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Testimony United States Senate Committee on Finance Subcommittee Penalties March 14, 1988

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TESTIMONY
UNITED STATES SENATE
COMMITTEE ON FINANCE
SUBCOMMITTEE ON PENALTIES
MARCH 14, 1988

by
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ORAL TESTIMONY

Mr. Chairman, Senators, Commissioner Gibbs, members of the press and guests:

I am Professor James W. Childs of The University of Akron School of Law and Director of The Center for Taxation Studies, Tax Clinic Program. Our Clinic represents low-income taxpayers in audits, collection proceedings, and litigation before The United States Tax Court. It is composed of 19 law students and graduate business students, 15 of whom are with me today, and two of whom will present the testimony. In addition, the Tax Clinic prepares between 200 and 400 low-income taxpayer's tax returns annually. The Tax Clinic

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assists in the training of 100 retired tax return preparer volunteers, and provides computer support for over 30 low income tax preparation sites. I wish to now yield to Cynthia Davis.

There are over 150 different penalties in the Internal Revenue Code (*supra.*, pp. 1-12). These penalties can range from fines to imprisonment, or both. These penalties are assessed, collected, and paid in the same manner as are tax deficiencies and interest. Interest begins running from the date of demand until the tax, accrued interest, and penalties are fully paid.

Interest is not viewed as a penalty, but as compensation for the government's being deprived of the use of the money. Some penalties are interest sensitive, and the daily accrual of interest on these penalties indicates a revenue yield policy. See pages 14 and 15 for examples of how this combination of interest and penalties can drastically increase the amount owed by the taxpayer, even multiplying the amount of the deficiency by as much as 530% over a ten year period.

Penalties on top of penalties indicate a revenue yield policy. These penalties are supposedly assessed to reimburse the government for the expense of investigation and litigation. A lack of Congressional guidance tends to result in IRS agents applying *all* penalties to taxpayers without qualified representation. The average low-income taxpayer does not have the necessary funds to acquire this service (see pages 15-17).

A major problem is that a lack of reading skills prevents many taxpayers from complying with the tax laws. The reading level of most IRS publications is extremely high in relation to most of the written material that low-income taxpayers would normally come into contact with. As measured by the Fry Readability Formula, a Form 1040EZ instruction booklet requires an 8.45 grade reading level. The reading level required for a Statutory Notice of Deficiency is 8.7. It should be noted that the March 3, 1988 Wall Street Journal required only a 7.1 grade reading level (see pages 19-21).

The Internal Revenue Service should write instructions for forms 1040, 1040A, and 1040EZ at between the second and fourth grade level. The University of Akron Center for Taxation Studies would be pleased to offer to provide technically correct instructions for such forms, written at a reading and understanding level of grades two through four within a time frame established by the Internal Revenue Service, and we could do so even if you were to pass legislation in November, which is unlikely this year.

According to the U.S. Department of Education, the following percent of the population possesses a 8.45 grade reading level: Blacks, 19.8%; Hispanics 37%; persons with less than a high school education, 11%; and high school graduates, 50.2%. This study indicates that the majority of low-income taxpayers will find it difficult, if not impossible, to comprehend and, thus, to comply

with the federal income tax laws (see pages 19-21).

Mr. Chairman, I now yield to E. Earle Burke.

We suggest two alternatives to help remedy these problems. At a minimum, representation should be provided to the taxpayer before penalties or interest are assessed. One possibility is to adopt the ombudsman concept. Another is the to establish Tax Clinics, like ours, nationwide. These clinics would be licensed and supervised by the Director of Practice of the IRS to assist taxpayers. A third is to use retired professionals in a senior citizen's clinic structure, also licensed by the Director of Practice. A fourth possibility is a combination of all three. If the taxpayer cannot afford representation, and pro bono representation is not available, then the penalty system should be altered with respect to low-income taxpayers. This could apply to taxpayers with a gross income of $25,000 or less per year, before FICA taxes (see pages 22-26).

We have encountered several cases in which taxpayers have missed the 90 day period to protest the assessment, and since they could not afford to pay the tax, they could not litigate the matter in court. Without litigation to obtain abatement, interest and penalties continue to accrue, sometimes to levels far beyond what the low-income taxpayer will ever be able to pay (see pages 18-19).

If the taxpayer can demonstrate the inability to pay the penalties and interest, the penalties and interest should be automatically abated at the audit level. Part of the justification for this proposal is the fact that a substantial number of these low-income taxpayers cannot at this time, and probably never will, be able to pay. Therefore, these amounts being carried on the books of the government are illusory (see pages 25-26).

We contend that in order to assess penalties and interest, the IRS should be required to notify every taxpayer who can be held responsible for the tax and the deficiency. This could be accomplished by sending all notices by certified mail (see page 26).

The low personal exemptions in the Code enable the IRS to impose levies on a substantial portion of the taxpayer's weekly wages. This IRS policy precludes collection and increases federal social service expenditures. Since the IRS will not levy against unemployment compensation or welfare benefits, this provides an economic incentive for low-income taxpayers to opt out of the job market and onto the public dole. The current exemption amounts bear no relationship to what the taxpayer needs for basic necessities. By increasing the exemption amount, the government will not only encourage a return to employment, but will also make at least a portion of the deficiency collectible, generating future tax revenue (see pages 26-28).

Unrepresented low-income taxpayers often do not fully understand their rights under the existing statutory notice of deficiency. In the case of a divorce, for example, the IRS might send the notice to the taxpayer's spouse. When a

joint tax return is involved, the IRS is permitted to send a single joint notice of deficiency to the last known address. This is true unless either spouse has notified the District Director that separate residences have been established. Even then, the IRS may still send a single joint notice, and one of the taxpayers will not be notified. Thus, after 90 days, the taxpayer loses the right to litigate in court, unless full payment has been made beforehand. This can be construed as denial of due process of law, which guarantees the right of access to the courts, regardless of economic status. Often, even the $60.00 filing fee intimidates the low income taxpayer, who considers it equivalent to a small fortune (see pages 26-33).

