tax after taking into account amounts timely paid pursuant to an extension.

6. Reduce the number of failure to pay penalty rates and eliminate interaction with the failure to file penalty.

Problem

The failure to pay penalty is difficult to understand and compute. In a 2004 report, the Treasury Inspector General for Tax Administration (TIGTA) found IRS employees made errors in manually computing the failure to pay penalty in 24 percent of the cases it sampled.[100] In 2008, TAS determined the IRS's overall error rate in computing failure to pay penalties and interest was 8.3 percent.[101] The failure to pay penalty computations are probably just as confusing for taxpayers. The penalty is imposed upon different taxpayers at a number of different rates and is coordinated with the failure to file penalty, as described below.

Shifting penalty rates generate complexity

The failure to pay penalty is 0.5 percent of the net amount of unpaid tax for each month it remains unpaid, up to a maximum of 25 percent.[102] As noted above, the five percent per month failure to file penalty is also subject to a 25 percent maximum.[103] If the failure to

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98 The taxpayer would only be subject to a flat $100 failure to file penalty pursuant to IRC § 6651(a).

99 A taxpayer generally has a non-delegable duty to timely file a tax return. *See, e.g., United States v. Boyle*, 469 U.S. 241 (1985). While reliance on the advice of counsel can sometimes constitute "reasonable cause" for failure to file, advice that a taxpayer should take the time to file a complete and correct return has been held not to constitute reasonable cause. *See, e.g., Estate of Campbell v. Comm'r*, T.C. Memo. 1991-615. Moreover, advice that a return is required but that there would be no penalty for late filing does not generally constitute reasonable cause. *See, e.g., Ballard v. Comm'r,* 854 F.2d 185, 189 (7th Cir. 1988).

100 TIGTA, Ref. No. 2004-30-184, *Errors in Failure to Pay Penalty Amounts Occur When the Penalty Is Computed Manually* 1 (Sept. 2004).

101 *See* Most Serious Problem, *The IRS Miscalculates Interest and Penalties but Fails to Correct These Errors Due to Restrictive Abatement Policies, supra.* The sample size was sufficient to allow TAS researchers to project with a 95 percent level of confidence that the IRS's overall error rate was within 2.8 percent of the projected 8.3 percent error rate that it found in the sample. *Id.*

102 IRC § 6651(a)(2), (3).

103 IRC § 6651(a)(1).

file and failure to pay penalties both apply to the same month, however, the failure to file penalty is generally reduced by the amount of the failure to pay penalty for that month.[104]

The failure to pay penalty rate increases to one percent per month once the IRS proceeds to collect the tax by issuing a notice of intent to levy or jeopardy assessment.[105] On the other hand, the penalty is only 0.25 percent for any month an installment agreement is in effect if the taxpayer timely filed his or her original return (taking extensions into account).[106]

Abatement difficulties driven by complexity

The IRS may abate the failure to pay penalty if the taxpayer shows the failure is due to reasonable cause and not willful neglect.[107] However, the IRS will not consider abating the penalty until the taxpayer fully pays the tax.[108] Because the penalty continues to accrue and interact with the failure to file penalty, if any, until the taxpayer pays the tax in full, the IRS's concern is that considering abatement requests submitted before the tax is fully paid would add complexity.[109]

Such concerns may be compounded by the IRS's practice of using automated computer programs to assess tax and penalties (*i.e.*, the IRS's Math Error, AUR, and Automated Substitute for Return programs). These programs likely increase the number of failure to file and failure to pay penalties the IRS imposes and subsequently abates.[110]

Example

A taxpayer is in an automobile accident that prevents him from timely filing and paying his taxes and other bills. During his hospitalization, the IRS sends him a notice of intent to levy. The IRS assesses the failure to pay penalty during different periods at two different

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104 IRC § 6651(c)(1); Treas. Reg. § 301.6651-1(a)(1); *Smith v. United States*, 571 F. Supp. 664 (S.D.N.Y. 1983). For example, a taxpayer who failed to file and pay for 50 months could be subject to a 25 percent penalty for failure to pay (0.5 percent x 50 months) and 22.5 percent penalty for failure to file (25 percent (5 percent x 5 months) minus 2.5 percent (0.5 x 5 months – the period during which both penalties applied)). However, if the return is filed over 60 days past the due date this coordination rule will not cause the failure to file penalty to be reduced below $100 or, if lower, the tax required to be shown on the return. IRC § 6651(a).

105 IRC § 6651(d).

106 IRC § 6651(h).

107 IRC § 6651(a)(1); Treas. Reg. § 301.6651-1(c). IRM 20.1.1.3.1.2 (Feb. 22, 2008).

108 IRM 20.1.2.1.3(2)(B) (Apr. 25, 2008).

109 According to the IRM:

> It is not in the taxpayer's interest for the Service to consider or effect FTP penalty abatements on accounts with outstanding tax due, as the penalty continues to accrue and often leads to the taxpayer having to make a second request for abatement. As a further example, if the Service were to consider and allow an abatement of FTP on a return filed five months late with unpaid tax, and the ½% FTP is abated for the first five months, the FTF rate goes from 4½% to 5%, effectively transferring the decreased FTP amount over to an increased FTF amount, creating a wash, while the maximum applicable FTP rate that had gone down to 22½% is re-started once again.... These type scenarios do not provide quality taxpayer relations and only serve to multiply confusions. IRM 20.1.2.1.3(2)(B) (Apr. 25, 2008).

110 For additional discussion of challenges facing automated programs which may assess penalties, see, *e.g.*, National Taxpayer Advocate 2007 Annual Report to Congress 259 (Most Serious Problem, *Automated Underreporter*); National Taxpayer Advocate 2007 Annual Report to Congress 275 (Most Serious Problem, *The Accuracy-Related Penalty in the Automated Underreporter Units*); National Taxpayer Advocate 2006 Annual Report to Congress 311 (Most Serious Problem, *IRS Implementation of Math Error Authority Impairs Taxpayer Rights*). For a discussion of other problems with the failure to pay penalty, see Most Serious Problem, *The IRS Miscalculates Interest and Penalties but Fails To Correct These Errors Due To Restrictive Abatement Policies, supra.*

rates: 0.5 percent and 1 percent. The penalty for late filing also applies during different periods at two different rates: 4.5 percent and 5 percent. Although he is eligible for abatement, the IRS will not consider abating any portion of the failure to pay penalty until he fully pays the tax.

