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COMPLIANCE PROVISIONS OF TAX EQUITY AND FISCAL RESPONSIBILITY ACT (TEFRA)

CHARLES RODDY

I. INTRODUCTION

Thank you, Professor Fischer.

You have done an excellent job in organizing this tax conference, and I am pleased to have been asked to participate.

Virginia and I always enjoy our visits to Williamsburg and its serene surroundings. Visits here not only offer a respite from the hustle of the outside world, but help to put our present day problems into perspective.

The Colonists had their own set of problems, including the system of taxation imposed by outside forces.

As 20th century citizens, we too have seen problems with the tax system in our country. As tax practitioners, our work has been challenged by two extensive tax measures in as many years. Taken together, the Economic Recovery Tax Act of 1981, and the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982, have dramatically changed tax administration.

Professor Fischer has asked me to comment on the compliance provisions of TEFRA. They are numerous, and, at first blush, appear rather burdensome. To master these provisions, tax practitioners need to review the new law not as a disjointed collection of fragments but as a whole and to become familiar with how the various elements combine and interact.

Today, I will discuss three aspects of the compliance provisions and put them in perspective with the entire bill. I will discuss the provisions relating to the "tax-gap," voluntary compliance, and IRS enforcement actions.

II. PROVISIONS TO DEAL WITH THE TAX GAP

The term "tax gap" is meant to apply to all revenue lost to the U.S. Treasury through non-compliance with our tax laws. As such, it includes losses from unreported income and underreported income, as well as overstated expenses, deductions, and exemptions claimed on tax returns.

It is estimated that one dollar of every five dollars in taxes that IRS should be collecting is not accounted for in government coffers. It has been the experience of the service that information returns increase tax compliance. And, if income tax is withheld, compliance is in the 97-99 percent range.

TEFRA adopted our findings and seeks to enforce laws already on the books. It is estimated that 32 billion dollars will be raised through such measures.

A. WITHHOLDING INCOME TAX

As you are aware, TEFRA provides for the withholding of income tax from interest, dividends, pensions, and annuities.

1. *Pensions and Annuities*

The tax gap from pensions is estimated to be 2.8 billion dollars in 1981, a four-fold increase since 1973. We had expected the figure to increase due to the increase in the number of retirees and the expansion of the number of retirement plans throughout the country. Also affecting this increase is the complexity of determining how much of the pension a retiree must report and how to comply with estimated tax rules.

Beginning January 1, 1983, payers of pensions and annuities are required to withhold income tax from their payments, unless the recipient files an exemption form. Also, payers will be required to determine the individual's contribution and taxability of payments. Regulations were issued in October.

2. *Interest and Dividends*

Another expansion of the withholding requirements is in the area of interest and dividend payments. This was also done to try and close the tax gap. It is estimated that 8.2 billion dollars of tax from this type of income went unpaid in 1981.

The temporary regulations for withholding are lengthy—some 127 pages. They were issued November 9, 1982. They implement the requirement for 10 percent withholding beginning July 1, 1983. A public hearing on the regulations will be held February 1, 1983.

Congress realized that these provisions will increase paperwork and accounting burdens and, therefore, there are provisions to allow the institutions to hold on to the tax for 30 days depositing the monies. Thus, institutions can earn interest on withheld funds. This delay will be in effect for one year for larger companies and two and three years for mid-size and smaller institutions.

B. INFORMATION REPORTS

In addition to the withholding provisions, there are expanded information reporting requirements designed to deal with the tax gap. Among the most far-reaching—and having the greatest impact—are those requirements affecting state and local governments, food and beverage establishments, and brokers.

1. *State and Local Governments*

State and local governments will be required to report to IRS income tax refunds, credits or offsets issued after December 31, 1982. The states are also required to furnish the individual recipients a statement during

January of the year following the calendar year in which the refund was made.

Therefore, we won't see the impact of this provisions until January 1984, for state refunds issued in 1983.

We will have to add a question to the tax form to ask individuals if they itemized in the prior year. Otherwise, we will be getting information that is not useful to us, or individuals may include unnecessary income on their forms.

2. *Tips*

Far more controversial than the information reporting by states, is the reporting requirement on tip income by food and beverage establishments.

It is no secret that tips—in fact and cash payment—are a source of unreported income. In 1981, the unpaid tax from unreported tip income was approximately 2.3 billion dollars. As a result of this, TEFRA requires food and beverage establishments with 10 or more employees to report to IRS:

- Gross receipts
- The amount of charge receipts,
- The amount of charge tips,
- The amount of tips reported by the employees.

If the employee-reported tips do not equal 8 percent of the gross receipts, an allocation on the difference must be made. The allocation will probably be shown on the W-2 form beginning in 1983. The regulations in this area have yet to be issued.

