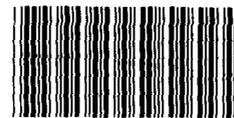


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UNITED STATES GENERAL ACCOUNTING OFFICE  
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STATEMENT OF  
JOHNNY C. FINCH, ASSOCIATE DIRECTOR,  
GENERAL GOVERNMENT DIVISION  
BEFORE THE  
COMMITTEE ON WAYS AND MEANS,  
HOUSE OF REPRESENTATIVES  
ON  
HOUSE BILL 3475  
TAX LAW SIMPLIFICATION AND IMPROVEMENT ACT OF 1983



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Mr. Chairman and Members of the Committee:

We are pleased to be here today to provide information for the Committee's use in considering H.R. 3475--the Tax Law Simplification and Improvement Act of 1983. Our testimony relates primarily to Title I of the bill, and particularly to that portion of Title I which pertains to estimated tax penalties assessed on individual taxpayers. However, we would also like to comment on another aspect of the bill that deals with an issue on which GAO has done some work--the repeal of stamp requirements (Title VI).

ESTIMATED TAX PENALTIES

As you know, Mr. Chairman, the Federal income tax system is a pay-as-you-go, self-assessment system. Employers are required to withhold income tax on compensation paid to employees in the form of salaries, wages, and tips. For income that is not subject to withholding, or income from which not enough tax is being withheld, individual taxpayers are required to make payments totaling at least 80 percent of their estimated tax in quarterly payments.

Each year, millions of taxpayers are required to make estimated tax payments. A significant number of these taxpayers incur penalties for not making adequate and/or timely payments. In fiscal year 1982, over 6 million such penalties were assessed, amounting to over \$800 million.

The present process requires taxpayers to determine if they have met their tax liability through withholding and/or esti-

mated tax payments. If they have not, they use form 2210, "Underpayment of Estimated Tax by Individuals," to calculate the penalty on the amount of the underpayment or to request that IRS abate the penalty on the basis of one of four exceptions shown on the form.

- Exception 1 hinges on the tax due for the previous year. If the current year's tax payments equal or exceed the tax shown on the previous year's tax return, the taxpayer is excused from the penalty. The previous year's return must cover a 12-month period and show a tax liability.
- Exception 2 hinges on the income for the previous year. If the current year's withholding and estimated tax payments equal or exceed the tax due on the previous year's income computed with the current year's rates the taxpayer is excused from the penalty.
- Exception 3 hinges on annualized income. If the current year's tax payments equal or exceed 80 percent of the tax on annualized income for periods from January 1 to March 31, May 31, or August 31, the taxpayer is excused from the penalty.
- Exception 4 is based on actual tax due. If the current year's tax payments equal or exceed 90 percent of the tax on the actual income from January 1 to March 31, May 31, or August 31 the taxpayer is excused from the penalty.

Once taxpayers have calculated the penalty, they are to attach the form 2210 to their form 1040 and remit the amount due. If they fail to do this, IRS will compute the penalty and send them a notice of the amount due. With the notice, IRS includes a form 2210 that taxpayers may use to determine if they meet any of the exceptions to the penalty. If the taxpayers find that they qualify for an exception to all or part of the penalty, they must return the completed form to IRS so that the proper adjustment can be made. Otherwise, the taxpayers must pay the full amount of the penalty as computed by IRS.

In a July 1980 report, we informed the Commissioner of Internal Revenue that taxpayers apparently found the exceptions, the form 2210, and the related instructions so confusing that they preferred to pay the penalty rather than try to determine if they met one of the exceptions. Our opinion was shared by IRS personnel at the Boston District Office who told us that many taxpayers asked if they could pay the penalty rather than prepare the form 2210. Our opinion was further supported by available statistics for 1979 which indicated that few taxpayers used the exceptions--less than 5 percent of the 3.6 million taxpayers who were assessed penalties.

Although IRS made some changes to form 2210 and the related instructions, taxpayer confusion was not completely eliminated because the exceptions remained the same. In this regard, Title I of H.R. 3475 is intended to simplify the exceptions to the estimated tax penalty. Under the current law, the taxpayer must pay estimated tax payments totaling 80 percent of the current year tax liability, or be subject to a penalty unless the penalty could be excused under one of the four exceptions previously discussed. The bill would allow the taxpayer to compute the estimated tax payments using one of three methods. Specifically, H.R. 3475 provides that estimated tax payments are to be based on annualized income or the lesser of (1) 100 percent of the previous year's tax, or (2) 80 percent of the current year tax liability. Thus, the bill would retain, in substance, two of the current exceptions to the penalty-- exceptions 1 and 3, but would not retain the other two exceptions--2 and 4. Title I also adds a provision to the Code which would allow estimated tax penalties to be abated for reasonable cause.