Recommendations[111]

A. Separate the failure to pay penalty and the failure to file penalty so that the failure to pay penalty does not reduce the failure to file penalty. Establish independent rates and caps for each penalty. This change would reduce the complexity of the failure to pay computation.

B. Eliminate the increased failure to pay penalty rate that applies after the IRS issues a notice of intent to levy.

Because only the IRS knows when it will issue a notice of intent to levy, the increased penalty that applies after the IRS issues the notice operates primarily to reimburse the government for the cost of enforcement activity rather than to enhance voluntary compliance. Pursuant to the principles articulated by the IRS Task Force Reports, discussed above, penalties should not be used to reimburse the government for the cost of compliance programs because this purpose may conflict with the goal of maximizing voluntary compliance. Especially if a taxpayer is not paying because he or she cannot afford to do so, such a penalty may seem unfair, potentially discouraging some taxpayers from working with the IRS to pay the liability. The increased charge may also violate principles of horizontal equity because it applies to taxpayers who receive a notice of intent to levy before reaching the rate cap, but does not apply to similarly situated taxpayers who have already reached the rate cap when they receive the notice (*e.g.,* because of IRS delay in issuing it).

7. Simplify the prior year estimated tax payment safe harbor and encourage taxpayers to use it.

Problem

The rules for computing estimated tax payments are complicated, especially for taxpayers trying to minimize payments in years when their income is falling. A telephone survey found approximately two-thirds of taxpayers with a balance due did not plan to owe a balance upon filing.[112] Many of these taxpayers likely inadvertently triggered an estimated tax

111 The National Taxpayer Advocate previously recommended substituting a higher underpayment interest rate for the failure to pay penalty. *See* National Taxpayer Advocate 2001 Annual Report to Congress 179. The Joint Committee on Taxation (JCT) also recommended replacing the failure to pay penalty with a five-percent per year late fee applicable to taxpayers who had not entered into an IA by the fourth month after the assessment. JCT Study at 3. The Treasury Department recommended increasing the penalty percentage from 0.5 percent to one percent per month after six months, but would cut the rate in half for any month in which an installment agreement is in effect. Treasury Study at 74.

112 *See* Wage and Investment Division (W&I), Research Group 5, Project No. 5-03-06-2-028N, *Experimental Tests of Remedial Actions to Reduce Insufficient Prepayments: Effectiveness of 2002 Letters* 7 (Jan. 16, 2004), *citing* W&I Customer Research Group 5, *Causes and Potential Treatments for Underwithholding and Insufficient Estimated Payments* (2000).

penalty as a result of the complexity of the computation, as well as difficulties in predicting future income.

This complexity probably stems from attempts to balance competing considerations. On one hand, the estimated tax payment system is very important in fostering voluntary tax compliance. According to IRS research, taxpayers who owe a balance upon filing their returns are more likely than others to understate their tax liabilities.[113] Moreover, according to the same study, more than 20 percent of such taxpayers with a balance due fail to pay it in full.[114] On the other hand, individual taxpayers have a right to minimize overpayments. Given these competing considerations, under current law individual taxpayers may compute the required quarterly estimated tax payments in three different ways.

One alternative is for taxpayers to make four equal estimated tax payments totaling 90 percent of the tax that will be shown on the return for the current year (the "90 percent rule").[115] For many taxpayers, it is very hard to predict the full year's income or tax in advance.[116] Fortunately, there are two other methods of computing the required payments.

A second alternative for computing estimated tax payments allows taxpayers to make smaller estimated tax payments earlier in the year if the taxpayer's "annualized income installment" – a complicated calculation that involves creating a *pro forma* return for a portion of the year preceding the quarterly due date – is less than the amount that would otherwise be payable.[117] This alternative is most helpful for taxpayers whose income is concentrated late in the year.

A third alternative for computing the payments, which results in lower payments for taxpayers whose taxable income is rapidly increasing, is to make four equal estimated tax payments totaling 100 percent of the tax shown on the individual's return for the preceding taxable year (the "prior year safe harbor").[118] For taxpayers who reported more than $150,000 in adjusted gross income ($75,000 if married and filing separately) on their return for the preceding year, the prior year safe harbor is based on 110 percent (rather than 100 percent) of the tax shown on the prior return (the "110 percent rule").[119] Notwithstanding the 110 percent rule, the prior year safe harbor is much simpler than the other two

113 *See id.*; Charles Christian, Phoenix District Office of Research and Analysis, *The Association Between Underwithholding and Noncompliance* 1-2 (July 14, 1995) (finding that "[o]n average, understated tax on balance due returns is ten times as large as understated tax on other returns.").

114 *See* W&I, Research Group 5, Project No. 5-03-06-2-028N, *Experimental Tests of Remedial Actions to Reduce Insufficient Prepayments: Effectiveness of 2002 Letters* 7 (Jan. 16, 2004). For the 2006 tax year, 15 percent of all taxpayers who owed a balance upon filing their return failed to pay it in full. Compliance Data Warehouse, Individual Returns Transaction File (IRTF) (Oct. 2008).

115 IRC § 6654(d).

116 Farmers and fishermen, taxpayers whose income may depend on forces of nature, are permitted to make only one installment late in the year. IRC § 6654(i).

117 Any such reduction must be recaptured in subsequent estimated tax installments. IRC § 6654(d)(2).

118 IRC § 6654(d).

119 IRC § 6654(d)(1)(C)(i).

alternatives for computing estimated payments. More importantly, it does not require taxpayers to predict the future.

