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TAX ADMINISTRATION

Administration of the Bad Check Penalty

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The Honorable Dan Rostenkowski
Chairman, Joint Committee on Taxation

The Honorable Lloyd Bentsen
Vice Chairman, Joint Committee on Taxation
Congress of the United States

On November 7, 1986, we briefed your office on the results of our review of the Internal Revenue Service's (IRS) administration of the bad check penalty provision. Following the briefing, your representative requested that we provide the Committee with a report setting forth the contents of our briefing.

Section 6657 of the Internal Revenue Code authorizes IRS to assess a penalty on taxpayer checks that are returned unpaid. The code established a penalty of 1 percent of the check amount for checks $500 and over, and $5 or the check amount (whichever is less) for checks under $500. The code further stipulates that the penalty shall not apply if the check was tendered in good faith and with reasonable cause to believe that it would be duly paid.

We initiated our review to evaluate IRS' administration of the bad check penalty because the minimum penalty has remained unchanged since 1954 and IRS twice has proposed to raise the minimum penalty from $5 to $10 without success. The specific objectives of our review were to determine (1) the number of bad checks returned to IRS by depositaries, (2) the extent to which IRS assesses the penalty against such checks, and (3) the extent to which penalty assessments cover the costs of processing bad checks and assessing penalties. Another objective was to research the issues that could indicate the extent to which the bad check penalty was a deterrent.

To accomplish our objectives, we analyzed a file of dishonored check cases closed by IRS during the first 6 months of calendar year 1986, reviewed IRS' procedures and manuals, examined IRS statistics and interviewed Department of the Treasury and IRS officials. We also identified research projects that assessed the extent to which penalties are a deterrent and we reviewed the legislative history regarding the tax revisions of 1954 and found that there was no discussion of the bad check penalty provision. The details concerning the scope and methodology of our review are described in the appendix, as are the results.

The following are some highlights of the results of our work.

-- IRS assessed penalties on about 82 percent of the 184,000 checks that were returned from depositaries during the first 6 months of 1986. IRS did not assess penalties on the balance of the checks because it determined that these checks were tendered in good faith and with reasonable expectation that they would be paid.

-- The deterrent effect of the bad check penalty is difficult to determine. Taxpayers who submit bad checks are also subject to bank processing charges and possibly other IRS penalty and interest assessments which may act as deterrents.

-- IRS' processing costs exceeded the amount of the penalty assessment for about 59 percent of the bad checks processed during the first 6 months of 1986. However, the average penalty assessment was $20.35, which was $13.88 higher than IRS' estimated processing costs of $6.47 per check. This occurred because the 1 percent penalty for bad checks written for large amounts more than offset the costs to process checks written for smaller amounts.

Because the penalty has remained unchanged since 1954, Congress may want to consider whether the amount of the penalty is still appropriate and to what extent it should serve as a deterrent or just recover processing costs. Regarding processing costs, an issue is whether costs should be recovered in total or on a per check basis.

As requested by your representative, we did not obtain official agency comments. However, Department of the Treasury and IRS officials reviewed a draft of this report and generally agreed with its contents, and we considered their comments in preparing the final product. As arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of this document until 10 days from the date of issuance. At that time, we will send copies to the Department of the Treasury, IRS, and others who request them.

If you have questions regarding this briefing report, please contact Ron Berteotti on (202) 566-6503.

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William J. Anderson
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Abbreviations

IRS	Internal Revenue Service
IRM	Internal Revenue Manual

IRS' ADMINISTRATION OF THE BAD CHECK PENALTY PROVISION

This report discusses the penalty assessed by IRS when taxpayers attempt to pay their taxes with a bad check. Section 6657 of the Internal Revenue Code authorizes IRS to impose penalties amounting to 1 percent of the check amount for checks $500 and over. The code stipulates that for checks less than $500, the penalty is $5 or the amount of the check, whichever is less. The code further stipulates that the penalty shall not apply if the check was tendered in good faith and with reasonable cause to believe that the check would be duly paid. The penalty was enacted as part of an extensive revision of the tax code in 1954. However, there is no legislative history regarding the specific provision.

When a taxpayer pays his or her taxes with a check, IRS credits the taxpayer's account with the payment and deposits the check. If a taxpayer's depositary refuses to honor the check, it is returned to IRS, and upon receipt of the dishonored check IRS reverses the credit to the taxpayer's account. IRS then notifies the taxpayer that the check has been dishonored and requests payment, including interest and penalty assessments as appropriate. As is generally the rule with other penalties, IRS assesses the bad check penalty based on reasonable cause. The Internal Revenue Manual (IRM) section 30(85)2.2 defines reasonable cause as "those reasons deemed administratively acceptable to the Service for justifying the nonassertion of applicable penalties against noncompliant taxpayers." In accordance with IRM section 30(85)4.1, reasonable cause determinations are to be based on an evaluation of (1) the relationship among the events or parties involved, (2) the responsibility of the taxpayer, and (3) whether or not the event could reasonably have been anticipated. For those cases where the taxpayer has not shown reasonable cause for paying their taxes with a bad check, a penalty is assessed. The taxpayer then has the option of requesting IRS to abate or nullify the penalty assessment. Should IRS deny the abatement request the taxpayer can appeal the penalty assessment to an IRS appeals officer.