In anticipation of a legislative proposal affecting the estimated tax provision, staff members of the Joint Committee on Taxation and this Committee asked us, in April 1983, to develop some statistical information to show (1) which of the four exceptions excusing taxpayers from paying estimated tax penalties are used the most and (2) the characteristics of taxpayers who

are incurring estimated tax penalties, including the number of taxpayers assessed penalties who were paying estimated taxes for the first time. We developed this information by sampling tax returns.

I would now like to discuss the preliminary results of our work and our assessment of how the changes proposed by H.R. 3475 would have affected the number of penalties incurred by the taxpayers in our sample. Since the bill would allow IRS to abate the penalty on the basis of reasonable cause, we would also like to discuss our preliminary findings from another study with regard to how IRS is interpreting reasonable cause in abating other types of penalties that are assessed.

#### Use of exceptions

In early 1982, IRS studied 6,000 randomly selected individual tax returns for the 1981 tax year to determine whether improvements to forms 1040 and 1040A were necessary. Of the 6,000 returns, 1,200 showed a balance due to IRS. We analyzed those 1,200 returns to determine how many of the taxpayers had been faced with an estimated tax penalty. We found that 600 of the 1,200 tax returns showed that the taxpayers had not paid at least 80 percent of their tax liability and, thus, were subject to an estimated tax penalty.

Of the 600 taxpayers, 250 were required to pay a penalty and 350 were not. The 350 were not required to pay generally because they either understated the tax payments that had been

made to IRS, owed an amount that was determined by IRS to be too small to collect, or were excused from the penalty under the exceptions.

Overall, 195 (32 percent) were excused from the penalty under one or more of the four exceptions. Basically, as shown in Attachment I,

--Exception 1, which deals with prior year tax, was used the most frequently. More than 78 percent of the 195 taxpayers were excused under this exception.

--Exception 4, which deals with actual tax, was the next most frequently used. Almost 12 percent of the taxpayers were excused under it.

--Exception 2, which deals with prior year income, was less frequently used. About 8 percent of the 195 taxpayers were excused under it.

--And, exception 3, which deals with annualized income, was used in only 1 percent of the 195 cases.

To determine the potential effect that H.R. 3475 may have on the number of estimated tax penalties, we applied two of the changes proposed under Title I to the taxpayers in our sample. These two changes are (1) eliminating exceptions 2 and 4, and (2) allowing IRS to abate the penalty on the basis of reasonable cause. In doing this, we assumed that first-time estimated taxpayers would be excused from the penalty on the basis of reasonable cause. We made this assumption because IRS is

permitted to consider ignorance of the law, together with other facts, in making abatement decisions on other penalties.

Our analysis showed that the proposed legislative changes would have resulted in a net reduction of 40, or 16 percent, of the 250 penalties assessed in our sample. Specifically, establishing reasonable cause would have decreased the number of penalties by 47, or about 19 percent, but eliminating exceptions 2 and 4 would offset this decrease by 7, or about 3 percent. This information is detailed in Attachment II.

Our analysis also showed that the adjusted gross income of taxpayers using exceptions 1 and 4--the two most frequently used exceptions--was almost equally divided above and below \$20,000. However, most of the taxpayers using exceptions 2 and 3 had adjusted gross income under \$20,000. Attachment III provides this information in more detail.

Characteristics of sampled  
taxpayers assessed an  
estimated tax penalty

As shown in Attachment IV, 250 of the 600 taxpayers in our sample were required to pay estimated tax penalties ranging from \$1 to \$2,457. Over 70 percent of the penalties assessed amounted to less than \$100. We also noted that 59, or about 24 percent, of the 250 taxpayers were making estimated tax payments for the first time, and that all but one of these taxpayers were assessed penalties under \$300.

We also looked at various characteristics of all 600 taxpayers who were included in our sample--the 250 taxpayers who were required to pay a penalty and the 350 who were not. The characteristics we used were the taxpayers' adjusted gross income and filing status, whether income tax was withheld, and whether estimated tax payments were made.