Taxpayers may be more likely to inadvertently trigger an estimated tax penalty if the rules discourage taxpayers from using the prior year safe harbor. However, taxpayers whose prior-year income exceeds the $150,000 threshold are required to make higher payments to meet it – 110 percent (rather than 100 percent) of the prior year's tax. An analysis of Schedule C filers with prior year income in excess of the $150,000 threshold confirmed that they were significantly more likely to trigger an estimated tax penalty when compared to those who had prior year income at or below the threshold (29.7 percent vs. 11.9 percent, respectively).[120]

Similarly, when economic activity and taxable income are declining and taxpayers have the greatest need to conserve cash, they have an incentive to use methods other than the prior year safe harbor to compute the required estimated tax payments. In such cases, taxpayers may not want to use the prior year safe harbor, especially if they would be subject to the 110 percent rule, because it could lead to significant estimated tax overpayments that do not bear interest and cannot be recovered by individuals later in the year.[121] Not surprisingly, Schedule C taxpayers whose incomes went down between tax year 2005 and 2006 were slightly more likely to trigger estimated tax penalties than those whose incomes went up.[122] These rules encourage individual taxpayers, especially those subject to the 110 percent rule, to resort to more complicated alternatives. Thus, we could likely reduce complexity and estimated tax penalties by encouraging taxpayers to use the prior year safe harbor to estimated tax payments, rather than more error-prone methods.

Example

A self-employed small business taxpayer reported tax of $25,000 on her 2006 return. Because she was married filing separately and her adjusted gross income for the prior year exceeded $75,000, she needed to make four estimated tax payments of $6,875 ($25,000 x 110 percent x 25 percent) during the year to qualify for the prior year safe harbor. She made her first quarterly payment of $6,875 during the 2007 tax year. However, because business revenues have been declining, she would like to minimize the remaining three

120 IRS Compliance Data Warehouse Individual Returns Transaction File and Individual Master File (Tax Years 2005 and 2006) (analysis of data from tax years 2005 and 2006 regarding filers subject to the $150,000 threshold, *i.e.*, those who were not married filing separately).

121 Rev. Rul. 54-149, 1954-1 C.B. 159 (explaining taxpayers cannot recover estimated tax overpayments); Treas. Reg. § 1.6425-1 (providing a procedure for corporations, but not individuals, to recover estimated tax overpayments). For purposes of computing interest on an overpayment, estimated tax payments are deemed to have been paid on the due date of the income tax return. *See* IRC 6611(d); IRC § 6513(b)(2); *Baral v. United States*, 528 U.S. 431 (2000). Thus, estimated tax payments do not bear interest before the due date of the return.

122 IRS Compliance Data Warehouse, Individual Returns Transaction File (Oct. 6, 2008) (TY 2005 and 2006) (13.5 percent vs. 13.2 percent) IRS Compliance Data Warehouse, Individual Returns Transaction File (Oct. 6, 2008) (analysis of data from tax years 2005 and 2006 regarding filers subject to the $150,000 threshold, *i.e.*, those who were not married filing separately). In 2005, individual taxpayers with incomes above the threshold were only slightly more likely to have a greater tax liability in the following year than those whose incomes were at or below the threshold. According to IRS data, 47.6 percent of taxpayers with income greater than the $150,000 threshold in 2005 had higher taxes in 2006 than in 2005, while 45.8 percent of the taxpayers at or below the threshold had higher taxes in 2006 – a difference of less than two percentage points. *Id.* Most individual taxpayers did not have a higher tax liability in the following year (2006), regardless of whether their income was above or below the threshold. *Id.*

estimated tax payments, especially since the IRS does not pay any interest on estimated tax overpayments.

Because her revenues were down by about 20 percent, the taxpayer estimated that she would owe 20 percent less tax in the 2007 tax year ($25,000 x 80 percent = $20,000), which would allow her to reduce her quarterly tax payments by about 35 percent (from $6,875 to $4,500) under the 90 percent rule ($20,000 x 90 percent = $18,000; $18,000 x 25 percent = $4,500). Since she believed she had overpaid on the first quarterly payment, she thought she could reduce the next two quarterly payments even further. Due to unexpectedly robust holiday sales at the end of the year and application of the AMT, her full-year taxable income increased from the prior year. The taxpayer increased the final estimated tax payment, but because she did not compute her 2007 tax liability before April of 2008 she could not be sure it was sufficient. She was subject to an estimated tax penalty for 2007.

Recommendation

Allow all individuals, regardless of income, to avoid an estimated tax penalty if they base their estimated tax payments on 100 percent of the prior year's tax shown on the return for the preceding year (rather than 110 percent for certain taxpayers).[123] This change would reduce complexity as well as the incentive for these taxpayers to use more complicated methods to compute estimated tax payments.[124]

8. Simplify the estimated tax penalty computation and provide an automatic waiver of *de minimis* estimated tax penalties.

Problem[125]

The estimated tax penalty is not easy to calculate. The penalty is computed by applying the underpayment interest rate to the underpayment from the date the quarterly payment was due until the earlier of the date the tax is satisfied or due (*e.g.*, April 15).[126] Because the underpayment interest rate changes quarterly and "quarterly" estimated tax payments are due on four oddly spaced dates (April 15, June 15, September 15, and January 15), each delinquent payment is subject to more than one penalty rate (*i.e.*, the rate applicable in two calendar quarters), even if satisfied by the next quarterly payment.[127]

Because penalty computations are so complicated, the IRS allows a taxpayer to either compute his or her own estimated tax penalty and report it on his or her return or have

123 The JCT recommended establishing a 100 percent prior year safe harbor for all taxpayers regardless of income (*i.e.*, eliminating the special 110 percent rule for certain taxpayers). JCT Study at 116.

124 The next recommendation further addresses the complexity of the estimated tax penalty.

125 The National Taxpayer Advocate identified this problem in her 2001 report. *See* National Taxpayer Advocate 2001 Annual Report to Congress 30-33 (Most Serious Problem, *Understanding Estimated Tax Payments*).

126 IRC § 6654(a). Underpayments continuing after the tax is due are subject to interest charges and failure to pay penalties, but not estimated tax penalties.