Certain assessments may be made without the taxpayer receiving any notice of deficiency. Thus, no assessment made under these circumstances may be litigated in Tax Court, since a notice of deficiency is a jurisdictional prerequisite. Interestingly, the Code specifically states that the notice of assessment in these situations is not a notice of deficiency (see pages 34).

The revenue yield from penalties results in a regressive economic impact on the low-income taxpayer. Often, just to pay the tax, installment payments must be arranged. However, without qualified representation, the low-income taxpayer may not even be aware of this option (see pages 35-36).

When the penalty system was originally enacted, it was created to enforce the collection of taxes. However, since 1981, legislative history indicates a trend toward using penalties as a revenue raiser. Abuses by high-income taxpayers have brought about a number of new penalties. Unfortunately, the low-income taxpayer has been caught in this net. Stacking of penalties generally works as a deterrent to abuses by high-income taxpayers, but since the low-income taxpayer usually lacks the necessary skills to understand the tax system, he is often penalized merely for failure to comprehend (see pages 37-38).

POSSIBLE SOLUTIONS

Interest sensitive penalties should have a floor placed beneath them. In that way, the low-income taxpayer with a minimal standard of living would be exempt. This would reduce the administration cost of collection and minimize regressiveness. At the same time as raising revenue, they would deter flagrant abuse of the tax laws by high-income taxpayers, as well as introducing some progressivity into the system (see pages 38-39).

Abatement of the second or higher non-interest penalties should be an audit level function in the case of the low-income taxpayer. These floor levels should be set by Congress and indexed. Stacked penalties should be automatically abated if, after the levy, the taxpayer does not have sufficient income to pay the primary deficiency (see page 39).

The mandatory services of a qualified representative should be provided

at the time of audit or at the very least before wage levies are imposed. Higher amounts of the taxpayer's income should be exempt from the wage levy, as well as being indexed for inflation. The option of obtaining bankruptcy relief for all taxes, interest, and penalties should be available to the low-income taxpayer (see pages 39-41).

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UNITED STATES SENATE FINANCE COMMITTEE SUBCOMMITTEE ON PENALTIES TESTIMONY

by
UNIVERSITY OF AKRON
CENTER FOR TAXATION STUDIES
STUDENT TAX CLINIC

I. PENALTIES AS REVENUE, LOW-INCOME TAXPAYER IMPACT.

A. *Current tax policy is not clearly set forth.*

There are over 150 different penalties presently in the Internal Revenue Code.

1. GENERAL PENALTIES

1. Sec. 6651(a)(1) Failure to file a return: 5% per month up to 25% of tax due.

2. Sec. 6651(a)(2) Failure to pay tax due on return in Sec. 6651(a): 0.5% per month up to 25% of the tax due.

3. Sec. 6651(a)(3) Failure to pay amount in Sec. 6651(a)(2) within 10 days of notice of deficiency: 0.5% per month up to 25% of the tax due.

4. Sec. 6651(a) Also states that failure to pay amount in Sec. 6651(a)(2) within 60 days of the notice of deficiency is at least the lesser of $100 or 100% of the tax due.

5. Sec. 6652(a)(1)(A)(i) Failure to file a statement regarding amount of payment required by Sec. 6041: $50.

6. Sec. 6652(a)(1)(A)(ii) Failure to file statement relating to fishing boat operators: $50.

7. Sec. 6652(a)(1)(A)(iii) Failure to file a statement relating to income tax withheld: $50.

8. Sec. 6652(a)(1)(B)(i) Failure to make a return required of direct sellers: $50.

9. Sec. 6652(a)(1)(B)(ii) Failure to make return required of brokers: $50.

10. Sec. 6652(a)(1)(B)(iii) Failure to make a return relating to reporting payment of wages in the form of group life insurance: $50.

11. Sec. 6652(a)(1)(B)(iv) Failure to make a return relating to reporting of tips: $50.

12. Sec. 6652(a)(1)(B((v) Failure to make a return relating to mortgage interest received: $50.

13. Sec. 6652(a)(1)(B)(vi) Failure to make return relating to cash received: $50.

14. Sec. 6652(a)(1)(B)(vii) Failure to make a return relating to abandonment of security: $50.

15. Sec. 6652(a)(1)(B)(viii) Failure to make a return relating to exchanges of partnership interests: $50.

16. Sec. 6652(a)(1)(B)(ix) Failure to make a return relating to donated property: $50.

17. Sec. 6652(a)(2)(A)(i) Failure to file statement related to payment of dividends: $50.

18. Sec. 6652(a)(2)(A)(ii) Failure to file statement relating to payment of patronage dividends: $50.

19. Sec. 6652(a)(2)(A)(iii) Failure to file statement relating to payment of interest: $50.

20. through 34. Sec. 6652(a)(3)(A) Separate penalty of 10%, $100, or 5% of gross proceeds for intentional disregard of filing requirements relating to 5 through 19.

35. Sec. 6652(b)(1) Failure to file statement relating to payment of dividends aggregating less than $10: $1.

36. Sec. 6652(b)(2) Failure to file statement relating to payment of patronage dividends aggregating less than $10: $1.

37. Sec. 6652(c) Failure to report tips: 50% of Sec. 3101 tax.

38. Sec. 6652(d)(1) Failure to file return by exempt organization: $10 per day.

39. Sec. 6652(d)(2) Failure of manager of exempt organization to file return: $10 per day.

40. Sec. 6652(d)(3) Failure to meet requirements with respect to public inspection of exempt organization's annual return: $10 per day.

41. Sec. 6652(e)(1) Failure to register pension plan: $1 per participant per day.

42. Sec. 6652(e)(2) Failure to file change of status by pension plan: $1 per day.

43. Sec. 6652(f) Failure to file information required in regard to deferred compensation: $25 per day.

44. Sec. 6652(g)(1)(A) Failure to file return required by Sec. 6039C: $25 per day.

45. Sec. 6652(g)(1)(B) Failure to furnish statement required by Sec. 6039C(b)(3): $25.

46. Sec. 6652(h) Failure to provide required information in connection with deductible employee contributions: $25 per day.

