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SUBCOMMITTEE ON OVERSIGHT

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COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

WRITTEN COMMENTS

ON

TAXPAYER RIGHTS

APRIL 2, 2001

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ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT

FOR IMMEDIATE RELEASE CONTACT: (202) 225–7601
March 19, 2001
No. OV–2

Houghton Announces Hearing on Request for Written Comments on Taxpayer Rights

Congressman Amo Houghton (R–NY), Chairman, Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee is requesting written public comments for the record from all parties interested on penalty and interest provisions in the Internal Revenue Code (I.R.C.), taxpayer privacy concerns, and other taxpayer rights.

BACKGROUND:

Penalties and Interest

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

In the IRS Restructuring and Reform Act of 1998 (P.L. 105–206), Congress directed the U.S. Department of the Treasury and the Joint Committee on Taxation to conduct studies to examine whether the current penalty and interest provisions: (1) encourage voluntary compliance, (2) operate fairly, (3) are effective deterrents to undesired behavior, and (4) are designed in a manner that promotes efficient and effective administration of the provisions by the Internal Revenue Service.

The Joint Committee on Taxation completed and released its study, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998* (*Including Provisions Relating to Corporate Tax Shelters*) (JCS–3–99), on July 22, 1999. The Treasury Department completed its report, *Penalty and Interest Provisions of the Internal Revenue Code*, on October 25, 1999. The Subcommittee requested written comments on November 15, 1999, on the penalty and interest provisions of the I.R.C. and held a hearing on January 27, 2000.

Taxpayer Privacy

In the IRS Restructuring and Reform Act of 1998, Congress directed the Treasury Department and the Joint Committee on Taxation to examine: (1) the present protections for taxpayer privacy, (2) any need for third parties to use tax return information, (3) whether voluntary compliance could be achieved by allowing the public to know who is required, but does not, file tax returns, (4) the interrelationship of the taxpayer confidentiality provisions in the I.R.C. and other Federal privacy laws including, the Freedom of Information Act, 5 U.S.C. section 552, and (5) the impact of taxpayer privacy of sharing tax return information for enforcement of State and local tax laws.

The Joint Committee on Taxation completed and released its study, *Study of Present-Law Taxpayer Confidentiality and Disclosure Provisions as Required by Section 3802 of the Internal Revenue Service Restructuring and Reform Act of 1998* (JCS–1–00, Vols. I, II, and III) on January 28, 2000. The Treasury Department completed its report, *Report to Congress on the Scope and Use of Taxpayer Confidentiality and Disclosure Provisions*, in October 2000.

On April 5, 2000, the Committee on Ways and Means marked up and favorably reported H.R. 4163, the "Taxpayer Bill of Rights 2000," which addressed several of the issues included in the studies by the Joint Committee on Taxation and the Treasury Department. The House passed the bill by a vote of 421–0 on April 11, 2000.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Any person or organization wishing to submit a written statement for the printed record should submit six (6) single-spaced copies of their statement, along with an IBM compatible 3.5-inch diskette in WordPerfect or MS Word format, with their name, address, and comments date noted on label, by the close of business, Monday, April 2, 2001, to Allison Giles, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515.

FORMATTING REQUIREMENTS:

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

1. All statements and any accompanying exhibits for printing must be submitted on an IBM compatible 3.5-inch diskette in WordPerfect or MS Word format, typed in single space and may not exceed a total of 10 pages including attachments. Witnesses are advised that the Committee will rely on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.

4. A supplemental sheet must accompany each statement listing the name, company, address, telephone and fax numbers where the witness or the designated representative may be reached. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press, and the public during the course of a public hearing may be submitted in other forms.

Note: All Committee advisories and news releases are available on the World Wide Web at 'HTTP://WWW.HOUSE.GOV/WAYS__MEANS/'.

KPMG LLP
WASHINGTON, DC 20036
April 2, 2001

The Honorable Amo Houghton
Chairman
Subcommittee on Oversight
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Re: COMMENTS ON PENALTY AND INTEREST PROVISIONS OF THE INTERNAL REVENUE CODE

Dear Mr. Chairman:

We are writing in response to your request for comments on the penalty and interest provisions of the Internal Revenue Code (the "Code"). We strongly support continued examination of the penalty and interest provisions of the Code, as well as legislation that will encourage voluntary compliance, fairness, deter undesired behavior, and promote efficient and effective administration.

Section 3801 of the IRS Restructuring and Reform Act of 1998 required the Joint Committee on Taxation and the Secretary of the Treasury to conduct separate studies on the administration and implementation of the interest and penalty provisions. Pursuant to this study, comments were sought on the penalty and interest provisions of the Code. In response to this request, we submitted a number of recommendations to improve the fairness and efficacy of the penalty and interest regime. Progress has been made on the penalty and interest provisions. We believe however, that there is room for further reform of the penalty and interest provisions. Therefore, we respectfully submit these recommendations to you in order to support the continued initiative to improve the fairness and efficacy of the penalty and interest regime for all taxpayers.

We believe that significant improvements should be made both to the structure of the penalty and interest provisions and to the ways in which they are administered. While some taxpayers may factor penalties and interest into the calculation when choosing not to comply with tax filing or payment requirements, we believe that, in most instances, the cause of noncompliance is due to the complexity of the law, or the result of unique events and circumstances. The cost of penalties imposed by the Internal Revenue Service (the "IRS" or "Service"), as well as the cost of responding to proposed penalty assessments as a result of examinations or through IRS notices, is staggering.

We believe that assessing penalties on taxpayers who have a good history of compliance is counterproductive. Assessing penalties against these taxpayers often contributes to the perception that the system is unfair and may not be conducive to encouraging voluntary compliance. Taxpayers with good track records generally should not systemically be subjected to penalty assessments.

The complexity inherent in calculating interest, particularly in large scale multiyear examinations, almost always results in errors by taxpayers and the IRS. Taxpayers and the government may be losing thousands of dollars (or more) due to such errors. Interest calculations must be simplified.

PENALTY PROVISIONS

I. GENERAL COMMENTS

A. Encouraging Voluntary Compliance

In general, the penalty provisions of the Code should encourage voluntary compliance by taxpayers. We do not believe that it is in the best interest of tax administration to enact penalties to raise revenue or to punish a taxpayer arbitrarily. For the most part, taxpayers understand that basic failures to comply with the Code—*e.g.*, failure to file an income tax return or to pay tax in a timely manner—will result in the imposition of penalties and interest, and taxpayers will try to comply with the law to avoid those adverse consequences. It should be noted, however, that frequently the events or circumstances that create late filing, late deposits, or late payments, for example, are unique events in the life of a taxpayer or business. Too heavy a sanction for an inadvertent failure to comply, especially when the burden of compliance is heavy, may have the unintended effect of undermining faith in the fairness of the system and discouraging future compliance.

Sections 6038A and 6038C provide examples of penalty provisions that do not encourage voluntary compliance. Sections 6038A and 6038C impose reporting requirements on foreign-owned corporations. Under these provisions, certain transactions with related parties must be reported on Form 5472. The penalties imposed for failure to comply with these reporting requirements are substantial—an initial penalty of $10,000 per form and an additional $10,000 for each month (or fraction thereof) if the reporting requirements are not met more than 90 days after the Service sends notice to the corporation. The penalty can be avoided if the corporation can show, to the satisfaction of the Secretary, that there was reasonable cause for failing to provide the required information, but it is unclear whether the reasonable cause exception would apply, for instance, in cases where the taxpayer did not know that the Form 5472 was required. These penalty rules would more likely encourage voluntary compliance (and comport with basic notions of fairness) if the penalties did not apply as long as the taxpayer corrected the error before the error was discovered by the IRS. This could be achieved by enacting in the foreign reporting context a one time rule similar to the "qualified amended return rule" in effect for purposes of the accuracy-related penalty. See Reg. Sec. 1.6664–2(c)(3) (if an error is discovered and corrected before the IRS contacts the taxpayer, no accuracy-related penalty can be imposed). A similar qualified amended return rule should be enacted for transactions required to be reported on Forms 5471.