127 IRC § 6621(b)(2). However, the estimated tax penalty rate that applies to the third month following the close of the taxable year (typically March) also applies to the first 15 days of the fourth month (typically April 15). IRC § 6621(b)(2)(B). The JCT recommended applying only one rate per tax installment period. JCT Study at 118.

the IRS compute it and send the taxpayer a separate bill.[128] The IRS does not bill taxpayers for estimated tax penalty amounts below a certain threshold.[129] According to TIGTA's most recent report on the subject, about 4.3 million (or 84 percent) of the taxpayers subject to the penalty computed it themselves in 1998 and 2.9 million (67.2 percent) of those taxpayers paid almost $116 million, which they would not have been required to pay if they had allowed the IRS to compute the penalty.[130] The result – charging penalties to taxpayers who self-assess but not charging similarly situated taxpayers who do not – violates horizontal equity principles.

Example

Taxpayer W completes her return, calculates that she owes an $X estimated tax penalty, and reports it on her return. She has to use two different rates to compute the penalty for a single quarter. Taxpayer Y also owes an $X estimated tax penalty, but opts to have the IRS compute it. W must pay the penalty, but because the IRS does not bill taxpayers for penalties of less than $Z (an amount greater than $X), the IRS does not assesses the penalty against Y.

Recommendations[131]

A. Apply only one estimated tax payment penalty rate for each estimated tax payment period.

B. Automatically waive small estimated tax penalties of less than a set amount.[132]

9. Allow the IRS to abate estimated tax penalties for first-time estimated tax payers who have reasonable cause.

Problem

The IRS is generally not authorized to waive the estimated tax penalty even if a taxpayer has a reasonable cause for the failure to pay and was never before required to make estimated tax payments.[133] As a result, the penalty sometimes applies to taxpayers who had a reasonable cause for failing to make estimated tax payments.

128 *See, e.g.*, Instructions for Form 2210, *Underpayment of Estimated Tax by Individuals, Estates, and Trusts* (2007) (explaining: "Because Form 2210 is complicated, we strongly encourage you to let the IRS figure the penalty. If you owe it, we will send you a bill.... If you want us to figure the penalty for you, complete your return as usual. Leave the penalty line on your return blank; do not file Form 2210.")

129 LEM 20.1.3.2.7 (Oct. 12, 2006). These small dollar thresholds are called "tolerances."

130 TIGTA, Ref. No. 2000-30-112, *Estimated Tax Penalty Assessment Processes Create Significant Taxpayer Inequity* i (Aug. 2000). The same tolerance levels exist today. LEM 20.1.3.2.7 (Oct. 12, 2006); LEM 3.6.7 (Sept. 25, 1998).

131 In connection with this reform, Congress should also consider certain technical changes previously recommended by JCT and General Accounting Office (now called the Governmental Accountability Office, or GAO) to simplify the estimated tax penalty computations. *See* JCT Study 116-22 (recommending: applying the same 100 percent preceding-year safe harbor to all individuals, regardless of income, applying only one rate per estimated tax payment period, providing that underpayment balances are cumulative, and using a 365-day year for penalty calculations); GAO, GAO/GGD-98-96, *Ways to Simplify the Estimated Tax Penalty* (May 1998) (making similar recommendations).

132 The Treasury Department recommended expanding penalty waivers for taxpayers with penalties in the $10-$20 range. Treasury Study at 88.

133 While the IRS is authorized to waive the penalty if due to certain "unusual circumstances" it would be against "equity and good conscience," this authority is very narrow and is not equivalent to "reasonable cause." See IRC § 6654(e)(3); IRM 20.1.3.4.1.2 (Sept. 12, 2006).

Taxpayers are not required to make estimated tax payments in the first year they earn income. They do not have to make estimated tax payments if they did not owe any tax in the prior 12-month taxable year, provided they were U.S. citizens or residents during that period.[134]

Taxpayers who earn income solely from wages generally do not need to worry about the estimated tax payment system. If they owe less than $1,000 in the current year after applying the credit for wage withholding (but not estimated tax payments), they are not required to make estimated tax payments.[135]

Similarly, individuals who retire or become disabled during the year are not subject to the penalty if an estimated tax underpayment is due to reasonable cause and not willful neglect.[136] These rules implicitly recognize that taxpayers may inadvertently fail to comply with the estimated tax payment requirements when they are first required to do so and should not be subject to a penalty.

However, no similar reasonable cause exception applies to other taxpayers who are subject to the estimated tax payment regime for the first time for other reasons. For example, no reasonable cause exception applies when an employee first becomes an independent contractor or first receives a sudden increase in investment income, and fails to make sufficient estimated tax payments. Nor does a reasonable cause exception apply when a taxpayer simply receives an unexpectedly large amount of income late in the year.

Example

Taxpayer X retires after age 62 and opens a lawn service business. As a result of bad advice from a tax advisor, she fails to make a sufficient estimated tax payment and is subject to a penalty. Because she reasonably relied on her advisor in her first year of retirement, she has a reasonable cause for the error. The IRS abates the penalty.

Taxpayer Y does similar work as an employee of a lawn services company. Y's employer reclassifies her as an independent contractor and stops withholding on her earnings. Y consults the same tax advisor and fails to make sufficient estimated tax payment in the first quarter after she becomes an independent contractor. Y has reasonable cause for the failure, but the IRS is not authorized to abate the penalty on the basis of Y's reasonable cause.

134 IRC § 6654(e)(2).

135 IRC § 6654(e). Both the JCT and Treasury Department have recommended expanding this safe-harbor by considering estimated tax payments in computing the $1,000 threshold, but each would require additional complex rules to prevent taxpayers from back-loading estimated tax payments. *See* Treasury Study at 82-88; JCT Study at 115.