OBJECTIVES, SCOPE, AND METHODOLOGY

The objectives of our review were to determine (1) the number of bad checks returned to IRS by depositaries, (2) the extent to which IRS assesses the penalty against such checks, and (3) the extent to which penalty assessments cover the costs of processing bad checks and assessing penalties. We also researched the issues that could indicate the extent to which the bad check penalty was a deterrent.

In order to determine the number of dishonored checks returned to IRS by depositaries and the extent to which IRS assesses the penalty, we examined IRS reports of bad check penalty assessments and analyzed a file of dishonored check cases closed by IRS. The reports examined were for fiscal years 1982 through 1985 and contained data on the number of bad check penalty assessments made by IRS prior to any penalty abatements that were requested by taxpayers and granted by IRS. We attempted to obtain data on all dishonored checks received by IRS during these fiscal years but IRS destroys such data every 3 months. The file of dishonored checks, contained on computer tapes provided by IRS, was for the first 6 months of calendar year 1986. We analyzed this file to identify (1) the number and amounts of dishonored checks processed by IRS and (2) the number of dishonored checks that were and were not assessed penalties and the reasons. We relied on the accuracy of the tapes and did not test their validity.

To determine the extent which the bad check penalty covers the cost of processing the checks and assessing the penalty, we analyzed the 6-month file tape to determine the number of checks for which IRS' processing costs exceeded the assessed penalty. It should be noted that we relied on IRS' methods for determining the estimated costs associated with processing a bad check.

To identify the issues that could indicate the extent to which the bad check penalty may be a deterrent, we performed the following.

-- We reviewed the legislative history on the bad check penalty provision to determine the purpose for which it was enacted.

-- We gathered data relating to other charges that a taxpayer is subject to after writing a bad check.

-- We identified research projects that assess the deterrent effect of penalties on taxpayers' filing practices.

We performed our work from May 1986 through November 1986 in accordance with generally accepted government auditing standards except that we did not verify the accuracy of the IRS tapes or cost figures.

NUMBER OF BAD CHECK ASSESSMENTS

During fiscal years 1982 through 1985, IRS assessed an average of 326,000 bad check penalties per year with average annual assessments totaling about $6 million. The number and amount of assessments for these 4 years are shown in table 1.

Table 1:
Bad Check Penalty Assessments

Fiscal year	Assessments[a]	
	Number	Amount ($000)
1982	334,435	$4,903
1983	337,750	8,254
1984	321,800	6,061
1985	310,377	4,709

[a]Penalty assessment figures used in this report represent IRS assessments prior to any penalty abatements that were requested by taxpayers and granted by IRS. Also, there is no available data on the total number of dishonored checks IRS received during fiscal years 1982 through 1985 because this data is destroyed every 3 months.

Source: IRS Annual Reports for fiscal years 1982 through 1985.

For the first 6 months of calendar year 1986, IRS processed 184,177 dishonored checks and assessed penalties on 150,855, or 82 percent of these checks. The penalized checks were submitted by 133,265 taxpayers, totaled about $281 million, and accounted for about $3.1 million in penalty assessments. Tables 2 and 3 show the number, amounts, and reasons that checks were or were not penalized, respectively.

Table 2:
Reasons for Assessing the
Bad Check Penalty

Reasons	Number of checks	Percent of total	Amount of checks ($000)	Percent of total
Insufficient funds	127,804	85	$235,623	84
Refer to maker[a]	9,175	6	23,072	8
Closed account	8,771	6	11,572	4
Other reasons[b]	5,105	3	11,067	4
Total	150,855	100	$281,334	100

[a]This category is used by banks and is usually synonymous with insufficient funds.

[b]This category includes checks written by the taxpayer for less than the minimum allowed by a money market fund and checks which exceed a credit limit.

Source: IRS dishonored check cases closed during January through June 1986.

Table 3:
Reasons for Not Assessing
the Bad Check Penalty

Reasons	Number of checks	Percent of total	Amount of checks ($000)	Percent of total
Stop payment[a]	9,972	30	$ 42,495	24
Unclassified[b]	9,797	29	80,603	45
Uncollected funds[c]	4,934	15	23,027	13
Signature missing	2,982	9	7,691	4
Other reasons[d]	5,637	17	25,718	14
Total	33,322	100	$179,534	100

[a]This category refers to checks which were not honored by a depositary because account holders directed the depositary to stop payment. According to an IRS official, stop payment checks are not considered dishonored checks.

[b]This category includes situations such as checks sent to the wrong depositary by IRS and illegible signatures.

[c]This category includes checks returned because deposits to the taxpayer's account have not been cleared or credited by the depositary.

[d]This category includes checks where the written amount and numerical amount do not match and checks with an altered, missing, or incorrect date. IRS considers these to be unintentional errors by the taxpayer and therefore checks rendered in good faith.