B. Enacting Substantially Uniform Penalty Provisions

We appreciate that the inordinate complexity of the tax law and its administration preclude perfectly consistent application of penalty and interest provisions to all taxpayers. Nevertheless, we respectfully request that greater effort be directed to enacting laws that promote uniform treatment of taxpayers and encourages voluntary compliance. Unfortunately, we are aware of numerous instances in which taxpayers with similar fact patterns have received completely different penalty treatment by the Service.

The section 6651(a)(2) and (3) failure to pay penalty leads to particularly unfair results. For example, this penalty is imposed when an individual taxpayer files a timely return but fails to pay the full amount of the tax shown on the return. The failure to pay penalty is not imposed, however, when the taxpayer files a Form 4868 and pays at least 90 percent of the tax due. The individual taxpayer who files timely and the taxpayer who files an extension will only be treated equally if there is a 10 percent safe harbor for the failure to pay penalty. The safe harbor should apply until the extension date (i.e., August 15). Thus, if an individual taxpayer files a timely return, pays at least 90 percent of the tax due on April 15, and pays the remaining 10 percent by August 15, no failure to pay penalty should be imposed. In order to treat individual taxpayers uniformly, the statute should be amended in order that the penalty not attach until after August 15. A similar rule applies to corporate taxpayers (*see* Reg. Sec. 301.6651–1(c)(3), (4)). As noted more fully below, however, we believe that the failure to pay penalty no longer serves its intended purpose and should be repealed.

II. SPECIFIC RECOMMENDATIONS

A. Expansion of Reasonable Cause and Good Faith Exception

We recommend the enactment of statutes that provide a reasonable cause and good faith exception to all penalties. The reasonable cause and good faith exception to various penalties (such as the section 6664(c) exception to the section 6662 and 6663 accuracy-related and fraud penalties) is one source of the Commissioner's authority to waive or not enforce penalties. There are some penalties, however, that do not have a reasonable cause and good faith exception. For example, there is no reasonable cause exception for estimated tax penalties imposed under section 6654 (with the exception of newly retired or disabled individuals) and section 6655. Another example is section 7519, which imposes extremely harsh penalties with no reasonable cause exception. We recommend the enactment of statutes that provide a reasonable cause and good faith exception to all penalties.

We also believe that the penalty provisions should be amended to recognize that taxpayers be afforded greater protection from penalties in the situations in which there is an absence of guidance on how a particular tax provision applies. For example, we would recommend that either reliance on well-reasoned treatises (or other publications), or the Service's failure to provide guidance on a tax law provision, should be taken into account in determining whether the taxpayer qualifies for the reasonable cause exception to the accuracy-related penalty.

B. Enactment of an Objective Reasonable Cause Standard

We do not believe that the penalty provisions are generally designed in a manner that promotes efficient and effective administration by the Service. In addition to a subjective "reasonable cause" standard to abate penalties, there should be enacted an objective standard (*i.e.*, one or more "safe harbors") for determining whether the penalty should apply in the first instance. Given the significant number of penalties that are abated under current law, objective standards should narrow the group of taxpayers to which a given penalty applies in a manner that corresponds to how the particular penalty has been administered historically. The subjective standard could be used as a supplementary measure to ensure that each penalty is being administered equitably and fairly. This two-pronged approach may very well result in more judicious initial application of penalties, which would be far preferable to the current process of proposing or assessing penalties and then abating a large number of them when protests are received.

1. *Waiver for First-Time Offenders*

We recommend enactment of a safe-harbor provision for first-time offenders as an exception to all the penalty provisions of the Code. In certain cases, rather than the Service assessing a penalty and then abating it if the taxpayer protests, we recommend enactment of a provision that requires educational notices be used for first-time offenders. If a taxpayer did not know of, and could not have easily learned of, an obligation, a penalty should not be imposed on that taxpayer for the first year in which the obligation arose. Any penalty waiver provision enacted should take into consideration a taxpayer's compliance history. Current law provides little relief for first-time offenders. For example, section 6656(c) provides an exception from the penalty for failure to deposit employment taxes for first-time offenders. Likewise, Reg. Sec. 301.6724–1(a) also provides a waiver of the penalty for failure to comply with certain information reporting requirements for first-time offenders. We believe that this concept should be expanded to all penalty provisions to ensure that the penalty provisions are fair for innocent first-time offenders.

In the case of a first-time offense, we recommend requiring that the Service inform the taxpayer of the amount of the penalty if the penalty had been assessed. Any notice issued to a taxpayer should contain information on what steps the taxpayer should take in the future to avoid the penalty. A subsequent delinquency would result in a penalty (unless special facts and circumstances in the subsequent year justified reasonable cause relief).

One recent example that we encountered was the assertion of a late filing penalty on a foreign based taxpayer who inherited property and income from a person within the United States. The taxpayer was initially given poor advice, but once he learned that he had a filing requirement, he took prompt corrective action without IRS intervention. The IRS Service Center refused the request for abatement of the late filing penalty. While the taxpayer subsequently prevailed at Appeals, the additional cost to do so was high.

2. *Waiver in Interest of Tax Administration*

We recommend adding a specific Code section that would allow the Commissioner or National Taxpayer Advocate to waive or abate any penalty or addition to tax if it is in the interest of tax administration. Currently, Department of the Treasury Order No. 150–10 gives the Commissioner broad authority in the administration of the tax law. This Treasury Order can be used to waive penalties. The waivers of the estimated tax penalty noted in News Releases IR 88–39 (waiver of estimated tax penalties for farmers who did not receive information returns from Department of Agriculture by Feb. 15, 1988) and IR 88–62 (automatic IRS waiver of estimated tax penalties on retirement income for 1987) are examples of the Commissioner's broad authority. We believe that in certain circumstances the Commissioner's or the National Taxpayer Advocate's waiver or abatement of a penalty may be in the best interest of tax administration.

3. *Waiver for Use of Payroll Service Provider*

We think the efficient administration of the penalty provisions could be greatly enhanced by modifying the rules relating to payroll service providers. Companies hire payroll service providers to help comply with the filing and deposit requirements related to payroll taxes. Payroll service providers are responsible for the timely payment of billions of dollars in withholding taxes to the U.S. Treasury on a daily basis. Despite this contribution, the IRS frequently fails to recognize the unique role such companies play. In view of the assistance payroll service providers provide to taxpayers and the Treasury, consideration should be given to legislation that would provide that the use of a competent payroll services company presumptively qualifies for reasonable cause (or "safe harbor") relief from penalties. The presumption could be rebutted by proof of action by the taxpayer that was inconsistent with reasonable cause and good faith.

C. Expansion of Required Content-Penalty Notices

We recommend that section 6751 be amended to require that penalty notices include the rationale for imposing the penalty and an analysis of how it applies to the particular taxpayer. Section 6751, added by section 3306(a) of the IRS Restructuring and Reform Act of 1998, requires that penalty notices identify the type of penalty and how it was computed. Current communications from the Service do not provide adequate explanations of penalties and interest. For example, a 30-day letter involving the accuracy-related penalty typically contains boilerplate language announcing that "[s]ince all or part of the underpayment of tax" for the relevant tax year is attributable to "one or more of" the accuracy-related penalties for negligence or disregard of rules or regulations, a substantial understatement of income tax, or a valuation misstatement, a 20% "addition to the tax is charged as provided by section 6662(a) of the Internal Revenue Code." It sets forth no rationale or analysis justifying the penalty and, indeed, does not even tell the taxpayer which component of the accuracy-related penalty is at issue. We do not believe that Congress intended in enacting section 6751 for taxpayers to receive so little helpful information in penalty notices.

