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BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

New Formula Needed To Calculate Interest Rate On Unpaid Taxes

Deficiencies in the formula used to calculate interest assessments on delinquent taxes deprived the Government of about $286 million in fiscal year 1979.

At present, the formula is adjusted every 2 years based on changes in the prime interest rate. As a result, the formula rates do not reflect, except by chance, the costs the Government actually incurs in connection with delinquent taxes--the costs of its own borrowings and credit administration. The problem is compounded by the practice of only making biennial adjustments in a period of rapidly and sharply shifting interest rates.

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

B-200489

To The President of the Senate and the
Speaker of the House of Representatives

The recent volatility in market interest rates prompted us to review the interest rate that the Internal Revenue Service assesses on delinquent taxes and pays on overpayments. This report makes several recommendations which, if adopted, will compensate the Government for the costs of financing and administering delinquent tax accounts through the interest rate charged on those accounts. These recommendations will at the same time assure that taxpayers are not over assessed. If our recommendations are adopted they should also encourage more timely payments by taxpayers.

Copies of the report are being sent to the Director, Office of Management and Budget; the Secretary of the Treasury; the Commissioner of Internal Revenue; and other interested parties.

Comptroller General
of the United States

COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

NEW FORMULA NEEDED TO CALCULATE INTEREST RATE ON UNPAID TAXES

D I G E S T

The formula IRS presently uses to calculate the interest rate on unpaid taxes fails to properly reflect the Government's costs for credit administration and its cost for borrowing money.

GAO estimates that in fiscal year 1979, the present formula deprived the Government of about $286 million in interest charges. This loss occurred because the interest rate did not properly reflect administrative costs and the rising cost of Federal borrowing. Conversely, in a period where the cost of Federal borrowing is declining the present formula could also cause interest to be overassessed to delinquent taxpayers.

Interest is the compensation received by creditors, the Government in the case of unpaid taxes, for the use of their money. GAO found that IRS' present interest rate formula does not

--assure that the Government recovers no more or less than the costs associated with unpaid taxes,

--provide for adjusting the interest rate frequently enough,

--encourage taxpayers to pay taxes promptly in all instances, or

--contribute to administrative efficiency.

THE GOVERNMENT SHOULD RECOVER COSTS ASSOCIATED WITH UNPAID TAXES

The IRS interest rate is recalculated once every 2 years using a formula based on 90 percent of the prime interest rate. This

GGD-81-20

rate resulted in interest assessments of $1.251 billion in fiscal year 1979. However, the assessments fell short of the Government's costs considered to be related to unpaid taxes. GAO estimated these costs to total $1.537 billion.

The costs included

--$1.305 billion in interest costs for funds to replace the unpaid taxes (see p. 6); and

--$232 million to process and collect unpaid taxes (see p. 7).

GAO believes that the formula for determining the interest rate to be assessed on unpaid taxes should be changed so that the Government is compensated for these costs. In September 1979, the month IRS' current interest rate was determined, the 1-year Treasury bill interest rate was 9.89 percent. To this should have been added an estimated operating cost component of 1.17 percent to cover administrative expenses. (See p. 7.) Thus, a rate of 11.06 percent would have been needed to fairly compensate the Government for its costs of financing and administering unpaid taxes. (Since this rate is also applied to refunds some of the additional interest assessed would be returned to taxpayers. See footnote 1, page 6.)

IRS' INTEREST RATE SHOULD BE ADJUSTED SEMIANNUALLY

Even if IRS' interest rate formula is restructured, it must be determined more often than every other year to accurately reflect the cost to the Government of unpaid taxes. In recent years interest rates have changed significantly over short periods of time. For example, in 1979, the prime rate rose 4 percentage points over a 5-month period. GAO estimates that if the IRS interest rate had been adjusted semiannually, interest assessments on taxes due in fiscal year 1979 would have been at least $119 million higher. (See p. 16.)

On the other hand, if the interest rate had been declining, a more frequent adjustment would have prevented taxpayers from being overassessed. GAO believes that adjusting the rate semiannually, using the 1-year Treasury bill rate and redetermining the overhead factor annually would keep the rate more in line with the Government's cost of unpaid taxes.

PRESENT INTEREST RATE DOES NOT ENCOURAGE PROMPT PAYMENT OF TAXES

The Congress, when establishing the present interest rate formula, noted that the rate resulting from the formula should encourage taxpayers to pay their correct taxes promptly. GAO's study indicates that when interest rates are generally rising, the present procedures for calculating interest rates on unpaid taxes will not encourage taxpayers to pay taxes promptly and may even discourage such payment. IRS' assessed interest is generally lower than the rate available in commercial money markets, thus discouraging prompt payment. In contrast, when interest rates are falling, taxpayers who have become delinquent in their tax payment should not be required to over-compensate the Government for costs related to collecting delinquent accounts. Adjusting the rate to reflect changes in money market rates would help to alleviate this problem.

IRS' INTEREST RATE SHOULD BE STATED TO TWO DECIMAL PLACES

The present interest formula provides for rounding the calculated interest rate to a whole percentage. Such a provision does little to advance its stated purpose of administrative convenience. (See p. 17.) IRS can easily calculate interest assessments regardless of whether the rate is a whole percent or a decimal. The rate calculated in October 1977 and used between February 1978 and January 1980 was rounded

from 6.42 percent to 6 percent. This procedure cost the Government at least $45 million in fiscal year 1979 alone.

