

# **JOINT COMMITTEE ON TAXATION**

## **PRESS RELEASE**

JCT Press Release: 99-02

For Immediate Release: July 22, 1999

For Further Information, Contact: Michael Boren (202-225-3621) (Michael.Boren@Jointtax.House.Gov)

The staff of the Joint Committee on Taxation (the "Joint Committee") today submitted its penalty and interest study to the House Committee on Ways and Means and the Senate Committee on Finance.

The Internal Revenue Service Restructuring and Reform Act of 1998 required the Joint Committee and the Secretary of the Treasury to conduct separate studies of the present-law interest and penalty provisions of the Internal Revenue Code of 1986 and make any legislative or administrative recommendations that the Joint Committee or the Secretary deems appropriate to simplify penalty and interest administration or reduce taxpayer burden. These studies are required to be submitted to the House Committee on Ways and Means and the Senate Committee on Finance by July 22, 1999.

Attached is the Executive Summary of the Joint Committee staff's study.

Volume I of the Joint Committee staff's study contains its analysis and recommendations. It is available now at the Joint Committee on Taxation website on the Internet at:

<http://www.house.gov/jct>

Volume II of the Joint Committee staff's study contains a summary of comments received, as well as reprints of the entire text of comments received and two GAO reports. It will be available later at the Joint Committee on Taxation website.

Both volumes of the Joint Committee's study also are expected to be available for purchase next week from the Superintendent of Documents, U.S. Government Printing Office, Washington, D.C. 20402. Telephone orders: 202-512-1808; stock order numbers: Vol. I - 052-070-07227-0; Vol. II - 052-070-07228-8.

## EXECUTIVE SUMMARY

### A. Overview

Under the IRS Reform Act, the Joint Committee on Taxation and the Secretary of the Treasury were each directed to conduct a study of the present-law interest and penalty provisions of the Internal Revenue Code of 1986 (the “Code”) and to make any legislative or administrative recommendations that the Joint Committee or the Secretary deems appropriate to simplify penalty and interest administration or reduce taxpayer burden. The legislative mandate for this study directed the Joint Committee staff to examine whether the current penalty and interest provisions (1) encourage voluntary compliance, (2) operate fairly, (3) are effective deterrents to undesired behavior, and (4) are designed in a manner that promotes efficient and effective administration of the provisions by the Internal Revenue Service (“IRS”). These studies are required to be submitted to the House Committee on Ways and Means and the Senate Committee on Finance by July 22, 1999.

After extensive review of the present-law system of penalties and interest, including input from the public and analysis by the GAO and the Congressional Research Service, the Joint Committee staff study developed the legislative and administrative recommendations contained in this study with respect to the present-law penalty and interest system in general and specifically with respect to corporate tax shelters.

The Joint Committee staff believes that legislative changes to improve compliance and enhance the fairness and administrability of present law should not be undertaken without careful and deliberative review by the Congress and the opportunity for public input. Furthermore, the Joint Committee staff believes that careful consideration should be given to the views of the Administration, and particularly the IRS, with respect to these recommendations. Indeed, the legislative mandate contained in the IRS Reform Act requires the Treasury to provide legislative and administrative recommendations to the Congress.

The Joint Committee staff also believes that the need for deliberative review is particularly critical with respect to the recommendations relating to corporate tax shelters. There is evidence that the use of corporate tax shelters has grown significantly in recent years and the Joint Committee staff, in its study, has identified characteristics of present law that may be contributing to this growth. The number and complexity of the transactions that are used as corporate tax shelters suggests a need for a legislative solution that articulates broad and flexible principles that will address not only the current corporate tax shelter transactions being utilized, but will provide to the IRS the mechanism by which future corporate tax shelter transactions can be prevented. However, any legislative solution to the corporate tax shelter problem must balance this goal of articulating broad and flexible principles with present law’s dependence on objective, rule-based criteria. Such a balanced approach will assure that the IRS is not granted open-ended authority that might be used to prevent transactions that the Congress did not intend to be considered corporate tax shelters. While the Joint Committee staff believes that its recommendations relating to corporate tax shelters will achieve the appropriate balance between flexibility and certainty, the staff recognizes that others will hold alternative views and will favor

alternative recommendations. The Joint Committee staff believes that deliberative review by the Congress of all points of view will strengthen the final legislative product.