136 IRC § 6654(e)(3).

Recommendation[137]

Expand the reasonable cause waiver that applies to taxpayers who are retired and disabled during the year to all first-time estimated tax payers.[138]

10. Make the Trust Fund Recovery Penalty more effective by clarifying that it covers third party payers.

Problem

The Trust Fund Recovery Penalty (TFRP) helps to ensure that trust fund taxes reach the government. However, it may not apply to "third party payers" – persons who contract to assist the taxpayer in paying trust fund taxes to the government and take possession of funds designated for that purpose. The TFRP applies to any person required to collect, truthfully account for, and pay over withheld income and employment (Social Security and railroad retirement) taxes, and collected excise taxes, who willfully fails to do so.[139] Despite its denomination as a "penalty," the TFRP serves as a collection device rather than a means of imposing an additional penalty over and above the amount of the unpaid tax.[140] In keeping with this purpose, the business and each of its "responsible persons" are jointly and severally liable for the entire unpaid trust fund tax liability, including interest and penalties; however, the IRS has a policy of collecting the liability only once.[141]

In FY 2007, third party payers transmitted approximately one third of all electronic federal tax deposits received by the Treasury.[142] In recent years, a number of third party payers have gone out of business or embezzled customer funds.[143] Because the taxpayer/customer remains liable for the taxes, he or she can experience significant burden if the third party does not make timely payments to the government. Such taxpayers may be required to pay the amount twice – once to the third party payer that absconded with or dissipated the funds and a second time to the IRS – plus interest and penalties. While in some cases a third party payer or one or more of its employees could be deemed a "responsible person,"

137 The National Taxpayer Advocate made a similar recommendation in 2001 to allow the IRS to grant one-time abatement of the penalties for failure to file and pay the first time a taxpayer makes an error. *See* National Taxpayer Advocate 2001 Annual Report to Congress 188.

138 The Treasury Department recommended applying reasonable cause waivers to individuals who are first-time estimated tax payers, provided the balance due on the return is below a threshold amount and paid with a timely filed return. Treasury Study at 88. We agree with this recommendation, except that we do not believe that first-time estimated tax payers who have a reasonable cause for the failure should be denied access to the abatement process solely because their income is too high or they were unable to pay the tax in full with their return. Such limitations also introduce additional complexity.

139 IRC § 6672. In certain cases, if a third party payer pays employee wages, it may be liable pursuant to IRC § 3504. *See, e.g., Pediatric Affiliates, P.A. v. United States*, 2006-1 USTC ¶ 50,201 (D.N.J. 2006); *Morin v. Frontier Bus. Tech.*, 288 B.R. 663, 671-72 (W.D.N.Y. 2003) (holding that agent was not liable for payroll taxes because it never had actual control over the funds used to pay employee wages).

140 *See, e.g., Kelly v. Lethert*, 362 F.2d 629 (8th Cir.1966) (stating that "[a]lthough 26 U.S.C. § 6672 denominates this liability as a penalty it is well settled that it is, in substance, a tax").

141 IRS Policy Statement 5-14, IRM 1.2.14.1.3 (June 9, 2003); IRM 5.7.3.1(8) (Oct. 30, 2007); IRM 5.17.7.1.9 (Nov. 2, 2007). *See also Botta v. Scanlon*, 314 F.2d 392, 393 (2d Cir. 1963) (noting "that section 6672 is simply a means for ensuring that the tax is paid....").

142 *See* IRS, *EFTPS Deposits Received and Processed, Volumes and Dollars Collected FY 2007 Year End* (Sept. 28, 2007). *See also* Brady Bennett, Director, Filing and Payment Compliance, W&I, *Talking Points, Important Contributions of Reporting Agents, SB/SE Focus and Updates*, National Reporting Agents Forum (Feb. 21, 2007).

143 SB/SE Fraud Digest (Aug. 2007). For a full discussion, see National Taxpayer Advocate 2007 Annual Report to Congress 337 (Most Serious Problem, *Third Party Payers*).

potentially subject to the TFRP with respect to its customer's tax payments, this result is far from certain.[144]

Example

A taxpayer hires a payroll service provider (PSP) to administer its payroll, collect payroll taxes, and file applicable IRS forms. The PSP collects payroll tax deposits from the taxpayer but does not pay them over to the IRS. The PSP also changes the taxpayer's mailing address on file with the IRS to the PSP's business address without the taxpayer's knowledge. When the IRS sends delinquent payroll tax notices to the taxpayer, the PSP receives them, but does not disclose the delinquency to the taxpayer. The taxpayer remains liable for delinquent payroll taxes, interest, and penalties. The IRS does not assert that the PSP or any of its owners or employees is liable for the TFRP because of the uncertainty regarding its applicability.

Recommendation

Clarify the definition of a "responsible person" who may be subject to the TFRP. The definition should expressly include a third party payer – a person that has agreed to fulfill the taxpayer's tax payment obligations – and the third party payer's agents and employees to the extent they exercise authority or control over the taxpayer's tax payments.[145]

11. Reduce the penalty for failure to make tax deposits in the prescribed manner.

Problem[146]

Taxpayers who inadvertently fail to make timely tax deposits because they made a deposit using the wrong method (*e.g.*, paid the IRS rather than the proper authorized depositary) may be subject to a disproportionate penalty.

Taxpayers must pay certain taxes by making deposits with an authorized depositary or through electronic payments on dates that vary from taxpayer to taxpayer. Taxpayers must make tax deposits of payroll taxes, such as income, Social Security, and Medicare (Forms

144 *Compare Bowlen v. U.S.*, 956 F.2d 723, 728 (7th Cir.1992) (noting that "responsibility under section 6672 encompasses all those connected closely enough with the business to prevent the default from occurring.") *and Quattrone Accountants, Inc. v. IRS*, 895 F.2d 921 (3d Cir. 1990) (holding that the accounting firm that managed financial affairs of a farmers' cooperative on a daily basis was a responsible person) *with Jorgenson v. U.S.*, 92-2 USTC ¶ 50,558 (N.D. Ind. 1992) (holding that the accountant who prepared monthly financial statements, assisted in the payroll process, and had check-writing authority was not a responsible person, since he did not have authority to determine whether employer would pay taxes) *and In re Professional Sec. Services, Inc.*, 162 B.R. 901 (Bankr. M.D. Fla. 1993) (stating that "[u]nder the statute, an entity, *i.e.* a corporation, does not qualify as a person."). IRC § 6671(b) explains that the term "person" for purposes of the TFRP "includes an officer or employee of a corporation, or a member or employee of a partnership, who as such officer, employee, or member is under a duty to perform the act in respect of which the violation occurs." As used in the IRC, however, the term "includes" means "includes without limitation," and the term "person" broadly includes individuals, corporations, and various other entities. *See* IRC §§ 7701(a)(1) and (c). Thus, the definition does not expressly include or exclude third party payers or their employees.