47. Sec. 6652(i) Failure to give notice to recipients of certain pensions: $10.

48. Sec. 6652(j) Failure to give written explanation to recipients of certain qualified rollover distributions: $10.

49. Sec. 6653(a)(1)(A) For negligence add 5% of underpayment.

50. Sec. 6653(a)(1)(B) and 50% of interest under Sec. 6601.

51. Sec. 6653(b)(1)(A) For fraud add 75% of underpayment.

52. Sec. 6653(b)(1)(B) and 50% of interest under Sec. 6601.

53. Sec. 6653(e) Failure to pay stamp tax: 50% of total underpayment.

54. Sec. 6654 Failure to pay estimated income tax: Sec. 6621 rate X underpayment X period of underpayment.

55. Sec. 6655 Failure of corporation to pay estimated income tax: same as Sec. 6654.

56. Sec. 6656(a) Underpayment of deposit of tax: 5% of underpayment.

57. Sec. 6656(b) Overstatement of claim of deposit of tax: 25% of claim.

58. Sec. 6657 Bad check: 1% of face value unless under $500, then lesser of $5 or amount of check.

59. Sec. 6659(a)(1) Overstatement of valuation by an individual: see Sec. 6659(b).

60. Sec. 6659(a)(2) Overstatement of valuation by a closely held or personal service corporation: see Sec. 6659(b).

61. Sec. 6659(f) Overstatement of value of charitable deduction: 30%.

62. Sec. 6660(a) Understatement of valuation for Estate/Gift Tax purposes: see Sec. 6660(b).

63. Sec. 6661(a) Substantial understatement of income tax liability: 10% of underpayment.

2. SUBCHAPTER B: ASSESSABLE PENALTIES

64. Sec. 6672(a) Failure to collect tax: 100% of tax.

65. Sec. 6672(a) Failure to truthfully account for tax: 100% of tax.

66. Sec. 6672(a) Failure to pay over tax: 100% of tax.

67. Sec. 6672(a) Attempt to evade or defeat tax: 100% of tax.

68. Sec. 6673 Bringing suit in Tax Court to delay assessment of tax: up to $5000.

69. Sec. 6673 Frivolous or groundless suit in Tax Court: up to $5000.

70. Sec. 6674 Failure to furnish statement to an employee: $50.

71. Sec. 6674 Fraudulent statement to an employee: $500.

72. Sec. 6675 Excessive claims with respect to certain fuels: greater of twice the excessive amount, or $10.

73. Sec. 6676(a)(1) Failure to put TIN on return: $5.

74. Sec. 6676(a)(2) Failure to furnish TIN to another person: $50.

75. Sec. 6676(a)(3) Failure to provide another person's TIN in a statement regarding such person: $50.

76. Sec. 6676(b)(1) Failure to provide the TIN of a payee of interest or dividends: $50.

77. Sec. 6676(b)(1) Including incorrect TIN of a payee of interest or dividends: $50.

78. Sec. 6676(c)(1) Failure to provide TIN to another person in regard to Sec. 215: $50.

79. Sec. 6676(c)(2) Failure to provide another person's TIN on return in regard to Sec. 215: $50.

80. Sec. 6677(a) Failure to file information with respect to a foreign trust: 5% of amount transferred to trust.

81. Sec. 6678(a)(1) Failure to furnish statement under Sec. 6041: $50.

82. Sec. 6678(a)(1) Failure to furnish statement regarding remuneration for services: $50.

83. Sec. 6678(a)(1) Failure to furnish statement regarding direct sales: $50.

84. Sec. 6678(a)(1) Failure to furnish statement regarding payment of dividends: $50.

85. Sec. 6678(a)(1) Failure to provide statement regarding payment of patronage dividends: $50.

86. Sec. 6678(a)(1) Failure to provide statement regarding brokers: $50.

87. Sec. 6678(a)(1) Failure to provide statement regarding payment of interest: $50.

88. Sec. 6678(a)(1) Failure to provide statement regarding payment of wages in the form of group life insurance: $50.

89. Sec. 6678(a)(2) Failure to provide statement regarding corporations: $50.

90. Sec. 6678(a)(3)(A) Failure to file a statement regarding windfall profits tax: $50.

91. Sec. 6678(a)(3)(B) Failure to file a statement regarding fishing boat operators: $50.

92. Sec. 6678(a)(3)(C) Failure to file a statement regarding crude oil: $50.

93. Sec. 6678(a)(3)(D) Failure to file a statement regarding income tax withheld: $50.

94. Sec. 6678(a)(3)(E) Failure to file a statement regarding employee's tips: $50.

95. Sec. 6678(b) Failure to file interest or dividend statement: $50.

96. Sec. 6678(c) Failure to notify partnership of exchange of partnership interest: $50.

97. Sec. 6679(a) Failure to file return with respect to foreign corporation: $1000.

98. Sec. 6679(a) Failure to file return with respect to foreign partnership: $1000.

99. Sec. 6682(a)(1) Furnishing false withholding information: $500.

100. Sec. 6684(a)(1) Becoming liable for Chapter 42 tax relating to a private foundation due to failure to act: a penalty equal to 100% of the tax.

101. Sec. 6685 Failure to comply with Sec. 7207 regarding private foundation's annual return: $1000.

102. Sec. 6686 Failure to file a return by a DISC or FSC: $100.

103. Sec. 6686 Failure to supply information by a DISC or FSC: $100.

104. Sec. 6687(a) Failure to supply place of residence regarding self-employment taxes: $5.

105. Sec. 6688 Failure to provide information in regard to Sec. 7654: $100.

106. Sec. 6689(a) Failure to file notice of redetermination of foreign tax: 5% per month up to 25%.

107. Sec. 6690 Fraudulent statement to plan participant: $50.

108. Sec. 6690 Failure to provide statement to plan participant: $50.

109. Sec. 6693 Failure to provide report on IRA: $50.

110. Sec. 6693 Failure to provide report on annuity: $50.

111. Sec. 6694(a) Negligent understatement of taxpayer liability by tax return preparer (TRP): $100.

112. Sec. 6694(b) Willful understatement of taxpayer liability by TRP: $500.

113. Sec. 6695(a) Failure to provide copy of return to taxpayer by TRP: $25.

114. Sec. 6695(b)(1) Failure to inform taxpayer of Sec. 274 requirements by TRP: $25.

115. Sec. 6695(b)(2) Failure of TRP to sign return: $25.

116. Sec. 6695(c) Failure of TRP to provide TIN: $25.

117. Sec. 6695(d) Failure to retain copy of return by TRP: $50.

118. Sec. 6695(e) Failure to file correct information return: $100.

119. Sec. 6695(f) Negotiation of refund check by TRP: $500.

120. Sec. 6697 Liability for tax of qualified investment entities: Penalty equals 100% of tax.

121. Sec. 6698(a)(1) Failure to file partnership return: $50 per month per partner.

122. Sec. 6698(a)(2) Failure to file a partnership return showing information required by Sec. 6031: $50 per month per partner.