Although the enactment of section 6751 is a move in the correct direction, section 6751 would not (unless amended) require including the rationale for imposing the penalty and an analysis of how the penalty applies to the particular taxpayer under the particular circumstances. Section 6751 should be amended to require that 30-day letters inform taxpayers of their options—*e.g.*, of explaining how to obtain relief from penalties on reasonable cause grounds—as well as of informing taxpayers of what they did incorrectly and of how to avoid the penalty in the future. Under the current system, a taxpayer may have to hire a tax practitioner to understand how to obtain a waiver of the penalty and how to avoid the penalty in subsequent tax periods. Voluntary compliance would be greatly enhanced if taxpayers were better apprised of their rights and responsibilities.

D. Conversion of Certain Penalty Provisions to Interest Provisions

We recommend the conversion of certain penalty provisions of the Code to interest provisions. We believe that where a penalty provision is essentially a fee for the use of money, such provision should be accurately classified as interest. For example, the individual and corporate estimated tax penalties should be replaced with interest charge provisions. The conversion of both estimated tax penalties into interest charges more closely conforms the titles and descriptions of those provisions to their effect. The penalties are essentially a fee for the use of money that is compensatory in nature.

E. Repeal of Failure to Pay Penalty

We recommend repeal of the failure to pay penalty under section 6651(a)(2) and (3). Although, in the past, some taxpayers would generate overpayments and underpayments to take advantage of disparities between commercial borrowing rates and the section 6621 rates, it has been our experience that this is no longer a significant issue. In response to the interest rate disparity that existed before 1986, Congress enacted the failure to pay penalty. The purpose of this penalty was to compensate the government for the fact that the interest rates on underpayments were substantially less than the commercial rates. When the interest rates were so structured, taxpayers were "encouraged" to put off paying their taxes for as long as possible. The interest rates, however, are now tied to the market interest rates and the original purpose for this penalty has disappeared. The government is now adequately compensated for the use of its money. Because the failure to pay penalty has outlasted its usefulness, we respectfully request its repeal.

F. Staying Collection Proceedings

We recommend legislation which provides that collection efforts be stayed pending completion of the administrative and/or judicial proceeding. For example, in some situations the Service attempts to collect the trust fund penalty imposed under section 6672 while the penalty is being contested administratively or judicially. It would ease the burden on taxpayers if the Code provided that collection efforts be stayed pending completion of these proceeding.

G. Establishment of National Office Level Oversight

In order to promote uniformity and fairness, taxpayers generally should be subject to a similar penalty regime. Although it would be reasonable to have penalties administered by each of the four operating units of the Service's reorganized structure, safeguards must be instituted to ensure that each such unit administers the penalties in a manner that is consistent with the way each other unit administers the penalties. In view of the potential for dissimilar treatment, we recommend legislation establishing a National Office level function to oversee the administration of penalties and to ensure that it is uniform and fair.

INTEREST PROVISIONS

I. Enactment of Single Statutory Interest Rate

We strongly support enactment of a single statutory rate of interest on corporate tax underpayments and overpayments. Under current law, a higher rate of statutory interest is imposed on corporate tax underpayments than on corporate tax overpayments. Charging a higher interest rate on corporate tax underpayments is equivalent to subjecting corporate taxpayers to a penalty equal to the interest differential. There is no policy basis for assessing a different figure for the time value of money depending upon whether the debtor is the federal government or a corporate enterprise. Imposing a single rate of interest on overpayments and underpayments would eliminate this unjustified differential.

Imposition of a single statutory rate of interest on overpayments and underpayments also has the advantage of being easier to administer than the current global interest netting rule. The global interest netting rule often requires a taxpayer to produce complex calculations to demonstrate periods of overlap and the amounts of overpayments and underpayments eligible for netting. Imposing a single rate of interest, by contrast, would generally have the effect of accomplishing "interest netting" automatically.

Finally, imposing a single rate of interest has the advantage of rendering moot several difficult interpretive questions raised by the global interest netting rule enacted by the IRS Restructuring and Reform Act of 1998. The global interest netting rule generally provides that a taxpayer is entitled to a net interest rate of zero for equivalent tax overpayments and underpayments during applicable periods of overlap. Questions have been raised as to whether the global interest netting rule applies where one taxpayer has an underpayment and a related taxpayer has an overpayment. As explained by the Joint Committee:

> The zero net interest rate only applies where interest is payable by and allowable to the same taxpayer. The zero net interest rate does not apply where interest is payable by one taxpayer and allowable to a related taxpayer. However, if the related taxpayers joined in a consolidated return for the underpayment and overpayment years, they are presumably treated as a single taxpayer and may apply the zero net interest rate.
>
> [However,] [c]ertain taxpayers are prevented by the Code from joining in a consolidated return even though one taxpayer is the wholly owned subsidiary of the other . . .

JCT Interest and Penalty Study, JCS–3–99, July 22, 1999, p. 95. If the tax law imposed a single statutory rate of interest on tax overpayments and tax underpayments, the difficult interpretive questions raised where interest is owed by one taxpayer and interest is payable to a related taxpayer would be eliminated.

Imposition of a single statutory rate of interest would not however, resolve a situation in which a taxpayer has an outstanding overpayment and underpayment during an overlapping period and interest is either not allowable on the underpayment or not payable on the overpayment.

II. Interest Netting Rule

A. Expansion of Global Interest Netting Rule

We recommend legislation that would expand the global interest netting rule to apply during certain legislative grace periods when there are overlapping overpayments and underpayments, regardless of the fact that, under the Code, interest is not paid. For instance, the Code provides that if the IRS processes a request for a refund within 45 days no interest may be paid on the overpayment. Interest only runs if the overpayment is not refunded within the 45-day grace period. Likewise, interest is not imposed on an "addition to tax" if it is paid within 21 business days of the date the IRS issues a "notice and demand"—or request for payment (10 business days if the amount of the penalty is at least $100,000). Despite these legislative grace periods, in each case there is still an outstanding tax overpayment or underpayment, and under "use of money" principles, interest should be accruing. We recommend that the global interest netting rule be expanded to apply during these grace periods. This approach would take account of the mutuality of indebtedness between the taxpayer and the government during the period of overlapping overpayments and underpayments.

B. Clarification of Periods of Limitations

We recommend legislation clarifying the transition rule to section 3301(c) of the IRS Restructuring and Reform Act of 1998 (the enacting legislation to section 6621(d)) to provide that only one period of limitation needs to be open on July 22, 1998 in order to qualify for global interest netting. We believe such an approach is consistent with Congress' mandate that "the most comprehensive interest netting procedures that are consistent with sound administrative practice" be adopted. We believe that this interpretation is in accordance with the remedial purpose of section 6621(d).

Section 3301(c) of the IRS Restructuring and Reform Act of 1998 is subject to differing interpretations. The Service interprets section 3301(c) as requiring that both periods of limitations be open as of July 22, 1998. This interpretation does not reflect what we believe to be the "comprehensive netting procedures" envisioned by Congress. *See* S. Rep. No. 105–174, at 62 (1998). We think that IRS's requirement that both periods of limitations be open as of July 22, 1998, is an unnecessarily narrow interpretation of section 3301(c). Section 6621(d) applies to interest periods beginning before July 22, 1998, "[s]ubject to any applicable statute of limitation not having expired with regard to either a tax underpayment or a tax overpayment. . . ." We believe the legislative history strongly supports the view that Congress intended that only one period of limitation need be open. The Conference Report states that the zero net rate of interest would apply retroactively if "the statute of limitations has not expired with respect to either the underpayment or overpayment. . . ." H.R. Conf. Rep. No. 105–599, at 74 (1998).