145 The National Taxpayer Advocate made a very similar proposal last year. *See* National Taxpayer Advocate 2007 Annual Report to Congress 538-59 (Key Legislative Recommendation, *Taxpayer Protection from Third Party Payer Failures*). She also proposed to make this liability non-dischargeable in a bankruptcy. *Id.*

146 For a discussion of the problem that taxpayers may be penalized for inadvertent failures to use the correct deposit method or for being late when their due date changed, see National Taxpayer Advocate 2001 Annual Report to Congress 41-42 (Most Serious Problem, *Awareness and Understanding of Federal Tax Deposit Requirements*).

941 and 943), Federal Unemployment (FUTA) taxes (Form 940), nonpayroll withholding (Form 945), withholding on payments to non-U.S. persons (Form 1042), railroad employer's retirement and unemployment taxes (Form CT-1), federal excise taxes (Form 720), and corporate and nonprofit income and unrelated business tax deposits (Forms 1120, 990-C, and 990-T).[147] To avoid penalties, taxpayers must make their deposits in full, on time, and in the right manner. Taxpayers that fail to do so are subject to a four-tier failure to deposit (FTD) penalty:

- Two percent if the correct deposit is one to five days late;
- Five percent if the correct deposit is six to 15 days late;
- Ten percent if the correct deposit is more than 15 days late; and
- Fifteen percent if the correct deposit is not paid within ten days after the IRS issues a delinquency notice or immediate payment demand in jeopardy cases.[148]

The FTD penalty is disproportionately high for those taxpayers who make timely deposits using the wrong method because the same (ten percent) penalty applies to a failure to deposit in the correct manner that applies to a failure to make the deposit at all.[149]

The IRS may abate the FTD penalty if the taxpayer establishes the failure was due to reasonable cause and not willful neglect.[150] The IRS will also generally waive an FTD penalty the first time a taxpayer uses an unauthorized deposit method.[151] In addition, it will generally abate first-time FTD penalties for taxpayers with an otherwise clean compliance history under its first-time abatement program.[152] However, because it is costly for taxpayers to seek and obtain an abatement, which may require a significant amount of fact-finding, taxpayers are more likely to pay small penalties than to request an abatement.[153] Table 2, *Top Ten Civil Penalties Assessed During FY 2003-2005 and Abated as of March 2008*, shows that for FY 2005 the IRS abated 15 percent of the FTD penalties, representing 63 percent of the FTD penalty dollars assessed, suggesting the IRS abated larger-than-average assessments more frequently than smaller ones. Thus, the perceived fairness of the penalty might be improved, and the administrative burdens associated with submitting and processing abatement requests might be reduced, if a smaller penalty applied to minor errors, such as the error of making a timely deposit using the wrong method.

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147 IRC § 6302.

148 IRC § 6656(b).

149 IRM 20.1.4.2.1 (Oct. 1, 2007).

150 IRC § 6656(a).

151 IRM 20.1.4.14.1.4 (Oct. 1, 2007). IRM 20.1.4.16.3 (Oct. 1, 2007). The IRS is authorized to waive FTD penalties with respect to employment tax deposits for taxpayers who inadvertently trigger the penalty and meet certain net worth requirements (*i.e.*, net worth of $2 million or less for individuals, estates and trusts, or $7 million or less for corporations or other business entities which must also have no more than 500 employees) if the taxpayer timely filed the related return and the failure occurred during the first quarter that a person was required to deposit any employment tax or with respect to the first deposit after a taxpayer was required to change employment tax deposit methods. IRC § 6656(c).

152 *See* IRM 20.1.1.3.5.1 (Feb. 22, 2008) (first time abatement (FTA) guidance).

153 The taxpayer must request the abatement, even if it would be granted automatically. *See* IRM 20.1.4.16 (Oct. 26, 2007).

Example

An employer ran out of federal tax deposit coupons, was unable to make a $2,000 deposit at his bank, and instead took it to a local IRS office. The IRS assessed a ten percent FTD penalty of $200 against him because he did not make the deposit through his bank, the authorized depository.[154] Because the employer had been delinquent once before and his deposit method had not changed, the IRS would not automatically abate the penalty. The employer would have to apply for an abatement of the penalty and an IRS employee would need to process the request.

Recommendation

Reduce the penalty rate for failure to make a deposit in the manner prescribed from ten percent to two percent.[155] Because making a deposit in the wrong manner is much less damaging to the tax system than failing to make a deposit at all, the penalty would be more proportionate if it were lower than the penalty for failing to make a deposit at all.[156]

154 *See generally* Treas. Reg. § 1.6302-1; IRM 20.1.4 (Oct. 1, 2007).

155 According to the Treasury Study, "the penalty for failure to use the correct deposit method should be reduced from 10 percent to 2 percent. The current-law 10-percent penalty is too severe for this type of error." Treasury Study at 5. *See also id*. at 96. The National Taxpayer Advocate made the same recommendation in her 2001 report. *See* National Taxpayer Advocate 2001 Annual Report to Congress 222 (Additional Legislative Recommendation, *Federal Tax Deposit (FTD) Avoidance Penalty*).

156 In addition, the IRS is apparently authorized to stack concurrent estimated tax and failure to deposit penalties for the same lapse. *See* GCM 36137 (Jan. 15, 1975). Although the IRS does not currently stack such penalties, Congress may wish to eliminate the potential for stacking these penalties in connection with any broad reform. *See, e.g.*, Arthur H. Boelter, 1 Tax Pen. & Int. § 2:107 (Nov. 2007) (noting, with respect to concurrent estimated tax and FTD penalties, that "[t]he author is aware of no instance in which this has occurred.").

Appendix A

Table 4, *The Number of FY 2007 Assessments for Selected Civil Tax Penalties by Internal Revenue Code Section*, below, lists about 130 civil tax penalties by code section and the number of assessments reflected in the IRS's penalty database for each one. Determining how to aggregate or disaggregate individual penalties required the exercise of subjective judgment. For example, someone could reasonably compile a similar list that would disaggregate the failure of individuals to pay estimated taxes under IRC § 6654, which we listed as a single penalty, into penalties applicable to different types of taxpayers, such as farmers and fishermen, who are subject to special rules and requirements. Others might list all of the failure to pay penalties under IRC § 6651, which we listed separately, as a single penalty. As the table shows, the IRS has no data or only aggregate data for many of the penalties listed below.