(The Treasury Department has been charged with preparing a study of tip reporting by the end of 1986, and with analyzing the cost effects of this compliance tool.)

3. *Brokers*

Another controversial part of the information reporting requirements of TEFRA involves reports by brokers. This provision was enacted to increase compliance in the area of capital gain income. Eleven percent of the tax gap (or 9.1 billion dollars) is estimated to be due to unreported income from capital gains.

TEFRA allows the Secretary of the Treasury to require the reporting of gross proceeds from transactions carried on by brokers for their customers. Reporting would be to both IRS and to the customers.

TEFRA defines brokers to include securities brokers, commodities brokers, and barter exchanges. The definition also appears to include real estate brokers, and, thus, this provision will have far reaching effects.

Including barter exchanges will be a great help to the service. As you

are probably aware, IRS has been conducting compliance checks of members of barter clubs and often finds that members either do not report all of their credits or fail to report them at fair market value. The reporting provision should improve compliance of members of barter exchanges.

Regulations on the reporting requirements of brokers are due within six months of enactment—they will apply to 1983 transactions.

For these reporting requirements to be effective, there must be more efficient handling of paper by the service. Thus, there will be an increased emphasis on magnetic—or computer—filing of information returns.

Also, there must be effective penalties on payers to make sure that the information is reported and is correct.

This leads us to the second aspect of TEFRA that I wish to discuss.

III. PROVISIONS TO STIMULATE VOLUNTARY COMPLIANCE

The provisions either strengthening old penalties or placing new penalties on the books are numerous.

A. OLD PENALTIES INCREASED

The sanctions are stiffer than in the past, so the taxpayer may be more inclined to comply to avoid penalties. Higher penalties will also make it more cost effective for IRS to enforce the law.

Since the penalty provisions are numerous, I will highlight those of special importance in dealing with tax protestors and other abuses of the system in recent years.

1. *Change in Computing Interest Charges*

The interest rate on delinquent payments and underpayments in recent years has not kept up with market rates. The Economic Recovery Tax Act (ERTA) of 1981 attempted to correct this by making the IRS interest rate 100% of the prime rate, to be changed annually. Thus, we had a 20% interest rate for 1982. We have seen an increase in compliance with estimated tax payment requirements since this change.

TEFRA made further changes in interest charges and payments. The service will change its interest rate twice a year, and the interest will be compounded daily. Previously, interest was charged at a simple rate.

TEFRA also enacted changes in the way IRS pays interest. We will not pay interest on tax returns until 90 days (July 15) after the return is filed. We had been paying interest after 45 days, or after June 1, for timely filed returns.

And, interest paid on claims will also be changed. With the higher interest paid by IRS, we found that some people delayed filing claims in order to get the higher interest payments. TEFRA changes this—the

United States will no longer be liable for interest for any overpayment before a claim is filed. Thus, when an overpayment is created because of a net operating loss, capital loss, or credit carryback, the carryback will be treated, for interest purposes, as arising when the claim is filed.

2. *Obstructive Court Petitions*

In addition to changes in interest, TEFRA also increases the penalty for filing cases in tax court primarily for delay. The \$500 penalty has been increased to \$5,000 when the taxpayer's position is "frivolous or groundless."

3. *Criminal and Civil Fraud Penalties*

Other increases in previous penalties involve fines in cases of criminal and civil fraud.

The civil fraud penalty used to be 50% of the entire underpayment of tax due to fraud. TEFRA has increased the civil fraud penalty to include an additional amount of 50% of the interest due on the portion of the underpayment attributable to fraud.

The criminal fraud fines have also been increased. The tax evasion fine is now up to \$100,000 from \$10,000, and the penalty for willful failure to file a tax return or supply required information is up to \$25,000 from \$10,000. The figures for a corporate violation have also been increased.

These increases are in effect now, and it was the intent of Congress that these penalties be treated as supplements to, not substitutes for, imprisonment.

B. NEW PENALTIES

In addition to increasing some current penalties, TEFRA added several new penalties to the code.

1. *Abusive Tax Shelters*

Abusive tax shelters have been a growing problem in recent years. In 1980, 174,000 tax shelter returns under examination resulted in 1,900 litigation cases; today, 300,000 returns under examination have resulted in 16,000 cases pending before the tax court. Many of the schemes being marketed today are not really tax shelters, but outright fraud.

Generally, the service defines abusive tax shelters as those involving transactions with little or no economic reality, inflated appraisals, unrealistic allocations—where the claimed tax benefits are disproportionate to the economic benefits.