Furthermore, requiring only one period of limitation to be open would be consistent with the application of the netting rules for interest periods beginning after July 22, 1998. *See* Rev. Proc. 2000–26, 2000–24 I.R.B. 1257. The following example illustrates this point:

> *Example 1:* Q Corp. had an underpayment from the 1994 tax year that ran from March 15, 1995, until July 1, 1999 (the date on which it was paid), and an overpayment from the 1997 tax year that runs from March 15, 1998, until March 12, 2002 (the date on which the refund was issued). The overlapping period of underpayment and overpayment is March 15, 1998, through July 1, 1999. Because the 1997 return was not "under consideration" on December 31, 1999, Q Corp. did not take steps to protect its right to interest netting, if any such steps are required. It appears that the IRS is proposing that, on these facts, no netting of Q Corp.'s 1994 underpayment and 1997 overpayment be done for the period from March 15, 1998, to July 22, 1998—even though netting will be required for interest periods beginning after July 22, 1998. Therefore, in this example, the IRS will only net the overpayment and underpayment for interest accrued between July 22, 1998, and July 1, 1999. Because there is no requirement that both statutes of limitation be open for interest periods beginning after July 22, 1998, we expect that the IRS will net the interest in this case, even though only one period of limitation will be open.

In Example 1, the period of limitation for the 1994 underpayment interest would have expired before March 12, 2002; however, the IRS would still be required to net for interest periods beginning after July 22, 1998. We do not believe it is logical to make the netting rule dependent on when an examination concluded, especially when the IRS has sole control over when an examination begins. It should be made clear that IRS is required to net the overlapping overpayments and underpayments for interest periods beginning before July 22, 1998, just as they are required to do for interest periods beginning after July 22, 1998.

Application of the zero net rate of interest will not run afoul of the general statutes of limitations on claims for refund, even when only one of the limitations periods is open. Section 6621(d) requires only that a zero net rate be applied; it does not mandate the manner in which this is done. As long as one of the periods of limitation is open, the interest rate on the overpayment or underpayment for that period can be adjusted to effectuate the zero net rate. The following example illustrates this point:

> *Example 2:* T Corp. had a deficiency of $3,000,000 in income tax for the 1988 tax year. That deficiency was timely assessed on March 15, 1992. T Corp. paid the assessment of tax and interest on April 1, 1992. Assume that the deficiency interest accrued between March 15, 1989, and April 1, 1992, at a rate of 9 percent.

T Corp.'s 1989 tax year has been the subject of litigation in the Tax Court. On September 10, 1998, the Tax Court entered a decision determining that T Corp. did not have a deficiency for the 1989 year and that T Corp., instead, had an overpayment of $2,000,000 for that year. As a result, the IRS owes T Corp. interest on the overpayment from March 15, 1990, through the date of payment. Assume that overpayment interest accrued at a rate of 8 percent during this period.

The overlapping period of underpayment and overpayment runs from March 15, 1990 (the date the 1989 return was filed), to April 1, 1992 (the date T Corp. paid the 1988 deficiency). During the overlapping period, T Corp. paid interest at the rate of 9 percent. The overlapping amount of underpayment and overpayment is $2,000,000. If the IRS refunds the overpayment using the 8 percent interest rate, the net rate of interest on the overlapping amount will be 1 percent. The period of limitation for the 1988 year has expired so, based upon current IRS interpretation, T Corp. cannot seek a refund of the interest rate differential—*i.e.*, 1% of $2,000,000, accruing between March 15, 1990, and April 1, 1992.

Even though the underpayment year was closed on July 22, 1998, the interest rate on the overpayment during the overlapping period can be adjusted to take into account the deficiency interest paid by T Corp. The IRS can adjust the interest rate on the overpayment to 9 percent (the underpayment rate) during the overlapping period to effectuate the zero net rate of interest.

Moreover, clarifying that only one year must be open is entirely consistent with the tax law as applied in other areas. As a general proposition, both taxpayers and the IRS can consider, and even make, adjustments to closed years in order to determine the correct tax treatment in an open year. As long as no assessment or refund is being made, the applicable statute of limitations is not being violated. *See*, *e.g.*, *Commissioner* v. *Van Bergh*, 209 F.2d 23 (2d Cir. 1954); *Jones* v. *Commissioner*, 75 T.C. 391 (1978). *See also* Rev. Ruls. 56–285, 69–543, 82–49, 81–87, 81–88; PLR 9504032. This is also the approach authorized by section 6214(b) when adjustments in years not before the Tax Court are taken into account in order to reach the correct result for the years at issue. *See Odend'hal* v. *Commissioner*, 80 T.C. 588, 618 (1983); *Russello* v. *Commissioner*, T.C. Memo. 1989–391 (For purposes of determining eligibility for income averaging, the court could look at the correct amount of income in the base period years even though assessment of a deficiency or refund of an overpayment would be barred by the statute of limitations). *See also* Field Service Advice dated 12/29/98 (Tax Analysts Doc. No. 1999–16631) ("Although the Tax Court is without authority to determine a deficiency or overpayment for [the closed year], it can consider such facts from [that year] as may be necessary to correctly redetermine the taxpayer's tax liability for a year with respect to which a deficiency has been determined and is properly before the court. I.R.C. section 6214(b).").

Because the net rate of zero can be effected by either adjusting the interest rate in the underpayment or overpayment year—as long as one statute is open—the taxpayer should be able to benefit from the netting provisions. It appears that clearly Congress intended that in drafting this statute, the interest netting rules be applied as broadly as possible. Therefore, we recommend clarification of the law to require that only one period of limitation—that of the underpayment year or the overpayment year—have been open on July 22, 1998.

III. Expansion of Notice Requirement

We believe that section 6631 should be amended to require that all bills for interest required to be paid—for both individuals and corporations—include the Code section under which the interest is imposed, a computation of the interest, and an explanation of how the interest charge is determined, including the base on which the interest is applied, the applicable interest rate, and the period during which the interest has accrued. The notice should also include the overlapping overpayment and underpayment periods during which the Service is applying the net zero rate of interest.

We believe there are solid reasons to require this interest information. For example, the Service's administration of the current interest provisions does not always appear to be efficient and effective. The service centers, appeals offices, and district counsel are sometimes taking inconsistent approaches to interest computations. We think this problem may be somewhat alleviated for individuals after December 31, 2000, when the Service will be required to provide individual taxpayers with notices containing both the Code section under which interest is imposed and a computation of the interest. *See* section 6631 (added by section 3308(a) of the IRS Restructuring and Reform Act of 1998). The Code currently does not guarantee adequate notice to taxpayers other than individuals. We recommend amending section 6631 in order to apply to all taxpayers.

IV. INTEREST ABATEMENT ON ACCOUNT OF EQUITY AND GOOD CONSCIENCE

We recommend amending section 6404 to allow the Service to abate interest in situations that do not necessarily involve a ministerial or managerial act, but that warrant abatement on grounds of equity and good conscience. The "ministerial" and "managerial" requirements are unnecessarily limiting, vague, and do not focus on the equities of the case. In addition, we recommend modifying the Commissioner's abatement authority to include the abatement of interest on all taxes, such as employment taxes. Section 6404(e) only allows the abatement of interest on taxes subject to the deficiency procedures. Because employment and other taxes are not subject to the deficiency procedures, interest on those taxes is not subject to abatement. *See Woodral* v. *Commissioner*, 112 T. C. 19 (1999). There can be situations, however, when interest on employment taxes should be abated because of unreasonable errors or delays by the Service. Section 6404(e) could be easily modified to account for these situations.

We recommend enactment of a statute that requires abatement of interest in situations where delays in IRS decisions or case actions have contributed to large interest assessments in relation to the tax owed.