Table 4, The Number of FY 2007 Assessments for Selected Civil Tax Penalties by Internal Revenue Code Section

IRC §	Description	Number of Assessments[157]
6038(b)(1)	Failure of certain controlling persons to furnish information with respect to controlled foreign corporations and partnerships	83
6038(b)(2)	Failure of certain controlling persons to furnish information with respect to controlled foreign corporations and partnerships after IRS notice	
6038A(d)	Failure of certain foreign-owned corporations to furnish information or maintain records	41
6038B(c)	Failure to furnish information with respect to certain transfers to foreign persons (on Form 926 or Form 8865, Schedule O)	8
6038C(c)	Failure of certain foreign corporations to furnish information or maintain records	-
6039F(c)	Failure to timely report receipt of large gifts from foreign persons	<5
6039G(c)	Failure to file expatriate/residency report (Form 8854)	
6651(a)(1)	Failure to file a return	5,686,080
6651(a)(2)	Failure to pay tax shown on return when due	18,289,071
6651(a)(3)	Failure to pay amounts greater than $100,000 within 10 days of notice of additional tax due	194,783
6651(a)(3)	Failure to pay amounts of $100,000 or less within 21 days of notice of additional tax due	
6651(d)	Failure to pay within 10 days of notice of intent to levy	
6651(f)	Fraudulent failure to file	2,070
6652(a)	Failure to file information returns for dividends aggregating less than $10	-
6652(b)	Failure to report tips	12,850

157 A dash ("-") indicates that either the IRS either has not assessed the penalty during the year or does not track the penalty assessment data. Where the number of assessments is greater than zero but less than five ("<5"), we do not list the actual figures.

IRC §	Description	Number of Assessments
6652(c)(1)(A)	Failure to file an annual return by exempt or political organization	86,382
6652(c)(1)(B)	Failure of manager to file annual return of exempt or political organization after IRS demand	
6652(c)(1)(C)	Failure of exempt or political organization to make annual returns and reports available for public inspection	
6652(c)(1)(D)	Failure of exempt or political organization to make application for exemption and notice of status available for public inspection	
6652(c)(2)(A)	Failure of certain trusts and terminating or reorganizing exempt organizations to file certain returns	
6652(c)(2)(B)	Failure of managers of certain trusts and terminating or reorganizing exempt organizations to file certain returns after IRS demand	
6652(c)(2)(C)	Failure of split-interest trust to file a return	
6652(c)(2)(C)	Knowing failure of required person to file trust return	
6652(c)(3)(A)	Failure of certain exempt organizations to report participation in certain "reportable" transactions	
6652(c)(3)(B)	Failure of certain exempt organizations to report participation in certain "reportable" transactions after IRS demand	
6652(d)(1)	Failure by certain pension plans to file an annual registration statement under IRC § 6057(a)	
6652(d)(2)	Failure by certain pension plans to file a notification of change in status under IRC § 6057(b)	
6652(e)	Failure to file a return or statement (Form 5500) required in connection with certain plans of deferred compensation	
6652(f)	Failure by foreign persons holding U.S. real property to file a return required under IRC § 6039C	
6652(g)	Failure by a plan administrator to file a return under IRC § 219(f)(4)	
6652(h)	Failure to give notice under IRC § 3405(e)(10)(B) to recipients of certain pension, etc., distributions	
6652(i)	Failure to give written explanation under IRC § 402(f) to recipients of certain qualifying rollover distributions	
6652(j)	Failure to file certification under IRC § 142(d)(7) with respect to certain residential rental projects	
6652(k)	Failure to make reports under IRC § 1202(d)(1)(C) with respect to qualified small business stock	-
6652(l)	Failure to file a return under IRC § 6043(c) with respect to certain corporate recapitalizations	-
6654	Failure by individuals to pay estimated tax	2,836,822
6655	Failure by corporations to pay estimated tax	96,280
6656(a)	Failure to deposit	1,967,698
6657	Bad check	255,605
6662(b)(1)	Negligence or disregard of rules or regulations	402,681
6662(b)(2)	Substantial understatement of income tax	
6662(b)(3)	Substantial valuation misstatement	
6662(b)(4)	Substantial overstatement of pension liabilities	
6662(b)(5), (g)	Substantial estate or gift tax valuation understatement	
6662(h)	Gross valuation misstatements	
6662A(a)	Disclosed reportable transaction understatement	47
6662A(c)	Undisclosed reportable transaction understatement	
6663	Underpayment due to fraud	4,024
6672	Failure to collect and pay over trust fund taxes – the "trust fund recovery penalty"	140,984
6673(a)(1)(A)	Instituting tax court proceedings primarily for delay	12
6673(a)(1)(B)	Instituting frivolous tax court proceedings	
6673(a)(1)(C)	Instituting tax court proceedings without pursuing administrative remedies	
6673(a)(2)	Instituting unreasonable and vexatious tax court litigation	