Examples of common abusive tax shelters involve

A. Over-valuation of assets occurs at promoter level, rather than the investor level;

B. Deferment of current year's tax liability and allows a quick refund of prior year's taxes;

and

C. The government ends up "paying" the cash required to invest in the scheme;

D. Non-recourse notes are a familiar part of these schemes. Two of the schemes with these characteristics involve manuscripts and recordings.

To deal with pre-1981 backlog, Commissioner Egger issued a new policy statement which allows deductions to the extent of the investment and disregards non-recourse loans.

To prevent further growth of these types of schemes:

TEFRA had added a new penalty for promoting abusive tax shelters. The penalty is the greater of one-thousand dollars or ten percent of the activity's current or future gross income.

Penalty can be based solely on the offering materials.

The new law also permits the United States to seek an injunction against any person engaged in promoting abusive tax shelters.

2. *Tax Protester Returns*

Another area of concern to the service has been the growth of tax protester returns. The new law provides for a flat 500 dollars penalty for any taxpayer who files a "frivolous" return.

Returns will be subject to the penalty if: they do not contain information on which the substantial correctness of taxes may be judged; or, they contain information that on its face indicates that the tax is substantially incorrect.

For the penalty to apply, the filing must be due to maintaining a position that is "frivolous" or to a desire to delay or impede the administration of federal tax laws.

3. *Substantial Understatement of Tax Liability*

Finally, in the category of new penalties to reinforce voluntary compliance, there is now a 10 percent penalty to deter substantial understatement of tax liability. The penalty is effective for returns filed after December 31, 1982.

A substantial understatement of tax is defined as the greater of 10 percent of the correct amount of tax or 5,000 dollars (ten thousand dollars in the case of a corporation).

During the debate on the new law, a number of persons objected to what they viewed as the inequity of applying a no-fault penalty. This concern has been embodied in the act. Thus, for *other than tax shelter items*, a taxpayer may avoid this understatement penalty, if the item on the return is supported by substantial authority; or all of the facts relevant to the tax treatment of the item are disclosed on the return or in a statement attached to the return.

Substantial authority is a new standard. There are no judicial or administrative decisions interpreting the phrase. Hence, a particular determination will depend on the circumstances of each case. Court opinions, treasury regulations, and official announcements in revenue rulings and revenue procedures need to be considered.

This will be an area for you to watch. But, it offers you, as practitioners, an opportunity to shape the standard into something meaningful and useful, as hearings are held and regulations written.

IV. PROVISIONS TO FACILITATE AUDITS

The final compliance provision of TEFRA that I will address involves provisions that will facilitate IRS audit tasks.

There are new provisions placing restrictions on bearer bonds and facilitating jeopardy assessments against illegally-generated, and apparently ownerless, cash.

Of even greater import to you as practitioners are the changes involving audits of partnership returns and administrative summonses.

A. PARTNERSHIP RETURNS

Because partnerships are conduits for tax purposes rather than taxable entities, items of partnership income, deductions, and credits were examined at the partner level. However, this created an unwieldy situation—especially if the partnership was large, with partners nationwide.

TEFRA provides that the tax treatment of partnership items generally be determined at the partnership level in a unified proceeding rather than in separate audits. If litigation develops, only one suit will be allowed to proceed. The change includes provisions with respect to notices, settlements, statutes of limitation. These changes will definitely make partnership audits far more efficient undertakings.

B. SUMMONS ENFORCEMENT

Finally, TEFRA makes significant changes in the laws of summons enforcement.

Administrative summonses can now be used for inquiring into any offense connected with the administration or enforcement of Internal Revenue laws. Previous use was limited to determining tax liability.

There are also changes to third-party recordkeeper summons, such as those served on banks.

At the present time and continuing through the end of 1982, a taxpayer may intervene in an administrative summons proceeding and stay compliance of the summons by notifying the third-party recordkeeper not to comply with it. To enforce the summons, the IRS has to go to a federal district court, at which time the taxpayer and the third-party recordkeeper may assert any defenses they may have to the enforcement of the summons.

The act restructures a taxpayer's right to contest an administrative summons served after 1982. Instead of having the right to stay compliance of a summons by simply notifying the third-party recordkeeper not to comply, the taxpayer will be required to file a court petition to quash the summons.

V. CONCLUSION

Much of what I have gone over may sound punitive and burdensome. I hope that by going over some of the reasons for the provisions you will see that is not the intent. Nor do I believe for the vast majority of individuals, firms, and tax preparers that will be the result. It will be and it is intended to be the result for those who insist on playing fast and loose with their tax obligations. We believe this will lead to a much higher level of compliance, which in turn, will lead to a more favorable perception by the general public and thus a stronger tax system.