We recommend amendment to the net worth requirements for Tax Court review of the Service's failure to abate interest. In certain cases the net worth requirements bar relief, resulting in inequity.

V. CLARIFICATION OF CODE PROVISIONS' STATUS AS PENALTY OR TAX FOR INTEREST PURPOSES

Section 6601(e)(2) sets forth the general rules for imposing interest on penalties and additions to tax. It is not clear, however, whether and when penalties other than those imposed by chapter 68 are subject to interest—*e.g.*, the penalties imposed by sections 5761, 6038A, 6038C, and 7261–7273. It is also unclear how interest accrues on certain "taxes"—*e.g.*, the tax imposed by section 4979 on excess contributions to a retirement plan. We recommend that these issues be clarified in a manner that encourages compliance (*i.e.*, that does not unnecessarily "stack" sanctions).

Certain interest rules act primarily as penalties and their application may result in the impermissible stacking of penalties. For example, the "hot interest" provision in section 6621(c) on large corporate underpayments compensates the government for the use of its money and effectively penalizes the taxpayer an additional two percent. In addition, before 1990, section 6621(c) imposed a 120 percent interest rate on tax-motivated transactions. This section was repealed for returns due after 1989, but the higher interest rate continues to apply to tax-motivated transactions that occurred in earlier years. Not only does this provision act as a hidden penalty, but it also results in the dissimilar treatment of similarly situated taxpayers.

Accordingly, we strongly recommend that all rules regarding interest should be based upon use of money principles as opposed to raising revenue or to the imposition of a penalty.

Respectfully submitted,

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Statement of Kathleen M. Nilles, Esq., Gardner, Carton & Douglas

I am a tax lawyer practicing in Washington, D.C. I have been involved in federal tax law for the past 16 years. Following law school, I worked for five years as a tax associate in private practice. Then I served as tax counsel to the Committee on Ways and Means. As Tax Counsel, I was responsible for advising the Committee on tax compliance issues, including IRS penalties and interest.

Since leaving Government service in early 1995, I have represented a variety of clients as a tax partner in the law firm of Gardner, Carton & Douglas. We currently represent the Partnership Defense Fund Trust, an organization funded by and formed to defend the interests of several hundred individual investors in the partnerships described below. This statement is submitted exclusively on the Trust's behalf. We do not represent any individual partners in these partnerships.

In connection with the Oversight Subcommittee's review of the penalty and interest provisions in the Internal Revenue Code, I would like to bring to the Subcommittee's attention a situation that has drastically affected the lives of thousands of taxpayers throughout the country. It is the kind of situation that this Committee attempted to address in the IRS Restructuring and Reform Act of 1998. To date, however, the IRS has failed to incorporate Congressional intent—both in its published guidance and in its actual administration of the tax law. Thus, I would urge Congress to consider whether stronger legislative measures are needed.

THE SITUATION OF THE INDIVIDUAL TAXPAYERS WHO INVESTED IN HOYT PARTNERSHIPS

From 1977 through 1997, approximately 3,000 individuals and couples throughout the United States were induced to invest in one or more of over 100 separate partnerships set up by Walter J. Hoyt, a nationally recognized cattle breeder. Twenty years later, many of these investors are confronting a fate much worse than the mere loss of their original investment in these now bankrupt partnerships. Pursuant to a complex fraud in which the partnerships' promoter inappropriately allocated a limited number of cattle among several partnerships resulting in excess deductions, many Hoyt investors have received tax, penalty and interest assessments totaling ten to twenty times their original investment. As a result of factors beyond their control, these individual investors—who are largely middle-class wage earners—typically face IRS liabilities of $200,000 to $600,000.[1] The enormity of these liabilities has caused great emotional distress and threatened many investors' financial and retirement security.

The Hoyt partnerships, although fraught with fraudulent misrepresentations and bookkeeping irregularities, were *not* a typical tax shelter. Mr. Hoyt and his family were nationally recognized cattle breeders. In the years 1984 to 1994, Hoyt's cattle operations owned between 4,000 and 10,000 head of cattle. The cattle were kept on ten to twelve separate ranches owned by the Hoyt partnerships with a combined acreage totaling over 500,000 acres, as well as on other leased land. The Hoyt investors could not have individually discovered the fraud. Indeed, it took IRS auditors and federal prosecutors years to develop sufficient evidence to verify their long-standing suspicions.

For several years after the IRS Criminal Investigation Division first began to investigate the Hoyt operations, Walter J. Hoyt was allowed to continue to conduct business as usual, to promote more partnerships, and to retain his role as the Tax Matters Partner ("TMP") for the approximately 118 separate partnerships he formed and promoted. In addition to failing to remove him as TMP, the IRS failed to take any of the following possible actions against him:

- The IRS failed to file an injunction against Mr. Hoyt as a tax return preparer. *See* IRC § 7407.
- The IRS failed to file an injunction against Mr. Hoyt as a promoter of an abusive tax shelter. *See* IRC § 7408.
- The IRS failed to disbar Mr. Hoyt from practice before the IRS as an "Enrolled Agent."[2]

An IRS officer, with substantial experience on this case, recognized that the investors were "unwitting victims" of Walter J. Hoyt's fraud. Appeals Officer William McDevitt filed a statement in 1997 in which he described the taxpayers as "unwitting victims," "unsophisticated in tax matters," and "confused by the" Tax Court's 1989 decision in *Bales* v. *Commissioner*.[3] The *Bales* case held that the partnerships were bona fide businesses and seemed to confirm most of Hoyt's assertions and theories.[4] Officer McDevitt concluded that "proposing penalties against these inves-

[1] One reason why the interest portion of these liabilities is so large is that the IRS has imposed a penalty form of interest, known as "tax-motivated interest," for tax years 1983 through 1988.

[2] From the late 1970's until 1997, Mr. Hoyt used his continued Enrolled Agent status as proof that he was a legitimate tax advisor. The IRS finally removed Mr. Hoyt's Enrolled Agent status in 1997 and as TMP in 1999.

[3] Statement of Appeals Officer William McDevitt, Appeals Supporting Statement (Dec. 23, 1997).

[4] In *Bales* v. *Commissioner*, T.C. Memo 1989–568, the Tax Court found that a Hoyt cattle partnership was not an abusive tax shelter; however, the Court also held that certain deductions for expenses in excess of the partners' actual investments should be disallowed.

tors would only be likened to pouring salt into their open wounds . . . it would amount to adding mere numbers to already uncollectable amounts."

Notwithstanding the *Bales* decision in October 1989, the IRS continued auditing the Hoyt partnerships, disallowing all claimed deductions and making adjustments consistent with the position that the partnerships constituted abusive tax shelters. In 1993, the IRS and Mr. Hoyt as TMP settled the 1981 through 1986 partnership tax years. The settlements meant that essentially all claimed deductions and losses allocated to the investors from the partnership returns would be disallowed, while substantial income that would have accrued to the Hoyt family was minimized.

The individual partners first received notice of their 1981 through 1986 personal tax liabilities from the settlement (via Form 4549 computational adjustment notices) beginning in 1998. The 1987 through 1996 tax years remain unresolved, with the selected dockets for the 1987 through 1992 tax years having been tried and other dockets awaiting trial.

On May 18, 2000, the Tax Court released its decision entitled *Durham Farms*. In *Durham Farms*, the Tax Court held that the investors in seven Hoyt partnerships are precluded from deducting *any* cattle-raising expenses for 1987 to 1992, because sufficient evidence was not produced to establish that the seven Hoyt partnerships owned any cattle. In light of this decision, a federal judge has asked the IRS and partnership attorneys to work out final settlement. However, several hundred cases still are pending in Tax Court.

In February 2000, a jury in a U.S. District Court found Walter J. Hoyt III and two of his co-defendants guilty of mail fraud, money laundering and conspiracy. To date, Walter J. Hoyt has not been arrested for any tax-related criminal charges.