As shown in Attachment V, we found that for two characteristics--adjusted gross income and filing status--there was no significant variation between taxpayers who were and were not penalized. For example, about 35 percent of the 350 taxpayers who were not penalized had an adjusted gross income of under \$10,000, while 31 percent of the 250 penalized were at the same income level. Further, among those penalized, there was no significant variation between those who were to have paid estimated taxes for the first time and those who had been liable for paying estimated taxes in prior years.

For the two characteristics of withholding and estimated tax payments, the only significant difference we noted was that taxpayers who were liable for making estimated tax payments for the first time were most likely to have had some taxes withheld. However, they were also least likely to have made any estimated tax payments. This information is detailed in Attachment VI.

IRS' experience with  
interpreting reasonable cause

As you know, Mr. Chairman, H.R. 3475 would permit IRS to abate the estimated tax penalty on the basis of reasonable cause. We are presently studying the manner in which IRS abates civil penalties and our preliminary findings may be of interest to you in considering some of the tax administration implications of this provision. While we have found that IRS is generally doing an effective job, it could improve its performance in interpreting reasonable cause when reaching abatement decisions. Specifically, because IRS guidelines do not sufficiently illustrate the kinds of information needed to support an abatement for reasonable cause, too many penalties are being inappropriately abated and some taxpayers are being treated inconsistently.

The Internal Revenue Code permits IRS to abate most types of civil penalties if the taxpayer shows that failure to file or pay is due to reasonable cause and not to willful neglect. Examples of conditions that IRS considers to be acceptable reasons for granting an abatement for reasonable cause include

- death or serious illness of the taxpayer,
- unavoidable absence of the taxpayer,
- destruction of tax-related records by fire or other casualty, and
- lack of funds despite the exercise of ordinary business care and prudence.

We found, however, that IRS employees were sometimes granting abatements for reasonable cause without considering whether the circumstances cited by taxpayers actually had a material effect on the timely filing of a return or the payment of taxes. This has resulted in too many penalties being inappropriately abated. For example, in one of the cases we reviewed, IRS granted an abatement because the taxpayer said that the bookkeeper was on vacation and could not make a timely payment to IRS. The files, however, did not contain sufficient information to demonstrate that the bookkeeper was the only person who could have made the payment.

Because IRS employees do not always obtain and analyze the facts involved, IRS cannot be assured of proper and consistent abatement decisions. To illustrate, we asked 112 employees who made abatement decisions at the locations we visited to judge 10 sample abatement cases using the guidance normally available to them. In only one of the 10 cases did more than 70 percent of the employees agree on the disposition of the case.

We plan to make some recommendations to the Commissioner aimed at helping IRS improve its performance in interpreting reasonable cause.

#### STRIP STAMP REQUIREMENTS

At this point, Mr. Chairman, I would like to briefly discuss Title VI of the bill which would repeal the requirement that approved closure devices be used on distilled spirits

containers. One such closure device is Government-supplied "strip stamps," which the Treasury Department provides free of charge to bottlers and distillers.

In a July 1982 report (GAO/GGD-82-60), we pointed out that strip stamps no longer serve their original purpose of signifying that the tax on the spirits was paid or that the spirits were lawfully bottled. We also noted that use of Government-supplied stamps might be viewed by some as the Government's official endorsement of the product. Given these findings, we recommended that (1) the Government-supplied stamps be eliminated or (2) the approved closure device requirement be repealed. Either approach would have the effect of saving the Government the \$1.7 million it spends annually to print and distribute strip stamps. The bill would fully implement our recommendation.

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Mr. Chairman, this concludes my prepared statement. We hope that the Committee will find this information useful in considering H.R. 3475. We would be pleased to respond to any questions you may have.