IRC §	Description	Number of Assessments
6673(b)	Instituting frivolous court proceedings under IRC § 7433 for unauthorized collection actions	5
6674	Willful failure to furnish an employee Form W-2, Wage and Tax Statement	-
6674	Willfully furnishing a false or fraudulent employee Form W-2, Wage and Tax Statement	-
6674	Willfully failing to furnish an employee Form W-2, Wage and Tax Statement, in the manner, at the time and showing all information required	-
6676	Erroneous income tax claim for refund or credit	-
6677(a)	Failure to file information (on Form 3520) with respect to creation of or transfers to certain foreign trusts under IRC § 6048(a)	7
6677(b)	Failure to file annual information return (on Form 3520A) with respect to certain foreign trusts under IRC § 6048(b)	126
6679(a)(1)	Failure to file timely and complete returns etc. with respect to certain foreign entities under IRC § 6046 or IRC § 6046A	-
6679(a)(2)	Failure to file timely and complete returns etc. with respect to certain foreign entities under IRC § 6046 or IRC § 6046A after IRS notice[158]	43
6682	Providing false information with respect to withholding that results in underwithholding	-
6684	Willful and flagrant failure with respect to certain tax exempt entities' liability for tax under chapter 42	-
6685	Willful failure to comply with public inspection requirements applicable to certain tax-exempt organizations	-
6686	Failure to file returns or supply information by DISC or former FSC	-
6688	Failure to report information (on Form 8898) regarding change residency in a U.S. Possession	-
6689	Failure to timely notify the IRS of a foreign tax redetermination	-
6690	Fraudulent statement or willful failure to furnish a statement to a plan participant	-
6692	Failure of a plan administrator to file an actuarial report in the time and manner required	-
6693(a)(1)	Failure to provide reports on certain tax-favored accounts or annuities in the time and manner required	<5
6693(b)(1)	Overstatement of designated nondeductible contributions	
6693(c)(1)	Failure of employer to provide one or more simple retirement account notices required by IRC § 408(l)(2)(C)	
6693(c)(2)(A)	Failure of trustee or issuer to provide one or more statements required by the last sentence of IRC § 408(i)	
6693(c)(2)(B)	Failure of trustee or issuer to provide one or more summary descriptions required by IRC § 408(l)(2)(B)	
6694(a)(2)(A)-(C)(i)	Understatement of taxpayer's liability by tax return preparer due to undisclosed positions without "substantial authority"	365
6694(a)(2)(C)(ii)	Understatement of taxpayer's liability by tax return preparer due to disclosed positions without a "reasonable basis"	
6694(b)	Willful or reckless understatement of taxpayer's liability by a tax return preparer	278
6695(a)	Failure of preparer to furnish a copy to the taxpayer	60
6695(b)	Failure of preparer to sign return	
6695(c)	Failure of preparer to furnish identifying number	
6695(d)	Failure of preparer to retain copy or list	
6695(e)	Failure of preparer to file correct information returns	
6695(f)	Negotiation by preparer of check issued to taxpayer	-
6695(g)	Failure of preparer to be diligent in determining eligibility for earned income tax credit	277
6695A	Substantial and gross valuation misstatements attributable to incorrect appraisals	-

158 The data showing the number of assessments under IRC § 6679(a)(2) may also include assessments under IRC § 6677(a).

IRC §	Description	Number of Assessments
6698	Failure to file a timely and complete partnership return	5,101
6699	Failure to file a timely and complete S corporation return	
6700	Promoting abusive tax shelters	96
6701	Penalties for aiding and abetting understatement of tax liability	134
6702(a)	Filing frivolous tax returns	5,939
6702(b)	Submitting specified frivolous positions	-
6704	Failure to keep records necessary to meet reporting requirements under IRC § 6047(d)	-
6705	Failure by broker to provide notice to payers	<5
6706(a)	Failure by issuer to set forth original issue discount information on certain debt instruments	-
6706(b)	Failure by issuer to furnish certain debt instrument information to the IRS (on Form 8281)	
6707(b)(1)	Failure to furnish information regarding “reportable” transactions that are not “listed”	<5
6707(b)(2)	Failure to furnish information regarding “listed” transactions	
6707A(b)(1)(A)	Failure to include information with a natural person’s return regarding “reportable” transactions that are not “listed”	<5
6707A(b)(1)(B)	Failure to include information with an entity’s return regarding “reportable” transactions that are not “listed”	
6707A(b)(2)(A)	Failure to include information with a natural person’s return regarding “listed” transactions	
6707A(b)(2)(B)	Failure to include information with an entity’s return regarding “listed” transactions	
6708	Failure to provide lists of advisees to the IRS upon request with respect to “reportable” transactions	<5
6709(a)	Negligent material misstatement with respect to a mortgage credit certificate	-
6709(b)	Fraudulent material misstatement with respect to a mortgage credit certificate	-
6709(c)	Failure to file a required report with respect to a mortgage credit certificate	-
6710(a)	Failure to disclose that contributions are nondeductible without reasonable cause	-
6710(c)	Intentional failure to disclose that contributions are nondeductible	-
6711	Failure by a tax-exempt organization to disclose that certain information or services are available from the federal government	-
6712	Failure to disclose treaty-based return positions (i.e., the position that a treaty overrules or otherwise modifies the IRC)	<5
6713	Improper disclosure or use of return information by preparers	-
6714	Failure to meet disclosure requirements applicable to quid pro quo contributions	<5
6716(a)-(b)	Failure to file information with respect to certain transfers at death and gifts without reasonable cause	-
6716(c)	Intentional failure to file information with respect to certain transfers at death and gifts	-
6717(a)	Refusal to permit entry or examination allowed by IRC § 4083(d)(1)	-
6720	Fraudulent acknowledgments with respect to donations of motor vehicles, boats, and airplanes or failure to provide acknowledgement required under IRC § 170(f)(12)	6
6720B	Fraudulent identification of exempt use property	-

IRC §	Description	Number of Assessments
6721(a)	Failure to file timely and correct information returns	24,497
6721(b)(1)	Untimely or incorrect information returns corrected within 30 days of due date	
6721(b)(2)	Untimely or incorrect information returns not corrected/filed within 30 days of due date, but corrected on or before August 1	
6721(d)(1)(A)	Failure to file timely and correct information returns by persons with gross receipts of not more than $5,000,000	
6721(d)(1)(B)	Untimely or incorrect information returns corrected/filed within 30 days of due date by persons with gross receipts of not more than $5,000,000	
6721(d)(1)(C)	Untimely or incorrect information returns not corrected/filed within 30 days of due date, but corrected/filed on or before August 1 by persons with gross receipts of not more than $5,000,000	
6721(e)	Failure to file timely and correct information returns as a result of intentional disregard	144,120
6722(b)	Failure to furnish correct and timely payee statements	1,051
6722(c)	Failure to furnish correct and timely payee statements as a result of intentional disregard	19
6723	Failure to comply with other information reporting requirements	42
7269	Failure to produce estate tax information upon request in connection with an examination	-
7482(c)(4)	Frivolous or groundless appeal from the Tax Court instituted or maintained primarily for delay	-
7519(f)(4)	Failure to make required payment by entities electing an alternate taxable year under IRC § 444	11