DCCUMENT RESUME

01924 - [A1222238]

[Assessment of 100% Penalties against Responsible Corporate Officials for Willful Nonpayment of Taxes Withheld from Employees' Wages and Certain Excise Taxes]. GGD-77-49; B-137762. May 3, 1977. 7 pp.

Report to Rep. Al Ullman, Chairman, Joint Committee on Taxation; by Elmer B. Staats, Comptroller General.

Issue Area: Tax Administration: Controls to Insure Audit Quality and Prevent Unwarranted Assessments (2702).
Contact: General Government Div.
Budget Function: General Government: Other General Government (806).
Organization Concerned: Internal Revenue Service.
Congressional Relevance: Joint Committee on Taxation.

A survey was conducted of the Internal Revenue Service's (IRS's) policies, procedures, and practices in assessing 100% penalties against responsible officials of corporations for willful nonpayment of taxes witheld from employees' wages and certain excise taxes. Sixty-one recommended penalty assessments involving 33 corporate cases handled by the Chicago District Office were reviewed, as well as 69 delinquent cases where the penalty was not used and 29 decisions rendered by Federal district courts which dealt with 100% penalties. Findings/Conclusions: The survey in the Chicago district disclosed no major deficiencies in the use of the 100% penalty. The penalty is an infrequently used collection tool of last resort. The justifications for using the penalty were adequately supported in almost all cases, and persons recommended for assessment were generally informed of their appeal rights. The appeal system appears to objectively serve those who have legitimate arguments against the use of the peralty. There was no indication that IRS failed to assess the penalty when it should have. The study did indicate a need to study how IRS can quickly identify and take collection action against employers who fail to deposit withholding taxes. (SC)

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-137762 MAY 3 1977

The Honorable Al Ullman, Chairman
Joint Committee on Taxation
Congress of the United States

Dear Mr. Chairman:

In response to your Committee's March 19, 1976, request, we surveyed the Internal Revenue Service's (IRS's) policies, procedures, and practices in assessing 100-percent penalties against responsible officials of corporations for willful nonpayment of taxes withheld from employees' wages and certain excise taxes. Our work revealed no significant deficiencies in the way this penalty is used. However, it did indicate a need to study how IRS can quickly identify and take collection action against employers who fail to deposit withheld taxes.

IRS considers delinquencies in the payment of these employment taxes a serious problem. In 1976 testimony before the Ways and Means Subcommittee on Oversight, IRS officials expressed concern that employers use withheld taxes as low interest loans from the Federal Government. They also expressed concern with employers who are repeatedly delinquent.

We discussed the results of our survey with the Chief of Staff of the Joint Committee, and he agreed that we should expand our study to examine IRS efforts to identify and take appropriate action against employers who do not make timely deposits of taxes withheld from employees' wages. In a February 2, 1977, letter he authorized the study which is now in process.

The following discussion presents the scope and results of our survey of 100-percent penalties.

BACKGROUND

The Internal Revenue Code provides that businesses are responsible for collecting from third parties and paying over to the Federal Government certain taxes. If these taxes are not collected or are collected and not turned over, those

individuals who were responsible for withholding and accounting for the delinquent taxes can, in the case of five specific taxes, be assessed a penalty equal to the unpaid tax. This is called a 100-percent penalty. It is the liability of the individual, not the business. Every responsible person may be penalized for the business' tax delinquency.

Three of the five taxes subject to the 100-percent penalty--social security, railroad retirement, and income--are employment withholding taxes. The other two--transportation (air) and communication (telephone and teletypewriter)--are excise taxes. The excise taxes are collected by the business providing the service.

The law provides that two requirements--responsibility and willfulness--be considered in assessing the penalty. IRS defines a "responsible person" as one who has the duty to perform or the power to direct the collecting of, accounting for, and paying over the collected or withheld taxes. A responsible person may be an officer or employee of a corporation, a member or employee of a partnership, or corporate director or shareholder with sufficient control over the disbursement of the business' funds. IRS defines "willful" as meaning intentional, deliberate, voluntary, and knowing as opposed to accidental. It also notes that the courts have held willfulness to include the preference of other creditors over the Government. Paying a net payroll while owing taxes has also been sufficient to satisfy the willfulness factor.

In addition to these two statutory requirements, IRS added a third requirement--collectibility. Collectibility was not adequately defined until December 1976 when IRS issued instructions providing that all penalties are to be considered collectible except for those cases where future collection is obviously impossible because of the responsible individual's advanced age or deteriorating mental or physical condition.