123. Sec. 6698A Failure to provide information regarding carryover basis property: $100.

124. Sec. 6698A(b) Failure to provide information regarding carryover basis property to beneficiary: $50.

125. Sec. 6699(a)(1) Failure to satisfy requirements of Sec. 409 regarding qualfied investments: Amount equal to failure.

126. Sec. 6699(a)(2) Failure to make contribution under Sec. 48(n): Amount equal to failure.

127. Sec. 6699(a)(3) Failure to satisfy any requirement of Sec. 409 regarding credit claimed under Sec. 44D: Amount equal to failure.

128. Sec. 6699(a)(4) Failure to make any contribution under Sec. 44G(c)(1)(B): Amount equal to failure.

129. Sec. 6700(a)(1)(A)(i) Organizing a partnership which promotes an abusive tax shelter: $1000 or 20% of the gross income derived.

130. Sec. 6700(a)(1)(A)(ii) Organizing any investment plan to promote an abusive tax shelter: $1000 or 20%.

131. Sec. 6700(a)(1)(A)(iii) Organizing any other plan or arrangement to promote an abusive tax shelter: $1000 or 20%.

132. Sec. 6700(a)(1)(B) Participating in the sale of any interest in a plan referred to in Sec. 6700(a)(1)(A): $1000 or 20%.

133. through 136. If in Sec. 6700(a) there is a gross overstatement as to any matter, the penalty is $1000 or 20% of the gross income derived.

137. Sec. 6701(a) Aiding and abetting understatement of tax liability: $1000.

138. Sec. 6701(a) Aiding and abetting understatement of tax liability by a corporation: $10,000.

139. Sec. 6702(a)(1)(A) Filing a return with insufficient information due to a frivolous position: $500.

140. Sec. 6702(a)(1)(B) Filing an incorrect return due to a frivolous position: $500.

141. Sec. 6702(a)(1)(A) Filing a return with insufficient information to delay tax: $500.

142. Sec. 6702(a)(1)(B) Filing an incorrect return to delay tax: $500.

143. Sec. 6704(a) Failure to keep records required under Sec. 6047(e): $50.

144. Sec. 6705 Failure of broker to provide notice to payors: $500.

145. Sec. 6706(a) Failure to show information required on debt instrument: $50.

146. Sec. 6706(b) Failure to furnish information required under Sec. 1275(c)(2): 11% of aggregate price of such issue.

147. Sec. 6707(a)(1)(A) Failure to register tax shelter: $500.

148. Sec. 6707(a)(1)(B) Registering false information in regard to a tax shelter: $500.

149. Sec. 6707(b)(1) Failure to furnish identification of tax shelter: $50.

150. Sec. 6707(b)(2) Failure to include identification number of tax shelter on return: $50.

151. Sec. 6708 Failure to maintain list of investors in potentially abusive tax shelters: $50.

152. Sec. 6708[9](a) Material misstatement about mortgage certificate due to negligence: $1000.

153. Sec. 6708[9](b) If #152 is due to fraud: $10,000.

154. Sec. 6708[9](c) Failure to file report regarding mortgage credit certificate: $200.

3. SUBCHAPTER A — CRIMES

There are 20 code sections (7201 through 7241) which cover criminal penalties, including fines and prison sentences.

4. SUBCHAPTER B — OTHER OFFENSES

There are nine code sections (7261 through 7275) which cover other penalties. These penalties are usually fines.

Some penalties are interest-sensitive.

Section 6651 failure to file, or Section 6651(a)(2) failure to pay tax, Section 6653(a) negligence penalty and Section 6653(b) for fraud are assessed, collected and paid as if they were a part of the tax or deficiency. If it is not paid in full within ten days of notice and demand from the district director, interest is charged upon the unpaid amount at an annual rate as prescribed under Internal Revenue Code Section 6651, from the date of notice and demand until the amount is paid.

According to Rev. Proc. 63-5 (1963-1 C.B.) ". . . deficiency or (485) will not stop the running of interest, whenever an offer of payment is made prior to the determination, the examining officer will inform the taxpayer that it is preferable to make payment when the amount of deficiency or additional tax is determined."

According to House of Representatives; Rept. 100-391; 100th Congress; 1st Session; H.R. 3545 "Interest on the negligence and fraud penalties generally begins on the date these penalties are assessed. . . ."

One can infer that interest-sensitive penalties indicate a Congressional policy of revenue yield from penalties.

"Interest payments are viewed not as a penalty but simply as compensation for the United States having been deprived of the funds in question for the period until they are actually paid to the IRS and available as general revenue." *United States v. Augspurger,* 508 F. Supp. 327 (1981).

Daily accrual of interest on tax deficiencies and penalties, including interest-sensitive penalties, further indicate a policy of revenue yield from penalties.

Example 1. If a taxpayer owing $500.00 was penalized under code section 6651 for failure to pay, he would owe penalties of 25% under section 6651(a)(1), 25% under section 6651(a)(2), 25% under section 6651(a)(3) and $100.00 under section 6651. This would total $975.00 and, at this point, interest would begin

to accrue. Assuming an interest rate of 10%:

YEAR ONE	$1,077.53
YEAR FIVE	$1,607.39
YEAR TEN	$2,649.96

It can be seen that in ten years the original deficiency of $500.00 has increased 530% due to the combined effect of interest and penalties.

If a taxpayer is subject to a single penalty at either the 25% or 50% rate, the interest generated at the current rate as prescribed by IRS Code would produce the following results.

