REFORM PENALTY AND INTEREST PROVISIONS

Legislative Recommendation #28

Convert the Estimated Tax Penalty Into an Interest Provision to Properly Reflect Its Substance

SUMMARY

- *Problem:* If a self-employed individual or business fails to pay sufficient estimated tax during the year, the IRS will impose an addition to tax that is computed as an interest charge but classified as a penalty. The term "penalty" implies that the individual or business has engaged in improper conduct, yet small businesses often experience significant fluctuations in their incomes and expenses from year to year that make it difficult for them to accurately estimate their tax liabilities.
- *Solution:* Reclassify the addition to tax for underpaying estimated tax as an interest charge (rather than a penalty).

PRESENT LAW

Through the combination of wage withholding and estimated tax payments, the IRC aims to ensure that federal income and payroll taxes are paid ratably throughout the year. IRC § 3402 generally requires employers to withhold tax on wages paid to employees. For many employees, wage withholding covers their tax liabilities in full. But taxpayers who are self-employed and taxpayers who have investment income typically are not subject to withholding on this "non-wage" income and instead must make estimated tax payments.

IRC § 6654 generally requires individual taxpayers to pay at least the lesser of (i) 90 percent of the tax shown on a tax return for the current tax year or (ii) 100 percent of the tax shown on a tax return for the preceding tax year (reduced by the amount of wage withholding) in four installment payments due on April 15, June 15, September 15, and January 15 of the following tax year.[1] IRC § 6655 generally requires corporate taxpayers to pay at least 100 percent of the tax shown on a tax return for the current tax year or, in some cases, 100 percent of the tax shown on a tax return for the preceding tax year in four installment payments due on April 15, June 15, September 15, and December 15.

IRC §§ 6654(a) and 6655(a) provide that a taxpayer who fails to pay sufficient estimated tax will be liable for a penalty that is computed by applying (i) the underpayment rate established under IRC § 6621(ii) to the amount of the underpayment (iii) for the period of the underpayment. IRC § 6621 is an interest provision. Therefore, the additional amount a taxpayer owes for failing to pay sufficient estimated tax is computed as an interest charge, even though it is denominated as a "penalty."

1 If the adjusted gross income of a taxpayer for the preceding tax year exceeds $150,000, "110 percent" is substituted for "100 percent" in applying clause (ii). IRC § 6654(d)(1)(C).

REASONS FOR CHANGE

For a variety of reasons, taxpayers often have difficulty predicting how much tax they will owe. Self-employed taxpayers or taxpayers who own small businesses may experience significant fluctuations in their income and expenses from year to year. Taxpayers with sizable investment incomes may experience significant fluctuations. Substantial changes in tax laws, such as those that took effect in 2018, may affect tax liabilities in ways that taxpayers do not fully anticipate. As a result, millions of taxpayers do not satisfy the requirements of IRC § 6654 and are liable for penalties each year, even though many have attempted to comply. Corporate taxpayers face similar challenges.

The term "penalty" carries negative connotations, and the National Taxpayer Advocate believes it should be reserved for circumstances in which a taxpayer has failed to make reasonable efforts to comply with the law. Thus, she agrees with the assessment of the House Committee on Ways and Means when it wrote during a previous Congress: "Because the penalties for failure to pay estimated tax are calculated as interest charges, the Committee believes that conforming their title to the substance of the provision will improve taxpayers' perceptions of the fairness of the estimated tax payment system."[2]

The Office of the Taxpayer Advocate has conducted research studies that have found "tax morale" has an impact on tax compliance.[3]

When the IRS imposes a "penalty" on a taxpayer, there is a strong implication that the taxpayer has engaged in improper conduct. For that reason, penalties generally should be subject to waiver for reasonable cause. Under current law, the estimated tax penalty cannot be waived. Thus, an individual who experiences a fire, flood, medical emergency, or other exigent circumstance that precludes payment by the estimated tax deadline will still be "penalized." This characterization is not good for "tax morale." If the addition to tax is recharacterized as an interest charge designed solely to compensate the government for the time value of money, it would be easier to justify imposing it without waiver.

RECOMMENDATIONS

- Recharacterize the penalty for failure to pay sufficient estimated tax as an interest charge – which is the basis for the calculation of the addition to tax. Toward that end, relocate IRC §§ 6654 and 6655 from part I of subchapter A of chapter 68 to the end of subchapter C of chapter 67 and make conforming modifications to the headings and text.[4]
- If a failure to pay sufficient estimated tax continues to be treated as a penalty, enact a reasonable cause exception so that the penalty will not apply when a payment is late due to circumstances beyond the taxpayer's control, such as a fire, flood, or medical condition that makes compliance impractical.[5]

2 H.R. Rep. No. 108-61, at 23-24 (2003).

3 *See* National Taxpayer Advocate 2013 Annual Report to Congress vol. 2, at 1 (Research Study: *Do Accuracy-Related Penalties Improve Future Reporting Compliance by Schedule C Filers?*), https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2020/08/2013-ARC_VOL-2-1.pdf.

4 For legislative language generally consistent with this recommendation, see Taxpayer Protection and IRS Accountability Act, H.R. 1528, 108th Cong. § 101 (2003).

5 For more detail on our recommendation to enact a reasonable cause exception if the additional charge for failure to pay estimated tax remains a penalty, see National Taxpayer Advocate 2008 Annual Report to Congress vol. 2, at 34 (Research Study: *A Framework for Reforming the Penalty Regime*), https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2020/08/08_tas_arc_vol2.pdf.