IRS uses the 100-percent penalty only when all other means of securing the delinquent taxes have been exhausted. It is generally used against responsible officials of corporations that have gone out of business but not against officials of an ongoing business because the delinquent taxes could still be collected. Also, IRS generally does not penalize owners of partnershhps or sole proprietorships since they are usually personally liable for the taxes.

While more than one responsible person may be penalized, it is IRS policy that the amount of the tax will be collected

only once. After the tax liability is satisfied, no collection action is taken on the remaining 100-percent penalties. They are eventually abated.

Only a small percentage of tax delinquencies result in the 100-percent penalty. In fiscal year 1976, for example, the IRS Chicago district had 28,559 businesses which were delinquent in paying $88.9 million in collected or withheld taxes; but only imposed the penalty on persons involved with 535 delinquent businesses. IRS made 762 assessments--760 for employment taxes and 2 for excise taxes. The year's total penalty assessments were $8.9 million on tax delinquencies of $6.2 million. There were 223 cases where IRS made more than one 100-percent penalty assessment for the same corporate liability.

We did our work at IRS' National, Midwest Regional, and Chicago District Offices where we reviewed its policies, procedures, and practices in assessing the 100-percent penalty. We reviewed 61 recommended penalty assessments involving 33 corporate cases. Some cases were selected at random while others were selected because they involved a specific type of taxpayer (i.e., a corporation involved in bankruptcy proceedings, and a person who paid the penalty and then filed for a refund). We also examined 23 penalty cases reviewed at IRS' Chicago Appellate branch.

In addition, we reviewed 69 delinquent corporate cases where the penalty was not used and 29 decisions rendered by Federal district courts which dealt with 100-percent penalties. We interviewed IRS headquarters, regional, district, and service center personnel who were involved in the 100-percent penalty process.

CHARACTERISTICS OF 100-PERCENT PENALTY CASES REVIEWED

For the 33 corporate cases we reviewed in the IRS Chicago District, the typical tax delinquency involved a small out-of-business corporation that owed $22,000 in employment taxes of which $16,000 was subject to the 100-percent penalty. (The penalty, interest, and employer's share of the social security tax are not subject to the 100-percent penalty.) The typical corporation was delinquent for about 1 year before going out of business. IRS considered assessing an average of three individuals per corporation but only recommended assessment against two. Within 2 years of the assessments, IRS collected 28 percent of the liability and still had 4 years to collect the remaining debt. The prospect for collecting the rest of the liability is unknown.

PENALTIES MET STATUTORY REQUIREMENTS

On all but four cases we reviewed IRS information generally contained support that the persons being peralized met both statutory requirements of responsibility and willfulness. However, we have no information to show that the individuals in the four cases should not have been assessed. These assessments involved corporate officials who were spouses of individuals found to be liable for the penalty. In one case the individual signed a statement agreeing to the penalty assessment. In another case a husband was assessed to protect the Government's interest because he filed joint returns with his wife. In the last two cases the taxpayers would not cooperate with IRS during the 100-percent penalty investigation and refused to be interviewed by IRS. Although given the opportunity, none of the four individuals appealed the assessments.

TAXPAYERS NOTIFIED OF THEIR RIGHT TO APPEAL

If the taxpayer disagrees with the recommended penalty assessment he may appeal to two levels within IRS--district conference and appellate conference--and to the courts. We found documentation in all but one case that IRS notified individuals being considered for assessment of their right to appeal the action.

Specifically, in 57 of 61 cases the individuals were advised of the recommended assessment and given ample time to appeal the action. In three of the four other cases quick assessments were made because of bankruptcy proceedings or because the statute of limitations was about to expire. The taxpayers were given the opportunity to appeal after the assessment. In the one case where there was no documentation that the appeal rights had been explained, the individual agreed to the assessment during a conference with an IRS representative.

To determine how well the appeals process worked we examined cases appealed to three different levels--district conference, appellate conference, and the district court.

District conference

Of the 61 recommended assessments covered by our study, 6 individuals requested and received a district conference review of their assessments. These reviews resulted in four assessments being upheld and two assessments being overturned because IRS determined the taxpayers did not act willfully. One of the taxpayers took his upheld case to appellate conference where the assessment was again upheld.

Appellate conference

Of the 61 recommended assessments, only 3 received an appellate conference. One assessment was appealed from the district conference and was upheld. The principals in two other cases bypassed the district conference and requested appellate hearings. Both cases were still open at the completion of our work.

We expanded our survey of appellate conference actions on 100-percent penalty assessments by selecting an additional 23 assessments reviewed at the appellate level. Twenty of these assessments were upheld and three were overturned.