On July 1, 1999, Treasury issued a White Paper relating to corporate tax shelters, titled The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals. In its White Paper, Treasury made a variety of legislative recommendations to address the corporate tax shelter issue. Because the Joint Committee staff completed its work on its recommendations before the issuance of the Treasury White Paper, the Treasury proposals were not considered in the preparation of the Joint Committee staff recommendations.

## **B. Joint Committee Staff Recommendations Relating to Penalties and Interest**

In accordance with the findings of the Joint Committee staff throughout the study, the Joint Committee staff recommends the following with respect to penalties and interest.

### **Provisions of general applicability**

- Provide one interest rate for both individual and corporate taxpayers. The rate, which would apply to both underpayments and overpayments of tax, would be the Applicable Federal Rate (“AFR”) plus 5 percent.
- Exclude interest paid by the IRS from the income of individual taxpayers.
- Convert the present-law penalty for failure to pay estimated tax into an interest provision, increase the threshold at which taxpayers are subject to an interest charge for underpayment of estimated tax from \$1,000 to \$2,000, and allow both tax withheld and certain estimated tax paid throughout the year to be considered in determining whether the threshold has been met.
- Repeal the present-law penalty for failure to pay tax. If a taxpayer has not entered into an installment agreement with the IRS by the fourth month after assessment, then an annual 5-percent late payment service charge would apply. For those taxpayers who agree to an automated withdrawal of each installment payment directly from their bank account, the present-law \$43 fee on installment agreements would be waived.

### **Interest**

In addition to the recommendation to apply one interest rate contained in the provisions of general applicability, the Joint Committee staff recommends the following:

- Allow abatement of interest if gross injustice would otherwise result.
- Expand the circumstances in which interest may be abated to include periods attributable to any unreasonable IRS error or delay.

- Allow abatement of interest if the taxpayer is repaying an erroneous refund based on IRS calculations without regard to the size of the refund.
- Allow abatement of interest to the extent interest is attributable to the taxpayer's reliance on written statements by the IRS.
- Allow taxpayers to deposit amounts in a "dispute reserve account," a special interest-bearing account within the U.S. Treasury, which would stop the running of interest on tax underpayments and allow taxpayers to earn interest generally to the extent that a taxpayer's deposit is not applied to a tax underpayment.

### **Estimated tax**

In addition to the recommendations to convert the present-law penalty for failure to pay estimated tax into an interest provision and to increase the threshold from \$1,000 to \$2,000, taking into account certain estimated tax payments, the Joint Committee staff recommends the following:

- Repeal the modified safe harbor that applies to individuals with AGI in the preceding taxable year in excess of \$150,000. All taxpayers would be subject to the same safe harbor, which would require that estimated payments be made based on either 90 percent of current year's tax or 100 percent of prior year's tax.
- Provide only one interest rate per underpayment period.
- Change the definition of "underpayment" to allow existing underpayment balances to be used in underpayment calculations for succeeding estimated tax payment periods.
- Require taxpayers to use a 365-day year for all estimated tax underpayment calculations, regardless of whether the taxable year is a leap year.

### **Accuracy-related penalties**

- Raise the minimum standards for undisclosed positions for both taxpayers and tax preparers such that, for each undisclosed position on a tax return, the taxpayer or tax preparer must reasonably believe that the tax treatment is "more likely than not" the correct tax treatment under the Code. Under present law, to avoid a penalty, taxpayers must have substantial authority for an undisclosed position, and, for tax preparers, the undisclosed position must have a realistic possibility of being sustained on the merits.
- Raise the minimum standards for disclosed positions for both taxpayers and tax preparers such that, for each disclosed position on a tax return, there must be at least substantial authority. Under present law, to avoid a penalty, taxpayers must have a reasonable basis for a return position and disclose the position (and it must not relate to a tax shelter item),

and, for tax preparers, the disclosed position must not have been frivolous (applies to tax shelter and non-tax shelter items).

- Change the preparer penalty from a flat \$250 per occurrence to \$250 or 50 percent of the tax preparer's fee, whichever is greater, for first-tier violations (i.e., preparation of a return with a position that does not meet the above-described recommended minimum preparer standards), and change the preparer penalty from a flat \$1,000 per occurrence to \$1,000 or 100 percent of the preparer's fee, whichever is greater, for second-tier violations (i.e., understatements that result from willful or reckless disregard of rules or regulations).