USE OF EXCEPTIONS

<u>Exception</u>	<u>Number</u>	<u>Percent</u>
1	153	78.5
2	17	8.7
3	2	1.0
4	<u>23</u>	<u>11.8</u>
	<u>195</u>	<u>100.0</u>

POTENTIAL EFFECT OF LEGISLATIVE CHANGE

<u>Proposed change</u>	<u>Effect on All Taxpayers</u>	
	<u>Number</u>	<u>Percent</u>
<u>Increase Penalties</u>		
Eliminate exceptions 2 & 4	7 <u>  </u>	2.8 <u>  </u>
<u>Decrease Penalties</u> <u>Assessments</u>		
Reasonable cause-effect on first time estimated taxpayers	47 <u>a/</u> <u>  </u>	18.8 <u>  </u>
Net reduction in tax- payers penalized	40 <u>  </u>	16.0 <u>  </u>

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a/ This figure does not include those first-time estimated taxpayers who would not be assessed a penalty under a provision in the Economic Recovery Tax Act of 1981. This provision, to be fully in effect by 1985, allows taxpayers to avoid an estimated tax penalty when the tax due after credits is less than \$500.

EXCEPTION USAGE BY ADJUSTED GROSS INCOME

<u>AGI</u>	<u>EXCEPTION</u>							
	<u>1</u>		<u>2</u>		<u>3</u>		<u>4</u>	
	<u>No.</u>	<u>%</u>	<u>No.</u>	<u>%</u>	<u>No.</u>	<u>%</u>	<u>No.</u>	<u>%</u>
Under \$10,000	21	13.7	8	47.0	2	100	4	17.4
10,000 - 19,999	55	35.9	6	35.3			7	30.4
20,000 - 29,999	33	21.6	2	11.8			9	39.1
30,000 - 39,999	13	8.5	1	5.9			2	8.7
40,000 - 49,999	7	4.6					1	4.4
50,000 - 59,999	6	3.9						
60,000 - 69,999	9	5.9						
70,000 - 79,999	2	1.3						
over 80,000	<u>7</u>	<u>4.6</u>	<u>---</u>	<u>---</u>	<u>---</u>	<u>---</u>	<u>---</u>	<u>---</u>
	<u>153</u>	<u>100.0</u>	<u>17</u>	<u>100.0</u>	<u>2</u>	<u>100.0</u>	<u>23</u>	<u>100.0</u>

RANGE OF PENALTIES

<u>Dollar Range</u>	<u>First time</u>		<u>Other</u>	
	<u>Number</u>	<u>Percent</u>	<u>Number</u>	<u>Percent</u>
1 - 99	45	76.3	131	68.5
100 - 199	12	20.3	30	15.7
200 - 299	1	1.7	11	5.8
300 - 399			7	3.7
400 - 499			1	.5
500 - 999			9	4.8
1000 plus	<u>1</u>	<u>1.7</u>	<u>2</u>	<u>1.0</u>
	<u>59</u>	<u>100.0</u>	<u>191</u>	<u>100.0</u>

RANGE OF ADJUSTED GROSS INCOME

<u>Dollar range</u>	<u>Taxpayers with no penalty</u>	<u>Taxpayers liable for paying estimated tax for 1st time</u>	<u>Other taxpayers with estimated tax penalty</u>
	------(percent)-----		
Under 10,000	35.0	30.5	32.4
10,000-19,999	32.6	27.1	31.4
20,000-29,999	15.3	15.2	16.8
30,000-39,999	6.6	13.5	9.5
40,000-49,999	3.6	3.4	2.0
Over 50,000	<u>6.9</u>	<u>10.2</u>	<u>7.9</u>
	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>

FILING STATUS

<u>Filing status</u>	<u>Taxpayers with no penalty</u>	<u>Taxpayers liable for paying estimated tax for 1st time</u>	<u>Other taxpayers with estimated tax penalty</u>
	------(percent)-----		
Joint	56.0	50.9	55.4
Single	40.2	38.9	38.3
Head of Household	2.3	6.8	6.3
Separate	<u>1.5</u>	<u>3.4</u>	<u>0.0</u>
	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>

WITHHOLDING

<u>Withholding</u>	Taxpayers with no penalty	Taxpayers liable for paying estimated tax for 1st time	Other taxpayers with estimated tax penalty
	----- (percent) -----		
Yes	46.9	64.4	42.9
No	<u>53.1</u>	<u>35.6</u>	<u>57.1</u>
	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>

ESTIMATED TAX PAYMENT

<u>Payment</u>	Taxpayers with no penalty	Taxpayers liable for paying estimated tax for 1st time	Other taxpayers with estimated tax penalty
	----- (percent) -----		
Yes	30.5	11.8	29.3
No	<u>69.5</u>	<u>88.2</u>	<u>70.7</u>
	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>