Example 2. $1000.00 assessment at 25% penalty

YEAR ONE	$1,250.00
YEAR FIVE	$2,013.14
YEAR TEN	$3,242.18

Example 3. $1000.00 assessment at 50% penalty

YEAR ONE	$1,500.00
YEAR FIVE	$2,415.77
YEAR TEN	$3,890.61

As illustrated by the above two examples of a singular penalty, the amount due has increased over 320% as a result of the tacking of interest.

Penalties on penalties and tax deficiency indicate a policy of revenue yield from penalties.

In *United States v. Thompson,* 279 F.2d. 165, 168-169 (10th Cir. 1960) quoting *Helvering v. Mitchel,* 303 U.S. 391, 401 (1938), we observed that given the policy underlying civil fraud penalty provision of (6653) that "the purpose of the additional assessment of 50 percent of the amount of the tax deficiency is to reimburse the government for the heavy expense of investigation and the loss resulting from the taxpayer's fraud."

Internal Revenue Code Section 6622 requires all interest payable under the Internal Revenue laws to be compounded on a daily basis, while the bond market normally calculates yields to a maturity by compounding on a semi-annual basis.

Lack of clear Congressional guidance as to policy results in auditing agents applying all available penalties in almost all audits where the taxpayer is not assisted by a qualified representative; most low-income taxpayers do not have a qualified representative at the audit level.

Practically speaking, many people who make less than $25,000, our suggested standard for a "low-income taxpayer," could not afford representation in any form. We suggest, in the alternative, that taxpayers of this classification either be provided with pro bono representation when they have a deficiency

assessed, or that they receive different treatment with respect to the penalties and interest attached to their assessment.

We were interested in seeing how many cases were won by the IRS and how many by the taxpayer at the Tax Court level. The only available information on this subject was a table in the 1986 IRS Annual Report which listed 1979 and 1980 results for cases with opinions rendered in different courts. It is our contention that many of the cases lost by taxpayers are argued pro se. Those that are represented by legal counsel win most of the time. The government supposedly won 52.2% of the tax cases in 1980. We believe that with representation low-income taxpayers would not only be able to avoid the accumulation of interest and penalties, but to avoid the tax itself. Researchers were unable to find either more current or more representative reports. For instance, only cases for which opinions were rendered were found in the report.

ALTERNATIVE ONE:

We would suggest that at a minimum, representation should be provided to taxpayers before penalties and interest are added.

There are only a handful of pro bono IRS approved tax clinics available in the nation to assist low-income taxpayers at the audit level. These clinics are granted permission to practice by the Director of Practice, currently Mr. Leslie Shapiro, and are designed to assist taxpayers in complying with the Internal Revenue Code. Our Clinic also has a contract with the U.S. Tax Court, and we litigate cases pro bono.

While we are not asking for federal funding for our Clinic, the fact remains that the taxpayers of the State of Ohio have a substantial investment in the Clinic to assist the federal government in the fair application of the federal revenue laws and to train future practitioners. Some of our graduates actively seek employment with the Internal Revenue Service. Congress may want to consider that federal funding of clinics such as ours in the over 200 law schools and graduate business colleges is an economical alternative to other proposals to provide pro bono taxpayer representation and to further provide an educated pool of talent to be employed by the I.R.S.

Most low-income taxpayers cannot afford quality representation and are forced to rely on public service announcements and uninformed sources. Some of these services are provided by the IRS. However, these services are very limited in what they offer.

Many low-income taxpayers are not aware of the significance of the 90 day notice, or even what to do when they receive one. This information is not provided to them in any form, from any source. Despite their lack of knowledge, interest and penalties are assessed against them in a manner which often precludes them from getting fair treatment under the system.

Lack of reading skills prevent low-income taxpayers from complying with the tax laws.

It was suggested to our Clinic that information alone, if distributed to taxpayers, should suffice to make low-income taxpayers aware of their rights and responsibilities. We believe that this would be insufficient and misleading as to its intended purpose, for the following reasons:

The reading levels for the following publications, as measured by the Fry Readability Formula, a commonly used guide to evaluate public school texts, were found to be the following:

A Statutory Notice of Deficiency required a reading level of grade 8.70; a Form 1040 EZ instruction book required a reading level of grade 8.45; a form 1040 instruction book required a reading level of grade 7.85; a New York Times, March 2, 1988, required a reading level of grade 7.65; and the Wall Street Journal, March 3, 1988, required a reading level of grade 7.10. *A Statutory notice of deficiency required a reading grade level 1.6 years higher than that of the Wall Street Journal.*

According to the U.S. Department of Education, the following percent of the population would possess the skill necessary to understand the type of information contained in the 1040 or 1040 EZ instructions:

Of those persons of Black racial origin, only 19.8% would possess the skills necessary to understand the instructions. Only 37.0% of those persons of Hispanic racial origin would possess such skills. Of the general population only 11.0% of the persons with less than a high school education could understand the instructions. Also only 22.0% of persons with some high school education could understand the instructions, and a mere 50.2% of high school graduates having less than two years of postsecondary education could understand the instructions. Of persons with a two-year degree or more than two years of postsecondary education, 82.8% can understand the instructions.

These studies indicate that four out of five Blacks or persons without a completed high school education, two out of three Hispanics, and nine out of ten persons with less than a high school education, cannot comprehend the instructions for a Form 1040, or a 1040 EZ, and a Notice of Deficiency is even more difficult.

The major problem in the readability of these documents is the complexity of their sentence structure. The average sentence length of these publications exceeds 25 words. To add to the complexity, one-third of the words in these publications are multi-syllabled words. This problem can and should be corrected.

This analysis is based on applying the Fry Tables to studies by Kirsch and Jungeblut, Literacy: Profiles of America's Young Adults, U.S. Department of

Education Research and Improvement, final contractor order from Educational Testing Service, September 1986.

If the taxpayer cannot read the instructions, how can the government expect compliance? We have no reason to believe that information distributed to the taxpayers about their rights and responsibilities with respect to unpaid taxes would be written at a greater level of understandability. Taxpayers in general, and especially low-income taxpayers, would never be able to read and comprehend such information. It is imperative that they be assisted if the penalty system is not improved.