RECENT CONGRESSIONAL FOCUS ON THE HOYT PARTNERSHIPS

W. Val Oveson, testifying as the IRS National Taxpayer Advocate at a January 27, 2000, Oversight Subcommittee hearing on penalty and interest reform, described the Hoyt situation (and others similar to it) as follows:

> One of the problems taxpayers are bringing to the Taxpayer Advocate Service with increasing frequency involves TEFRA partnerships determined to be tax shelters. Taxpayers, as early as the 1970's and up through the 1990's, invested in a number of partnerships whose major, if not only, purpose was to shelter income from tax liability.[5] For a number of reasons, audits of shelter cases can be quite extensive and Tax Court proceedings fairly lengthy. Thus, for taxpayers who do not settle these cases, but await the results of litigation, final resolution can leave them with liabilities dating back 10 years or more with penalty and interest accruals to match.
>
> The enormity of these liabilities has caused taxpayers to seek assistance from a number of sources, including their Congressional representatives and various functional areas within the Service, including my office, to abate all or part of the accumulated liabilities or to suspend collection action. Some taxpayers have filed for bankruptcy protection. More than most, shelter cases can reflect the burden associated with the past and current penalty and interest structures. *Very few taxpayers are prepared to pay or can pay penalty and interest accumulations that may date back to the 1970's*.

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

Statement of W. Val Oveson, National Taxpayer Advocate, Internal Revenue Service, before the Subcommittee on Oversight, Committee on Ways and Means (January 27, 2000) (emphasis added).

Subcommittee Chairman Houghton highlighted the Hoyt investors' situation in his Opening Statement at that same hearing to illustrate the heavy burden of compounded interest on tax liabilities that take years to resolve:

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[5] Note: Although Mr. Oveson's statement generally describes the situation of the Hoyt investors, the Hoyt partnerships do not fit the definition of a tax shelter (i.e., an organization whose major or exclusive purpose is to shelter income).

> I doubt that there is anyone on this panel who hasn't heard more than one heartbreaking story from constituents who find themselves facing crushing back taxes, penalties and interest payments because they were unable to comply with a tax code they have no hope of understanding. Albert Einstein once said that compounded interest is the most powerful force in the universe. Taxpayers whose interest payments far exceed their underlying taxes can well appreciate the truth of his words.
>
> Just yesterday my staff met with representatives of a group of investors who were defrauded by an enrolled agent. His promotional materials targeted working people, promising them "quality investments for folks that dream about owning a piece of the country."
>
> * * * * *
>
> Today, nearly all of the investors face back taxes, penalties and interest—going back in some cases to the 1970's—because their deductions were disallowed. One of the investors, Ed Van Scoten, says the IRS is trying to collect about half a million dollars from him. "Who are they trying to kid?," he asks. "They could never get $500,000 from me if I worked five lifetimes."
>
> In some cases individual investors first received notice from the IRS of their 1981–1986 tax liability beginning in early 1998. The interest clock was running all this time.
>
> The unscrupulous will always prey on the unsuspecting, but something is seriously wrong with a penalties and interest regime that adds to the problems faced by the victims of this sort of scam.

Statement of Congressman Amo Houghton (R–NY), before the Oversight Subcommittee of the Committee on Ways and Means (January 27, 2000).

Congressional Mandate To Expand Offer in Compromise Criteria

Section 7122 of the Internal Revenue Code authorizes the IRS to settle tax cases with taxpayers under appropriate circumstances for less than the full amount of tax, penalties and interest owed. In the IRS Restructuring and Reform Act ("RRA") of 1998, Congress amended Section 7122 and directed the Secretary to prescribe guidelines to determine when an offer-in-compromise should be accepted. *See* Code § 7122(c) as added by Section 3462 of the RRA. The legislative history of this amendment clearly indicates what members of the tax-writing committees wanted the IRS to address:

- The Conference Report of the 1998 RRA directs that "the IRS [in formulating these rules] take into account factors such as *equity*, *hardship*, and *public policy* where a compromise of an individual taxpayer's income tax liability would promote effective tax administration." H. Conf. Rep. No. 599, 105th Cong., 2d Sess. 289 (1998) (emphasis added).
- The legislative history also specifies that the IRS should utilize this new authority "to resolve longstanding cases by forgoing penalties and interest which have accumulated as a result of delay in determining the taxpayer's liability." *Id*.

Consideration of factors such as equity and public policy represents a significant expansion of the traditional grounds for settling tax cases. Formerly, offers-in-compromise were limited to two situations: (1) doubt as to liability and (2) doubt as to collectibility.

IRS Proposed Regulations on Expanded Offer in Compromise Tests

On July 21, 1999, the IRS issued proposed regulations which clearly do *not* incorporate the Congressional mandate of encouraging offers-in-compromise in longstanding cases in which penalties and interest have accumulated as a result of delay. Instead, the regulations continue the traditional focus on economic factors while giving short shrift to equity and public policy considerations. Specifically, the regulations provide that if there are no grounds for compromise based on doubt as to collectability or liability, a compromise may be entered into to promote effective tax administration when:

> (i) collection of the liability will create economic hardship; or
>
> (ii) regardless of a taxpayer's financial circumstances, exceptional circumstances exist such that collection of the full liability will be detrimental to voluntary compliance by taxpayers; and
>
> (iii) compromise of the liability will not undermine compliance by taxpayers with the tax laws.

Temp. Reg. § 301.7122–1T(b)(4)(i) through (iii).

The regulations provide specific factors for determining when the first and third prongs are satisfied, but no specific factors are provided for determining when the second prong—“exceptional circumstances”—may be satisfied. Unfortunately, the temporary and proposed regulations only offer two examples of cases of “exceptional circumstances:”

(i) the first involves a taxpayer who suffered a serious illness and was unable to manage his financial affairs during such time; and

(ii) the second example involves a case where a taxpayer relied on incorrect advice from the IRS in an informal E-mail response concerning the rollover period for an IRA account.

Temp. Reg. § 301.7122–1T(b)(4)(iv)(E) (examples 1 and 2).

The regulations provide a third example that involves embezzlement of payroll withholding taxes. This example could be viewed as illustrating equitable considerations in the case of a victimized taxpayer. However, the example is classified as a financial hardship example because paying the accumulated taxes, penalties and interest would cause the taxpayer's business to fail. Temp. Reg. § 301.7122–1T(b)(4)(iv)(D) (example 4).

In practice, the IRS continues to view “exceptional circumstances” with the same narrowly focused lens as it always has. In the IRS view, the overriding factor is the taxpayer's ability to pay (i.e., financial hardship). This exclusive focus on financial factors *to the exclusion of equitable considerations* is evidenced in a recent letter from the IRS Chief Counsel's Office to Representative John M. McHugh (R–NY) in response to his inquiry about how the IRS planned to deal with Hoyt investor partners who are facing large interest accumulations:

> Taxpayers may at any time enter into an offer in compromise with regard to their tax liability. We understand that, in many cases, taxpayers will be unable to pay their liability in full, and an offer in compromise based on doubt as to collectibility will be considered under the established procedures for such a request. There are no special rules for Hoyt Partnership investors . . . .

Letter of Deborah A. Butler, Assistant Chief Counsel (Field Service), Internal Revenue Service to The Honorable John M. McHugh (June 4, 1999). Thus, although Congress specified in the 1998 RRA that the IRS should consider equity and public policy and to resolve “longstanding cases” by foregoing penalties and interest, the IRS has shown no inclination whatsoever to provide for significant interest abatement based on equitable considerations or exceptional circumstances.[6]

CONCLUSION

Where innocent taxpayers are victimized by a tax shelter promoter and the process of adjudicating the tax liabilities takes as long as 20 years, equitable factors are strongly present. The broader issue raised by the fraud perpetrated on the Hoyt partnership investors is how such equitable considerations should be taken into account in determining whether a portion of a taxpayer's total liability (e.g., the interest) should be compromised or abated.