### **Pension penalty provisions**

- Consolidate the Internal Revenue Code and ERISA penalties for failure to file Form 5500 series annual return/report, designate the IRS as the agency responsible for enforcement of reporting requirements, and reduce from three to one the number of government agencies authorized to assess, waive, and reduce penalties for failure to file Form 5500.
- Repeal the separate penalties for failure to file Schedules SSA and B and for failure to provide notification of plan status change; any such failure would constitute a failure to file a complete Form 5500.

### **Tax-exempt organization penalty provisions**

- Clarify that the penalty imposed under section 6652(c)(2)(A), for failure to file annual trust information returns under section 6034, applies to a trust's failure to file Form 5227. Increase the penalty under section 6652(c)(2)(A), as applied to a trust's failure to file Form 5227, to that imposed by section 6652(c)(1)(A), which is \$20 each day the failure continues, not to exceed the lesser of \$10,000 or 5 percent of the organization's gross receipts.
- Recommend that the Congress consider whether it is appropriate to increase the penalty imposed under section 6652(c)(2)(A) for failure to file returns under section 6034 generally.

### **General administrative provisions**

- Apply a higher standard of behavior to conduct by the IRS, similar to that which would be imposed on practitioners by the Joint Committee staff recommendations made elsewhere in this study.
- Require the IRS to publish, annually, statistics concerning the number of payments made and total amount paid out under section 7430 for taxpayers' reasonable administrative and

litigation costs, as well as a summary of the administrative issues raised with respect to these payments and how these issues were resolved by the IRS.

- Require the IRS to improve the supervisory review of the imposition of penalties as well as their abatement in order to provide greater uniformity in penalty and interest administration and application.
- Require the IRS to develop better information systems in order to provide better statistical information on abatements and the reasons and criteria for abatements.
- Require the IRS to shorten significantly the current 45-day processing time for address changes.
- Require the IRS to establish administrative systems that assure that the proper representative of a taxpayer receives the proper notice directly from the IRS.
- Require the IRS to consider whether recent technological advances, such as e-mail and facsimile transmissions, permit the utilization of alternative means of communicating with taxpayers.

### **C. Joint Committee Staff Recommendations Relating to Corporate Tax Shelters**

The Joint Committee staff recommends that a meaningful penalty structure be established to discourage corporate taxpayers from entering into corporate tax shelter transactions. Thus, the Joint Committee staff has developed a series of recommendations that would modify the penalties and standards of practice as they relate to corporate tax shelters. The recommendations fall into two categories: (1) those that affect corporations that participate in tax shelters, and (2) those that affect other parties involved in corporate tax shelters. In addition, the Joint Committee staff makes a number of recommendations regarding new disclosure and registration obligations with respect to corporate tax shelters. In accordance with its findings, the Joint committee staff recommends the following with respect to corporate tax shelters.

#### **Recommendations that affect corporations which participate in corporate tax shelters**

- Clarify the definition of a corporate tax shelter for purposes of the understatement penalty with the addition of several “tax shelter indicators.” With respect to a corporate participant, a partnership, or other entity, plan, or arrangement will be considered to have a significant purpose of avoidance or evasion of Federal income tax if it is described by one (or more) of the following indicators:
  - C The reasonably expected pre-tax profit from the arrangement is insignificant relative to the reasonably expected net tax benefits.
  - C The arrangement involves a tax-indifferent participant, and the arrangement (1) results in taxable income materially in excess of economic income to the tax-

indifferent participant, (2) permits a corporate participant to characterize items of income, gain, loss, deductions, or credits in a more favorable manner than it otherwise could without the involvement of the tax-indifferent participant, or (3) results in a noneconomic increase, creation, multiplication, or shifting of basis for the benefit of the corporate participant, and results in the recognition of income or gain that is not subject to Federal income tax because the tax consequences are borne by the tax-indifferent participant.