Source: IRS dishonored check cases closed during January through June 1986.

DETERRENT EFFECT OF THE BAD CHECK PENALTY

In reviewing the issues which could indicate whether the bad check penalty is a deterrent against taxpayers who use bad checks to pay their taxes, we found that a number of other factors can act as deterrents. Therefore, we were unable to determine the extent to which the bad check penalty is, on its own, a deterrent.

Many experts from the private sector have determined penalties to have a deterrent effect. As a result penalties are generally used by IRS to enhance taxpayer compliance with the tax laws. These experts (economists and legal researchers) who model taxpayer behavior have linked deterrence with penalties--the greater the penalty, the higher the deterrent effect. Furthermore, these experts have concluded that one way the government can strengthen tax enforcement is to increase penalties. While these models have established a link between penalties in general and deterrent effect, they have not specifically addressed the deterrent effect of the bad check penalty.

Measuring the deterrent effect of the bad check penalty is complicated by the fact that taxpayers are also subject to other charges which might deter them from writing bad checks. Taxpayers are usually assessed appropriate penalty and interest amounts by IRS if the bad check results in a failure to pay taxes by the specified due date. Additionally, taxpayers submitting bad checks to IRS may be charged fees by the depositary. Depositaries charge for checks returned for insufficient funds to recover the added costs of processing the returned check as well as discouraging recurring incidences. In 1985, the American Bankers Association reported that bank charges for checks returned due to insufficient funds averaged between $10 and $14 per check.

IRS' PROPOSALS TO INCREASE THE BAD CHECK PENALTY

In 1982 and 1985, IRS requested that the Department of the Treasury seek legislation to raise the minimum bad check penalty from $5 to $10. In requesting the increase, IRS cited growth in the number of dishonored checks and the inability to recover the costs of processing such checks. IRS also noted the minimum penalty had not kept pace with bank charges which averaged between $7 and $10 per check in 1982 and between $10 and $14 per check in 1985.

In its 1982 proposal to raise the minimum bad check penalty, IRS cited growth from 1979 and 1980 in the number of bad checks received. This data included checks which were assessed penalties, checks which were not assessed penalties, and checks which could be redeposited by IRS without further action. IRS reported that the cost to process these checks exceeded the amount of the penalty assessment in 40 percent of the bad checks written by businesses and 77 percent of the checks written by individuals. IRS' 1985 proposal cited similar findings.

Department of the Treasury officials in the Tax Legislative Counsel Office told us they had not acted on the IRS proposals to raise the minimum penalty because they had devoted their resources to higher priority matters. When advised of our results, they said they would give the issue further consideration.

Data we gathered for the first 6 months of 1986 also showed that the minimum bad check penalty was not adequate to cover the processing costs for over 50 percent of the bad checks written. IRS estimated in 1986 that it cost $6.47 to process a bad check, assess a penalty, and process the subsequent taxpayer repayment. As shown in table 4, about 59 percent of the penalty assessments were less than IRS' estimated processing costs.

Table 4:
Comparison of Penalty Assessments
and Processing Costs

	Number of checks	Percent of total
Checks with penalty less than $6.47	88,751	58.8
Checks with penalty equal to or greater than $6.47	62,104	41.2
Total penalized checks	150,855	100

Source: IRS dishonored check cases closed during January through June 1986.

Our analysis also showed that while IRS did not recover its processing costs on each individual check, the average penalty assessment exceeded IRS' estimated processing costs by a substantial margin. During the first 6 months of 1986, the average penalty assessment was $20.35, which was $13.88 higher than IRS' estimated processing costs of $6.47 per check. This occurred because the 1 percent penalty for checks written for large amounts more than offset the costs to process checks written for smaller amounts.

OBSERVATIONS ON IRS' PROPOSAL TO RAISE THE BAD CHECK PENALTY

IRS officials in the Returns Processing and Accounting Division and the Legislative Affairs Division with whom we discussed our results continue to favor raising the minimum bad check penalty. They believe it is appropriate that IRS recover its processing costs on each assessment. It is interesting to note that unlike IRS, banks and other institutions generally charge a flat fee regardless of the amount of the dishonored check. Thus, these fees cover the cost of processing each dishonored check, not just some.

These IRS officials further said that the minimum penalty had not been adjusted since its adoption in 1954 and that the administration and Congress are interested in penalty assessments as a source of government revenues. In connection with this point, we estimate that a $10 minimum penalty in effect during the first 6 months of 1986 could have generated an additional $463,000 in revenues.

Although IRS recovers its aggregate cost for assessing the bad check penalty, at issue here is whether IRS should recover its costs on each check processed. Currently, penalties for checks written for large amounts offset the costs to process checks written for smaller amounts.

MATTERS FOR CONSIDERATION BY THE CONGRESS

Since the bad check penalty has remained unchanged since 1954, Congress may want to consider whether the penalty is still appropriate and the extent it should serve as a deterrent or just recover processing costs. Regarding processing costs, an issue is whether costs should be recovered in total or on a per check basis.

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