

REFORM PENALTY AND INTEREST PROVISIONS

Legislative Recommendation #29

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

SUMMARY

- *Problem:* If a self-employed individual fails to pay sufficient estimated tax during the year, the IRS will impose an addition to tax that is calculated as an interest charge but classified as a penalty. The term “penalty” implies that the taxpayer has engaged in improper conduct, yet small business taxpayers 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 from a penalty to an interest charge.

PRESENT LAW

Through the combination of wage withholding and estimated tax payments, the tax code 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 or 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 calculated as an interest charge, even though it is classified as a penalty.

Unlike the failure-to-file and failure-to-pay penalties described in IRC § 6651(a)(1) and (2) and the accuracy-related penalty described in IRC § 6662, the penalty for failure to pay estimated tax generally is not subject to a “reasonable cause” exception. IRC § 6654(e)(3) allows the IRS to waive the estimated tax penalty for

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).

individual taxpayers only in certain limited circumstances, including when the Secretary determines that imposing the penalty would be “against equity and good conscience” by reason of “casualty, disaster, or other unusual circumstances” or when a taxpayer retired after having attained the age of 62 or became disabled during the taxable year *and* the underpayment was due to reasonable cause.

REASONS FOR CHANGE

For a variety of reasons, taxpayers often have difficulty estimating 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 also 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 reasonably 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. Her position aligns 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 TAS has conducted research studies that have found “tax morale” has an impact on tax compliance.³ Conforming the estimated tax penalty’s title to reflect its true substance as an interest provision should improve fairness and encourage voluntary compliance.⁴

RECOMMENDATIONS

- Reclassify 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 chapter 68 to chapter 67 and make conforming modifications to the headings and text.⁵
- If the failure to pay sufficient estimated tax continues to be treated as a penalty, consider expanding the reasonable cause exception in IRC § 6654(e)(3)(B) to apply to all individual taxpayers.⁶

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 Interest provisions do not normally include waiver exceptions based on equitable considerations. See Internal Revenue Manual (IRM) 20.2.1.1.2(3), Authority (Jan. 25, 2021), https://www.irs.gov/irm/part20/irm_20-002-001r. Nonetheless, Congress may consider preserving the limited waiver exception for the individual estimated tax penalty, which allows the IRS to waive the charge when it would violate equity and good conscience to impose it. IRC § 6654(e)(3)(A).

⁵ For legislative language generally consistent with this recommendation, see Taxpayer Protection and IRS Accountability Act, H.R. 1528, 108th Cong. § 101 (2003).

⁶ Expanding the reasonable cause exception in IRC § 6654(e)(3)(B) to all individual taxpayers, not just newly retired or disabled individuals, would allow the IRS to base relief on what is reasonable, rather than the more difficult standard of “against equity and good conscience.” See IRM 20.1.3.3.2.1.2, Waiver Criteria Under IRC 6654(e)(3)(A) (July 23, 2020), https://www.irs.gov/irm/part20/irm_20-001-003r (explaining that the “against equity and good conscience” standard is more limited than “reasonable cause”). For more details on a recommendation to expand the reasonable cause exception to all individual taxpayers who may be subject to the estimated tax payment regime for the first time, 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.