Another suggestion is that low-income taxpayers should be told to call someone at the IRS level to obtain information about their rights and responsibilities with respect to deficiencies. For instance, most taxpayers are not aware that they only have 90 days to object to an assessment before their relief is barred without litigation. Most low-income taxpayers will probably have the penalties automatically assessed because of their lack of information.

We also do not believe that a phone line will be beneficial. Studies have shown an error rate for the call in question and answer system set up by the IRS ranged from 25%, as reported by Commissioner Gibbs, to 39% as reported by The General Accounting Office. Either way, the information does not seem to be reliable. It is imperative that low-income taxpayers be informed, not misinformed.

For the reasons stated above we firmly believe that a requirement of representation should be used in conjunction with the penalty system.

ALTERNATIVE TWO:

If taxpayers who are not able to provide their own representation are not to be provided with representation, we believe that the penalty system should be altered with respect to them.

We are not advocating the complete prohibition of interest and penalties based on a gross income level of less than $25,000, even though this looks to be a very feasible possibility, but are instead suggesting the implementation of a system which would permit low-income taxpayers to at least be presented with a forum before the interest and penalties become so outrageous that they will never have "their day in court."

We acknowledge that to effectively administer the tax laws it is necessary to limit the ability of a taxpayer to abuse judicial economy and prevent wasting the court's time. However, many low-income tax payers are in a position as to not even be able to pay the tax itself let alone all of the attached interest and penalties.

B. *Regressive Economic Impact*

In our Tax Clinic, we have encountered several cases where taxpayers, for differing reasons, had missed the 90-day period to protest the assessment, yet could not afford to pay the tax in order to litigate the matter.

One such case involved an innocent spouse who had filed a joint return with her husband at his insistence after a separation, but before a divorce. Once divorced, he received the notice of deficiency and yet failed to contact her and give her notice. By the time we had been approached to represent her, a tax of approximately $1000, which she could never have paid in the first place, had been increased by interest and penalties to over $2000, which she STILL has not been able to pay. Because the Tax Court has no jurisdiction to hear this case, we as a Clinic are not able to defend her in this matter. The interest and penalties are still accruing, far beyond what she will ever be able to pay.

This particular taxpayer has a number of potentially valid defenses to the liability on the tax yet she is prevented from having herself cleared of such liability because of the jurisdictional requirement. To add insult to injury, she is being charged interest and penalties on a daily basis. We believe that there are several ways that taxpayers in this situation, the number of whom are far greater than one would imagine, could be afforded relief.

A taxpayer who is to receive these suggested allowances should be able to demonstrate an inability to pay the deficiency, a prima facie meritorious defense to the deficiency, and present a case of ineffective notice. The allowances could be, but are not limited to, the ability of U.S. Tax Court to grant extensions of time past the 90-day imposed threshold, the staying of the accumulation of interest and penalties until one has received sufficient notice, or even the ability of the Tax Court to obtain jurisdiction upon payment of a portion of the tax itself rather than all of the tax, penalties and interest.

The extension on time which, we suggest, would be analogous to that permitted by the Federal Rules of Civil Procedure as found in rule 6(b). The Tax Court, if directed, could choose to accept petitions on deficiencies after the 90-day period has expired. This would not affect the ability of the Government to use the penalty system as a revenue raiser. If the taxpayer does not have a meritorious defense, or cannot prove their innocence, the Government will then be able to assess interest and penalties.

By refusing taxpayers with meritorious claims the ability to prove their innocence, the Government is merely padding the books as to outstanding "revenues" available for collection. In most cases, based on information received from private tax practitioners, when a person is able to get to court, many if not most, of the penalties themselves are abated. Therefore, it is our contention that the low-income tax payers, who cannot get into court or do not know about the system of abatement are accumulating large debts attributable to in-

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terest and penalties, which will prevent them from ever being relieved of this liability.

As a practical matter, these "revenues" will never be collected. but they will be a burden and embarrassment to otherwise lawful citizens. In all of our extensive research we were unable to find any statistics to show exactly how much of the outstanding federal debt attributable to uncollected taxes are the responsibility of low-income taxpayers. We wanted this information to see how heavily the penalty system affected this class of taxpayers.

With respect to our second suggestion, the staying of the accumulation of interest and penalties until the taxpayer in question has received sufficient notice, is partly self explanatory. We contend that in order to assess penalties and interest charges, the IRS should be required to prove that the taxpayer did, in fact, receive notice. This could be accomplished simply by requiring that the notice of deficiency be delivered by certified mail. Until the IRS can make a showing that the taxpayer received and understood the significance of the deficiency, we believe that no penalties should be assessed.

Extremely low personal exemptions in the Code result in a low-income taxpayer being able to retain out of earnings after I.R.S. levy on wages, a weekly sum less than the taxpayer could receive in levy exempt unemployment payments. I.R.C. section 6334 provides that various types of property shall be exempt from levy.

Internal Revenue Code Section 6334(a)(4) provides that unemployment compensation payments are exempt from levy. Section 6334(d) provides that there shall be exempt from levy $75 per week of wages, salary or other income exempt from levy plus $25 for the spouse and each individual for which the taxpayer has provided over half the support. For example, a single individual with no dependents might choose to "lose" his job if he would receive more than $75 dollars per week in unemployment compensation.

Also, Policy Statement P-5-32 of the Internal Revenue Manual provides that, although not exempt, welfare payments will not be levied against. Therefore, the same situation exists in regards to welfare payments as for unemployment compensation. A taxpayer may very well be faced with the choice of working and keeping only $75 per week or going on public assistance to receive a "pay raise."

The scenarios described cannot be beneficial to the government or the taxpayer and we support increasing the exempt amount in 6334(d)(1) to an amount that would not encourage this practice.

Existing penalty and interest structure added to the deficiency, invariably exacerbate the plight of the low-income taxpayer. A wage levy of all amounts in excess of exemptions often never reduces the primary tax deficiency, since

the interest and penalties accrue greater than the maximum levy.

For example, the Tax Clinic has what it feels is a meritorious defense to a deficiency assessed for Social Security taxes. The taxpayer in question was a State of Ohio employee, and therefore should never have been subject to federal social security taxes. Notwithstanding this fact, the taxpayer received a direct assessment and was not afforded an opportunity to litigate his claim in Tax Court. When we first encountered this case the taxpayer was making $18,000 per year and could not be levied against in an amount sufficient to reduce his outstanding liability.