In 1998, Congress determined that interest abatement should be part of the new offer-in-compromise procedures in certain situations. As noted above, Congress directed the IRS to take into account factors like “equity” and “public policy.” However, two years later, the IRS has yet to develop reasonable guidelines to facilitate offers in compromise that give proper attention to these factors.

If the IRS continues to exhibit resistance to Congressional intent, Congress may want to revisit the issue in a legislative context. The Joint Committee on Taxation staff has recommended that abatement of interest be utilized if a “gross injustice” would otherwise result if interest were to be charged. It is anticipated that such authority would be used infrequently. Although I believe that the IRS already has the authority to address situations of gross injustice under the expanded offer-in-compromise authority of RRA 1998, enactment of a new statutory remedy may be necessary.

Attached hereto is a proposed statutory amendment that would clarify Congressional intent with regard to the offer-in-compromise criteria that should apply to long-standing cases involving equity.

[6] At the Ways and Means Oversight Subcommittee hearing on January 27, 2000, Treasury Tax Legislative Counsel Joseph Mikout testified: “. . . Treasury's position remains that it is appropriate that situations involving abatement of interest be narrowly drawn.”

PROPOSED STATUTORY AMENDMENT FOR IRS OFFERS-IN-COMPROMISE

Present law

Section 7122 of the Internal Revenue Code gives the IRS the authority to settle cases for less than the full amount of tax, penalties and interest owed. In the IRS Restructuring and Reform Act of 1998 (RRA '98), Congress directed the Secretary to develop guidelines for offers-in-compromise incorporating criteria other than the traditional grounds for such settlements—doubt as to liability and collectibility. The RRA '98 Conference Report specified that the factors to be taken into account when considering an offer-in-compromise include equity, hardship and public policy. The legislative history also specified that the IRS should utilize this new authority to resolve longstanding cases in which penalties and interest have accumulated as a result of delay.

Reason for statutory amendment

The IRS has expressed uncertainty about the standards that should apply with regard to abatement of interest on equitable grounds in the offer-in-compromise context. IRS proposed regulations issued in 1999 failed to provide workable guidelines for IRS field personnel. Consequently, Congressional intent is not being effectuated. In particular, such intent is not being effectuated in situations where penalties and interest have accumulated as a result of delay and equitable grounds are present. H.R. 4163, the Taxpayer Bill of Rights 2000, contains a provision which provides for the abatement of interest on equitable grounds if a gross injustice would otherwise result (i.e., if interest were to be charged); however, this provision would be effective only for interest accruing on or after the date of enactment.

Proposed statutory amendment

Section 7122 of the Internal Revenue Code should be amended to provide the IRS with authority to abate penalties and interest accumulated as a result of delay where equitable grounds or exceptional circumstances are present. The amendment should also clearly state that the IRS may exercise such authority to abate penalties and interest notwithstanding the provisions of section 6404.

Effective date

This amendment applies to proposed offers-in-compromise submitted after the date of enactment.

PROPOSED STATUTORY AMENDMENT FOR OFFERS-IN-COMPROMISE

Evaluation of Offers—Section 7122 of the Internal Revenue Code of 1986 (relating to compromises of civil or criminal cases arising under the internal revenue laws prior to reference to the Department of Justice) is amended by adding at the end of subsection (c) the following new subparagraph:

> *'(3) Interest and Penalties—Notwithstanding the provisions of section 6404, the Secretary may use his authority under this section to resolve longstanding cases by foregoing penalties and interest, in part or whole, which have accumulated as a result of delay in determining the taxpayer's liability and taking into account equity or other exceptional circumstances.'.*

Statement of Wendy S. Pearson, Esq., Pearson, Merriam & Kovach, P.S.

I am a tax lawyer and partner in a small law firm in Seattle, Washington that specializes in federal tax controversies. Each of the attorneys in our firm are former IRS counsel or Department of Justice Tax Division counsel. The combined experience of the law partners in handling federal tax matters extends more than 50 years.

Our firm presently represents over 250 individuals who were partners and investors in cattle and sheep breeding partnerships promoted by Walter J. Hoyt III. Mr. Hoyt was recently convicted for fraudulently inducing the investors to purchase interests in the partnerships and misrepresenting the number and quality of livestock operated by these partnerships. These selfsame partnerships have been audited by the Internal Revenue Service for more than 20 separate tax years (called the "Hoyt Project"), with many of the tax years remaining unresolved as long as 15 years after the IRS began the audit.

For purposes of the review of penalty and interest provisions of the Internal Revenue Code, we would like to present to the Oversight Subcommittee some information and insights about the inequitable impact of penalty and interest provision on taxpayers who become unwitting victims of a tax shelter promoter. Our colleague, Ms. Kathleen Nilles of the law firm Gardner, Carton & Douglas, has suggested to this subcommittee that prior Congressional action in the IRS Restructuring and Reform Act of 1998 (RRA 98) was intended to ameliorate the impact of interest and penalties on individual taxpayers like the Hoyt investors, but that the IRS has failed to effectuate such Congressional intent. We echo those comments and urge Congress to clarify its intent or to consider stronger legislative measures.

We will not reiterate here the factual background of the Hoyt Shelter Project as explained by Ms. Nilles in her comments dated April 2, 2001. We offer the following additional information to assist the subcommittee in its evaluation of the IRS effectuation of legislative intent and the adequacy of current tax law to address tax administration issues that arise in cases like this.

THE IMPACT OF HOYT'S FRAUD ON TAXPAYERS

The following scenarios depict some of the typical investors whom we represent. We have submitted offers in compromise (under 26 U.S.C. § 7122) for these investors, wherein we have requested interest abatement due to the “longstanding” nature of the cases and equitable consideration of their retirement or medical needs in determining the minimum acceptable offer. The IRS has indicated that RRA 98 does not serve as a basis for abating interest and that interest will not be abated for Hoyt investors under the offer in compromise program, namely because the IRS does not believe that it contributed to a delay in the resolution of the cases and it does not want to abate interest in tax shelter cases. Similarly, the IRS has indicated that the minimum offer will be based on the net realizable value of assets and income, without consideration of equity and retirement needs. Further, the IRS has indicated that pending offers of Hoyt investors will not be processed, because each investor is a general partner in a Hoyt partnership with pending litigation (i.e., no one can get out until the partnership litigation is over).

The impact of the IRS position and policy on these investor cases can be illustrated as follows. You will see that these taxpayers not only lose their entire investment to Hoyt's fraud, but they lose their entire life savings to pay the tax, penalties and interest attributable to Hoyt's fraud. interest attributable to Hoyt's fraud.

(1) RETIREMENT/MEDICAL EXAMPLE
Retired Couple: Husband is 67, Wife is 65; Initial Tax Year of Investment—1983

INVESTMENT		
Amounts paid to Hoyt including Tax Refunds Received		$ 97,228
Tax Refunds Received		($ 67,698)
Net out of pocket loss		$ 29,530
TAX LIABILITY		
Tax Only		$ 83,445
Interest (Including Tax Motivated Interest)		$243,743
Penalties (87–96)		$ 31,639
TOTAL		$358,827
ASSETS/INCOME		
Savings		$ 11,500
Life Insurance (cash value)		$ 17,528
Burial plots (cash value)		$ 5,900
Vehicle Equity		$ 1,000
Home Equity (Manufactured home)		$112,850
Total Assets		$148,798
Monthly Income (Social Security and Small Pension)		$ 3,150
TRADITIONAL IRS MINIMUM OFFER	**PAY**	**$153,598**

Total value of all assets PLUS discretionary income (×) 48 months.
Assumption for this couple: $100 discretionary income per IRS standards.