One of the three recommended assessments was overturned because the conferee believed the individual was misinformed by the other corporate officials. The decision was based on judgment and could have gone either way. In the second assessment, the person sent two checks to the wrong place, and by the time IRS applied the checks to the taxpayer's account there were not sufficient funds in the bank to cover the checks. The conferee stated that although the individual could be considered negligent, he did not willfully fail to pay the tax. The third case dealt with duplicate payments of the tax and an erroneous refund by IRS. IRS did not determine that one check was bad before it refunded the second check which was good. The conferee determined that the taxpayer's actions were not willful.

An IRS study of 100-percent penalty cases handled nationally during the first 6 months of 1976 indicated that all Appellate Branch Offices were settling 100-percent penalty cases in the same manner. The study was limited to appellate handling of penalty cases and did not apply to the use or development of 100-percent penalties by IRS.

District Court

A level of appeal outside IRS is the Federal District Court. The courts found in favor of the taxpayer in 7 of the 29 District Court decisions we reviewed. In five of these cases the taxpayers were found not to be responsible officials. One case involved a third party lending institution which the court found not liable for the borrower's tax liability. The last case was decided against the Government on the basis of the court's ruling that the individuals IRS considered employees of the business were in fact independent contractors and the taxpayer was not liable for employment taxes.

NO INDICATION THAT IRS FAILED TO ASSESS THE 100-PERCENT PENALTY WHEN IT SHOULD HAVE

The 100-percent penalty is not used in all cases of corporate employment tax delinquencies. However, our review of randomly selected corporate delinquency cases where the penalty was not used gave no indication that IRS failed to assess the penalty when it should have. In 45 cases the penalty did not apply because the tax subject to the penalty had been paid. The remaining delinquencies in these cases were for penalties, interest, and the employer's portion of the social security taxes. In the remaining 24 cases the penalty was not used because (1) the amounts of the liabilities were below the minimum IRS considers worth pursuing or (2) the responsible individuals could not be identified.

EFFECTIVENESS OF PENALTY AS A COLLECTION DEVICE IS UNKNOWN

Although IRS considers the 100-percent penalty a collection tool, it does not know how effective the penalty is in insuring collection of taxes. IRS does not keep statistics on the amount of penalties assessed or on results of its collection efforts. For the cases we reviewed in the Chicago district, IRS collected 28 percent of the $534,000 tax liabilities for which the penalties were assessed. These figures cannot be considered the final collection results since IRS has until 1981 to pursue further collection activity.

Development of collection statistics was not feasible at the time of our study. IRS information on 100-percent penalties is not computerized but maintained manually on unit ledger cards located at IRS Service Centers. Information on any individual corporate case may be located at more than one service center, so a manual review would have had to be done at all locations. We believed the time required for such a review was not justified.

IRS is implementing a reporting system which will give statistical information on 100-percent penalties assessed and collected by the districts. IRS officials told us that this system should be operational sometime during 1977. However, we believe it will be 2 years after the system is implemented before the effectiveness of the 100-percent penalty as a collection tool can be determined. It will take that long to determine trends in the success of collection actions, and it will take 6 years to determine

actual collection made before the statute of limitations expires.

CONCLUSIONS

Our survey in the IRS Chicago district disclosed no major deficiencies in the use of the 100-percent penalty. The penalty is an infrequently used collection tool of last resort. The justifications for using the penalty were adequately supported in almost all cases, and persons recommended for assessment were generally informed of their appeal rights. For those who chose to appeal the assessments, the appeal system at the district conference, appellate conference, and district court levels appeared to be effective and impartial. The appeal system appears to objectively serve those who have legitimate arguments against IRS' use of the penalty. In addition, we found no indication that IRS failed to assess the penalty when it should have.

The results of our work in the Chicago district gave no indication that other districts might administer the 100-percent penalty differently. A national IRS study of the way the Appellate Branch handled these cases showed no difference. Further, IRS Midwest Region officials told us that, based on their experience, there were no significant differences in the way the nine districts under their jurisdiction handled 100-percent penalty cases. In addition, IRS manual instructions are generally explicit and leave little room for variation. The one area where major differences could have existed was determining that the penalty would be "collectible" before it was assessed. IRS identified this problem and issued more explicit instructions to insure more uniform use of the penalty between districts.

We would be pleased to discuss these matters further with your Committee as well as any other assistance we can provide in this area. We are sending copies of this report today to the Vice Chairman of the Joint Committee, the Secretary of the Treasury, and the Commissioner of Internal Revenue.

Sincerely yours,

Comptroller General
of the United States