- C The reasonably expected net tax benefits from the arrangement are significant, and the arrangement involves a tax indemnity or similar agreement for the benefit of the corporate participant other than a customary indemnity agreement in an acquisition or other business transaction entered into with a principal in the transaction.
  - C The reasonably expected net tax benefits from the arrangement are significant, and the arrangement is reasonably expected to create a “permanent difference” for U.S. financial reporting purposes under generally accepted accounting principles.
  - C The reasonably expected net tax benefits from the arrangement are significant, and the arrangement is designed so that the corporate participant incurs little (if any) additional economic risk as a result of entering into the arrangement.
- An entity, plan, or arrangement can still be a tax shelter even though it does not display any of the tax shelter indicators, provided that a significant purpose is the avoidance or evasion of Federal income tax.
  - Modify the penalty so that, with respect to a corporate tax shelter, there would be no requirement that the understatement be substantial.
  - Increase the understatement penalty rate from 20 percent to 40 percent for any understatement that is attributable to a corporate tax shelter. The IRS would not have the discretion to waive the understatement penalty in settlement negotiations or otherwise for corporate tax shelters.
  - Provide that the 40-percent penalty could be completely abated (*i.e.*, no penalty would apply) if the corporate taxpayer establishes that it satisfies certain abatement requirements. Foremost among the abatement requirements is that the corporate participant believes there is at least a 75-percent likelihood that the tax treatment would be sustained on the merits. Another requirement for complete abatement involves disclosure of certain information that is certified by the chief financial officer or another senior corporate officer with knowledge of the facts.
  - Provide that the 40-percent penalty would be reduced to 20 percent if certain required disclosures are made, provided that the understatement is attributable to a position with respect to the tax shelter for which the corporate participant has substantial authority in support of such position.

- Require a corporate participant that must pay an understatement penalty of at least \$1 million in connection with a corporate tax shelter to disclose such fact to its shareholders. The disclosure would include the amount of the penalty and the factual setting under which the penalty was imposed.

### **Recommendations that affect other parties involved in corporate tax shelters**

- Increase the penalty for aiding and abetting with respect to an understatement of a corporate tax liability attributable to a corporate tax shelter from \$10,000 to the greater of \$100,000 or one-half the fees related to the transaction.
- Expand the scope of the aiding and abetting penalty to apply to any person who assists or advises with respect to the creation, implementation, or reporting of a corporate tax shelter that results in an understatement penalty if (1) the person knew or had reason to believe that the corporate tax shelter could result in an understatement of tax, (2) the person opined or advised the corporate participant that there existed at least a 75-percent likelihood that the tax treatment would be sustained on the merits if challenged, and (3) a reasonable tax practitioner would not have believed that there existed at least a 75-percent likelihood that the tax treatment would be sustained on the merits if challenged.
- Require the publication of the names of any person penalized under the aiding and abetting provision and an automatic referral of the person to the IRS Director of Practice.
- Clarify the U.S. government's authority to bring injunctive actions against persons who promote or aid and abet in connection with corporate tax shelters.
- Include the explicit statutory authorization for Circular 230 in Title 26 of the United States Code and authorize the imposition of monetary sanctions.
- Recommend that, with respect to corporate tax shelters, Treasury amend Circular 230 generally to (1) revise its definitions, (2) expand its scope, and (3) provide more meaningful enforcement measures (such as the imposition of monetary sanctions, automatic referral to the Director of Practice upon the imposition of any practitioner penalty, publication of the names of practitioners that receive letters of reprimand, and automatic notification to state licensing authorities of any disciplinary actions taken by the Director of Practice).

### **Disclosure and registration obligations**

#### Corporate taxpayer disclosure

- 30-day disclosure.--Arrangements that are described by a tax shelter indicator and in which the expected net tax benefits are at least \$1 million would be required to satisfy certain disclosure requirements within 30-days of entering into the arrangement.



- The 30-day disclosure would include a summary of the relevant facts and assumptions, the expected net tax benefits, each tax shelter indicator that describes the arrangement, the analysis and legal rationale, the business purpose, and the existence of any contingent fee arrangements.
- The chief financial officer or another senior corporate officer with knowledge of the facts would be required to certify, under penalties of perjury, that the disclosure statements are true, accurate, and complete.
- Tax-return disclosure--Arrangements that are described by a tax shelter indicator (regardless of the amount of net tax benefits) would be required to satisfy certain tax-return disclosure requirements.
  - The tax-return disclosure would include a copy of any required 30-day disclosure.
  - The tax-return disclosure also would identify which tax shelter indicators describe one or more arrangements reflected on the return.

#### Tax shelter registration

- Modify the present-law rules regarding the registration of corporate tax shelters by (1) deleting the confidentiality requirement, (2) increasing the fee threshold from \$100,000 to \$1 million, and (3) expanding the scope of the registration requirement to cover any corporate tax shelter that is reasonably expected to be presented to more than one participant.
- Require additional information reporting with respect to the registration of tax shelter arrangements that are described by a tax shelter indicator. The additional information would include the claimed tax treatment and summary of authorities, the tax shelter indicator(s) that describes the arrangement, and certain calculations relating to the arrangement.