Comments:

Taxpayers have to liquidate all assets and obtain a loan for equity in the home, even though there is no additional income to pay for the home loan. Does not allow for any "extraordinary expenses" such as home repair, home modifications due to illness, additional medical costs for serious illness, or the purchase of a new car when vehicles need replacement. The wife is very ill with no chances of recovery. A T. Rowe Price Retirement Analyzer shows that this couple will run out of money in 2012, because they have to obtain a home equity loan to cover medical and other living expenses if the IRS takes all of their cash assets in the offer. The loan would be necessary to account for inflation and for any extraordinary expenses such as increased medical costs and home maintenance.

Accordingly, equity allowances for special medical needs and retirement needs are important to these taxpayers.

(2) INTEREST ABATEMENT EXAMPLE
Widow, 68; Initial Tax Year of Investment—1984

INVESTMENT		
Amounts paid to Hoyt including Tax Refunds Received		$ 57,507
Tax Refunds Received		($ 24,310)
Net out of pocket loss		$ 33,197
TAX LIABILITY		
Tax Only		$ 63,724
Interest (Including Tax Motivated Interest)		$143,216
Penalties (87–96)		$ 24,562
TOTAL		$231,502
ASSETS/INCOME		
Retirement Accounts		$ 36,000
Annuities		$ 70,000
Vehicle Equity		$ 6,000
Home Equity		$140,000
Total Assets		$252,000
Monthly Income (Social Security and Small Pension)		$ 3,100
TRADITIONAL IRS MINIMUM OFFER	**PAY**	**$231,502**

Total value of all assets PLUS discretionary income (×) 48 months.
Assumption for this taxpayer: $100 discretionary income per IRS standards.

Comments:

Taxpayer will be considered capable of paying the tax liability in full. To do this, she must liquidate all assets and obtain a loan for equity in the home, even though she has insufficient additional income to pay for the home loan. It also does not allow for any "extraordinary expenses" such as home repair, home modifications due to illness, additional medical costs for serious illness, or the purchase of a new car when vehicle needs replacement. The offer does not allow for the retention of assets to subsidize retirement needs during her life expectancy.

Accordingly, interest abatement and consideration of retirement needs under equitable provisions is important to this taxpayer.

(3) INTEREST ABATEMENT EXAMPLE
Retired Couple: Husband is 72, Wife is 67; Initial Tax Year of Investment—1984

INVESTMENT	
Amounts paid to Hoyt including Tax Refunds Received	$ 96,184
Tax Refunds Received	($ 69,969)
Net out of pocket loss	$ 29,530
TAX LIABILITY	

(3) INTEREST ABATEMENT EXAMPLE Retired Couple: Husband is 72, Wife is 67; Initial Tax Year of Investment—1984		
Tax Only		$160,255
Interest		$392,361
(Including Tax Motivated Interest)		$ 77,453
Penalties		
TOTAL		$630,069
ASSETS/INCOME		
Retirement Accounts		$203,319
Stocks & Money Market		$ 12,245
Cash		$ 20,459
Vehicles (2) Equity		$ 20,000
Home Equity		$250,500
Total Assets		$506,523
Monthly Income (Pension & Social Security)		$ 2,830
TRADITIONAL IRS MINIMUM OFFER	**PAY**	**$520,923**
Total value of all assets PLUS discretionary income (×) 48 months. Assumption for this couple: $300 discretionary income per IRS standards.		

Comments:

The taxpayers must sell everything and obtain a loan for equity in the home. Note, the additional amount due over the value of assets is from the present value ($14,400) of discretionary income of $300.00/month. They have no means of acquiring this additional $14,400.00 to satisfy the minimum offer. The minimum offer also does not allow for any "extraordinary expenses" such as home repair, home modifications due to illness, additional medical costs for severe illness, or the purchase of a new car when vehicles need replacement.

Accordingly, interest abatement is important to these taxpayers.

(4) RETIREMENT EXAMPLE Widow, 78; Initial Tax Year of Investment—1984		
INVESTMENT		
Amounts paid to Hoyt including Tax Refunds Received		$ 67,153
Tax Refunds Received		($ 41,833)
Net out of pocket loss		$ 25,320
TAX LIABILITY		
Tax Only		$ 88,908
Interest (Including Tax Motivated Interest)		$206,724
Penalties		$ 34,319
TOTAL		$329,951
ASSETS/INCOME		
Retirement Accounts		$ 13,000
Mutual Funds		$ 2,000
Vehicle Equity		$ 3,000
Home Equity		$ 12,000
Total Assets		$ 30,000
Monthly Income (Social Security)		$ 2,406
TRADITIONAL IRS MINIMUM OFFER	**PAY**	**$ 30,000**

(4) RETIREMENT EXAMPLE Widow, 78; Initial Tax Year of Investment—1984
Total value of all assets. Assumption based on IRS standards: No discretionary income.

Comments:

Taxpayer must liquidate all assets and obtain a loan for equity in the home, even though she does not have sufficient income to pay for the home loan. It does not allow for any "extraordinary expenses" such as home repair, home modifications due to illness, additional medical costs for severe illness, or the purchase of a new car when vehicle needs replacement. It does not allow taxpayer to retain any assets to support her living needs during her life expectancy.

Accordingly, consideration of retirement needs under equity provisions is important to this taxpayer.

THE IRS HANDLING OF THE HOYT TAX CASES DOES NOT PROMOTE EFFECTIVE TAX ADMINISTRATION

Notwithstanding the many shortcomings in the IRS handling of the Hoyt Project cases, the current IRS position on the resolution and closure of these cases impairs effective tax administration. For the majority of Hoyt investors whom we represent, they are unable to pay even a fraction of the principal tax liability, let alone the interest and penalties thereon. Even if one were to accept the IRS' unwavering conviction that these taxpayers deserve to be punished for investing in an abusive tax shelter, what end is served by rendering them penniless? Similarly, accepting the premise that the interest charged on their tax deficiencies is to exact a cost for the use of money[7] in order to encourage proper tax reporting (or deter improper reporting), how does the imposition of that charge serve such purposes when the government has acknowledged that the taxpayers had no idea that they were making improper tax claims because they were being defrauded?[8]

More to the point, the interest charges on these cases stem from the longstanding nature of the audit and case administration. Clearly, no one can disagree that a tax shelter audit project begun in the late 1970's and ongoing to date is a longstanding case. And, Congress recognized in RRA 98 that effective tax administration may be served by abating interest in longstanding cases, regardless of fault or reasons for the delay in resolution of the cases. I submit that RRA 98 was intended to remedy and ameliorate the effect of cumulative interest and penalties on precisely taxpayer cases such as this one. And, the IRS handling of offers in compromise in these cases illustrates the fact that there will be no instance in which the IRS considers the abatement of interest to be justified (except as set forth in the interest abatement provisions under 26 U.S.C. § 6404(e)). The IRS position is inconsistent with RRA 98 and does not promote effective tax administration.

We urge the Subcommittee to adopt the Offer in Compromise reform proposals submitted by and through our colleague, Kathleen Nilles, as part of the new taxpayer Bill of Rights being considered by the Subcommittee for this year.

Thank you for your consideration of these comments.

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[7] Note, the investors were required to pay Hoyt at least 75% of their tax benefits. And in most instances, the investors paid Hoyt all of their tax benefits plus additional amounts out of pocket. Thus, Hoyt had the use of the government's money for the entire period of time the IRS chose not to shut him down.

[8] In the recent prosecution of Hoyt, the government made its case based on the fact that the investors were unwitting victims. Similarly, the IRS Appeals Officer in the Hoyt audits concluded the investors were unwitting victims.