Such amounts carried on the books of the I.R.S. as collectible are illusory and, in reality, are uncollectible.

Due to the three-year rule the low income taxpayer can find no relief in bankruptcy. 11 U.S.C.A. sec. 507. See 11 U.S.C.A. sec. 523.

Voluntary compliance with the tax laws is negatively impacted by the regressive economic effect of the existing perception on the part of the low-income taxpayer of a revenue yield policy: it is seen as unfair; it is seen as a form of legal blackmail; and it encourages an underground economy at the lower end of the economic spectrum.

C. *Existing policy with its regressive impact on low-income taxpayers amounts to de facto confiscation, with few effective due process of law remedies available.*

Unrepresented low-income taxpayers do not fully understand their rights under the existing statutory notice of deficiency. In divorce situations, one party often does not even receive the notice, and loses the 90-day window to litigate such provisions as innocent spouse, in Tax Court without full payment.

The Fifth Amendment of the Constitution of the United States provides, *inter alia*, that no person shall ". . . be deprived of life, liberty, or property without due process of law. . . ." The Supreme Court has interpreted "due process of law" to include a right of access to the courts: ". . . [although] many controversies have raged about the cryptic and abstract words of the Due Process Clause, there can be no doubt that at a minimum they require that deprivation of life, liberty, or property by adjudication be **preceded** by notice and opportunity for hearing appropriate to the nature of the case." (*Mullane v. Central Hanover Trust Co.*, 339 U.S. 306, at 313 (1950); emphasis supplied); "It is to courts, or other quasi-judicial official bodies, that we ultimately look for the implementation of a regularized, orderly process of dispute settlement. Within this framework, those who wrote our original Constitution, in the Fifth Amendment, and later those who drafted the Fourteenth Amendment, recognized the centrality of the concept of due process in the operation of this system. Without this guarantee that one may not be deprived of rights, neither liberty nor prop-

erty, without due process of law, the State's monopoly over techniques for binding conflict resolution could hardly be said to be acceptable under our scheme of things." (*Boddie v. Connecticut,* 401 U.S. 371, at 374 (1970)); and, most significantly, "Just as a generally valid notice procedure may fail to satisfy due process because of the circumstances of the defendant, so too a cost requirement, valid on its face, may offend due process because it operates to foreclose a particular party's opportunity to be heard. The State's obligations under the Fourteenth Amendment are not simply generalized ones; rather, the State owes to each individual that process which, in light of the values of a free society, can be characterized as due."

We have included these references to point out the fact that the courts have interpreted due process of law to include access to the courts regardless of economic circumstances. The payment of the assessment and filing fees, while it would present no major problem for most of us, may be an insurmountable barrier to the low-income taxpayer, who often finds it difficult merely to provide himself and his family with the bare necessities of life. The low-income taxpayer is, in effect, denied any judicial remedy, just as surely as though the doors to the courthouse were locked in front of him.

A $60.00 filing fee intimidates some low-income taxpayers, who consider such an amount a fortune, and who are not capable of appreciating what lies in store for them. This type of litigation is by no means frivolous, nor should this right be treated as a luxury, since the low-income taxpayer has a much greater proportional interest at stake than the middle or high-income taxpayer; for the low-income person, the question is often not whether he will eat steak or hamburger, but whether he will eat.

It is worth noting at this point that there is a certain deference associated with what has been called the "tax label"; that is, when a statute is labeled a "tax" statute, it is scrutinized differently than any other type of legislation (see Sundberg, Jacob W. F., *The Tax Label,* privately published). That is the case here, since the principle of due process of law seems to operate in a vacuum in tax cases, with the justification being couched in such terms as "tax autonomy" and "tax sovereignty," and the use of such phrases as "legislative grace" in describing the "privilege" to litigate these matters. Certainly, the founders never intended to create exceptions to fundamental civil rights, such as due process, simply because one of the parties represents the administrative apparatus of the State.

The failure of a statutory notice of deficiency being received by one of the spouses is common in a divorce situation.

Under IRC Section 6212(b)(2), when a joint income tax return is involved, the Internal Revenue Service is permitted to send a single joint notice of deficiency to the taxpayers at their last known address. This is true unless either spouse has notified the I.R.S. that separate residences have been established.

Under Internal Revenue Code Regulation 301.6212-1(b)(2), this notice must be sent to the district director for the district in which the return has been filed. Therefore, even though the taxpayers may be divorced and have actually established separate residences and filed subsequent income tax returns using their new addresses, the I.R.S. may still send a single joint notice of deficiency. Thus, one of the two persons involved will not receive a notice of deficiency. *Edward J. Camous*, 67 TC 721.

Most low-income taxpayers are not sophisticated enough to know that they are required to notify the IRS of their new address upon being divorced. Even fewer taxpayers would know or have the means to find out that the notice is to be sent to the district director.

The failure of the I.R.S. to ascertain the latest address of the separate taxpayers, and to send separate notices to them, could be construed as a denial of due process, since adequate notice to defend will not reach at least one party. The I.R.S. should at least be required to consult their central computer to see if there is a more recent address for each of the taxpayers involved. In cases where the I.R.S. may not be aware of a divorce situation, this computer check could also establish the current marital status of the taxpayers (per the filing status on subsequent returns filed). While this may not solve all the problems involved in this area, it could eliminate some of the bitterness towards the IRS in this situation.

Certain assessments can be made under the Internal Revenue Code without the taxpayer receiving a notice of deficiency. The most commonly seen illustration of this is probably Internal Revenue Code Section 6213(b)(1) which allows the I.R.S. to assess taxes in cases dealing with "mathematical or clerical errors." Any assessments made in these circumstances cannot be litigated in Tax Court, since a notice of deficiency is a jurisdictional prerequisite, and Section 6213(b)(1) specifically states that the notice of such an assessment shall not be considered a notice of deficiency. While the notice of such an assessment is required to explain the alleged error, it is not required to include an explanation of the taxpayers appeal rights. IRC Section 6213(b)(2) allows for the automatic abatement of these assessments, if the taxpayer files a request for abatement with the Secretary within 60 days of notice of such assessments. While in most cases these mathematical and clerical errors will indeed be errors (as defined in the Internal Revenue Code), in a few cases they are correct.

II. PENALTIES AS A DETERRENT TO NON-COMPLIANCE.

A. *The prevailing view since the inception of the Internal Revenue Code.*

Historically, there were no interest sensitive penalties, which resulted in a less regressive economic impact on low-income taxpayers. Low-income taxpayers traditionally purchase a larger percentage of goods and services on credit,

paying interest. Interest-sensitive penalties add to an already heavy interest burden. Penalties as a percentage of deficiency have a theoretical non-regressive, non-progressive economic impact. This theory is not borne out for the low-income taxpayer, where the deficiency itself may represent a higher percentage of net spendable income after basic necessities than to a higher-income taxpayer. A larger percentage of higher-income taxpayers have the services of qualified representatives at audit and appeals, who succeed in obtaining remission of penalties. Disparity of representation creates a reduced, but still regressive, economic impact to such penalties.

REVENUE YIELD POLICY FROM PENALTIES

The revenue yield from penalties as presently enacted results in a regressive economic impact on the low-income taxpayer. As stated before, for a great number of low-income taxpayers the tax deficiency itself is an insurmountable burden. The University of Akron Tax Litigation Clinic sees this situation in almost all of its cases. Many times, just to pay the tax, installment payments have to be arranged. However, these taxpayers are at an advantage. They have had some sort of representation who has informed them of the availability of the installment system. Unrepresented taxpayers will probably not know of this arrangement.

We cannot hope to represent them fairly and equitably if the dictates of the Code are not followed. Since we have gone from the deterrent effect as intended by Congress when the penalties were enacted, to a revenue raising purpose, it is time to revamp the consequences to taxpayers who are no longer fairly represented. Regardless of the intention of Congress, or the Courts, in writing and interpreting the penalty system of the Internal Revenue Code, what is most important is how the Code is interpreted by the I.R.S., both for and against the taxpayer.

What is the reason for the implementation of the penalty system? Was it designed to have a deterrent effect, or was it designed to raise revenue? The answer to this question is of vital importance, especially to the low-income taxpayer.

When the penalty system was originally enacted, it was to enforce the collection of duties and taxes. *Dorsheimer v. U.S.* 74 U.S. 166 (1868). Currently, there are differing views for its use depending, on who is speaking.

The Internal Revenue Manual states that fair and equitable treatment of taxpayers requires the I.R.S. to administer civil penalties in a manner which fosters voluntary compliance and confidence in the tax system. The I.R.S. will strive to meet this expectation in the interest of fairness, equality and effective tax administration.

More recent discussions belie the original intent of the penalty system,

with so much emphasis placed on the amount of revenue which is raised or to be raised as a result of the penalty system. Review of Taxation of Individuals, No. 1, 47 (1987) said that the penalty area is a growth industry for the I.R.S. Penalties contributed more than $3 billion in 1985, while contributing untold dollars to the system, by encouraging increased voluntary compliance by fear.

The legislative history of years 1981 through 1987 indicate a trend towards the idea of using penalties as a revenue raiser.

While little-considered by the courts, there is a de facto lack of equal protection. Congress has also not adequately recognized, nor has it addressed, this problem in considering penalties. The low-income taxpayer has about as much knowledge of how to obtain abatement of a penalty through problems resolution as he/she does of getting to the moon. Abuses by high-income taxpayers have brought about a plethora of new penalties. Unfortunately, the low-income taxpayer has been caught in this net. The number of penalties should be a deterrent, not a means for increasing revenue. Stacking of penalties generally works as a deterrent for high-income taxpayers, and, in this context, stacking of penalties is a progressive economic concept. However, penalty-stacking is also economically regressive at the lower end of the economic spectrum. Penalty-stacking for all tax noncompliance violates the concept that stacking is meant to deter specific tax conduct.

III. POSSIBLE SOLUTIONS.

A. *Interest-sensitive penalties.*

These penalties should have a floor placed under them.

A taxpayer with a minimal standard of living taxable income should be exempt. There is economic savings in administration cost of collection due to the fact that at this level the penalties are, in fact, uncollectible. It minimizes regressiveness. As revenue raisers they will deter flagrant misconduct by high income tax abusers. It instills a degree of progressivism to the tax system. Progressivism is then the price the abuser pays.

B. *Penalty-stacking.*

Abatement of the second or higher non-interest sensitive penalty should be made an audit function for a low-income taxpayer; i.e., below a certain economic floor. The low-income floor should be set by Congress and indexed. Stacked penalties should be automatically abated if a taxpayer, after levey, does not have sufficient income to be paying on the primary deficiency.

C. *Other needed remedies for the low-income taxpayer.*

The mandatory services of a qualified representative or ombudsman before a wage levy should be required.

The services of a qualified representative will increase the opportunities available to the low-income taxpayer to pursue the abatement of certain penalties and interest assessed by the IRS. A qualified representative could also provide a first-tier screening process as to the validity of the taxpayers' defense.

Indexed and higher amounts should be exempt from wage levy.

Present law states, in Section 6334(d)(1), that the following amount is exempt from wage levy: ". . . in the case of an individual who is paid or receives all of his wages, salary, and other income on a weekly basis, the amount of the wages, salary, and other income payable to or received by him during any week which is exempt from levy under subsection (a)(9) shall be $75.00 plus $25.00 for each individual who is specified in a written statement . . ."

It appears, in today's environment, that it would be extremely difficult for a family of four to exist on a mandatory stipend of $150.00 per week. This removes, or reduces, an individual's incentive to work and would tend to encourage unemployment coupled with increased reliance upon government assistance. This has what we consider to be three major drawbacks: 1. Inability to collect the original deficiency; 2. Reduced future tax revenues since earned income is now non-existent; and, 3. Increased public expenditures due to reliance on public-assistance programs.

The ability to obtain bankruptcy relief for all taxes, interest, and penalties for the low-income taxpayer.

Currently, the IRS code does not permit relief even when a taxpayer is in bankruptcy. It is our feeling that this is unfair treatment for the economically disadvantaged.