For some periods, the interest rate may be rounded up, which would result in overassessing interest for some taxpayers. The interest rate formula should state the interest rate to two decimal places and, to avoid the necessity of changing the rate only hundredths of a percent, a minimum change of 0.25 percent should be required before a change can be made.

AGENCY COMMENTS AND GAO'S EVALUATION

In their comments, the Department of the Treasury and IRS correctly pointed out that it is difficult to determine an interest rate which would be fair to both the taxpayer and the Government on both over- and underpayments. They are currently considering a proposal to adjust IRS' interest rate to 100 percent of the prime. They believe this is the most appropriate rate since most taxpayers pay more than the prime rate to borrow money and receive less than the prime rate when lending money. In addition, they believe that sound business practices used by banks and other financial institutions cannot be applied to IRS, noting that collecting taxes is unlike granting a loan.

The criteria GAO applied in this review was that the Government should recover the full costs of providing special benefits or services to individuals or groups from those receiving such benefits. For purposes of this evaluation, GAO considered that the taxpayers who use low cost funds owed the Government (by reason of their failure to make timely payment of taxes) are receiving a special benefit.

When Treasury officials commented on Senate Bill S.999, which dealt with IRS' interest rate, they stated, "The payment of interest is an economic concept, it is not a punitive one." GAO agrees that interest is an

economic concept and therefore requires the use of sound business principles in its application.

In GAO's opinion, Government policy and sound business principles require that a new formula be used to calculate the interest rate assessed by IRS on delinquent taxes. This rate should fairly compensate the Government for the costs of financing and administering delinquent taxes. If these costs are not recovered from delinquent taxpayers, they must be recovered from all taxpayers.

RECOMMENDATIONS TO THE CONGRESS

The Congress should amend the Internal Revenue Code to require IRS to:

--Establish an interest rate reflecting the prevailing Government borrowing rate plus a factor for administrative expenses.

--Establish semiannual adjustments of the interest rate stating it to two decimal places and limiting changes to 0.25 percent or more.

Contents

ABBREVIATIONS

IRS	Internal Revenue Service
GAO	General Accounting Office

CHAPTER 1

INTRODUCTION

The Internal Revenue Service (IRS) has established due dates for filing income tax returns and paying tax liabilities. Generally, if taxes are not paid when due, IRS assesses the delinquent taxpayer interest on the unpaid tax balance. IRS also assesses interest on tax deficiencies identified by audit. Conversely, in most instances IRS pays taxpayers interest if claims for tax refunds are not processed within 45 days of the filing or due date, whichever is later. The Congress, in determining the interest rate IRS uses, noted that the interest rate could provide an incentive for the taxpayer to file properly and for IRS to process tax returns promptly.

IRS also assesses penalties when taxpayers either fail to file income tax returns, to pay taxes on time, or to comply with other provisions of the Internal Revenue Code. As opposed to interest, which is compensatory, penalties are considered to be punitive. Although both interest and penalty assessments are related to the amount of unpaid taxes, this report discusses only interest assessments.

IRS INTEREST RATE INTENDED TO ENCOURAGE PROMPT PAYMENT OF TAXES

In 1921, the Congress initially enacted legislation requiring IRS to pay interest of 6 percent to taxpayers who had tax refunds coming. In 1935, this rate was also applied to underpayments. Historically, the 6-percent interest rate has been higher than the prevailing money market rate. For instance the prime interest rate, the rate banks charge their best commercial customers for short-term loans, was 6 percent or less between 1935 and 1967. The Senate report on Public Law 93-625, notes that this relatively high rate was to provide both taxpayers and IRS with an incentive to pay their tax obligations on time.

When the prime rate climbed to 12 percent in 1974, the IRS interest rate assessment no longer provided an incentive to pay promptly. To update the IRS interest rate and keep it in line with money market rates, the Congress, in 1975, enacted Public Law 93-625. The Congress had at least three objections to an IRS rate below money market rates. First, taxpayers were finding it profitable to "borrow" tax funds at the 6-percent IRS rate rather than pay their taxes when due, with their own or borrowed funds. Second, the low rate

may have encouraged taxpayers to claim questionable deductions since a later disallowance of the deduction would only cost 6 percent. Third, since the Government had to pay more than 6 percent for borrowed funds, the low refund rate provided IRS no incentive to make prompt refunds.

Public Law 93-625 raised IRS' interest rate from 6 to 9 percent, effective July 1, 1975. Thereafter, this rate was to be adjusted every 2 years beginning February 1, 1976. The formula, specifically included in the Public Law, provides that the rate be set at 90 percent of the average prime rate for September, rounded to the nearest whole percent.

The prime rate was chosen as an index because it is widely known and generally accepted as being responsive to money market conditions. No reason was given for using 90 percent of the prime. Adjusting the rate only every 2 years, rounding it to the nearest whole percent, and making it effective in February were provisions intended to simplify IRS' administration of the interest assessments.

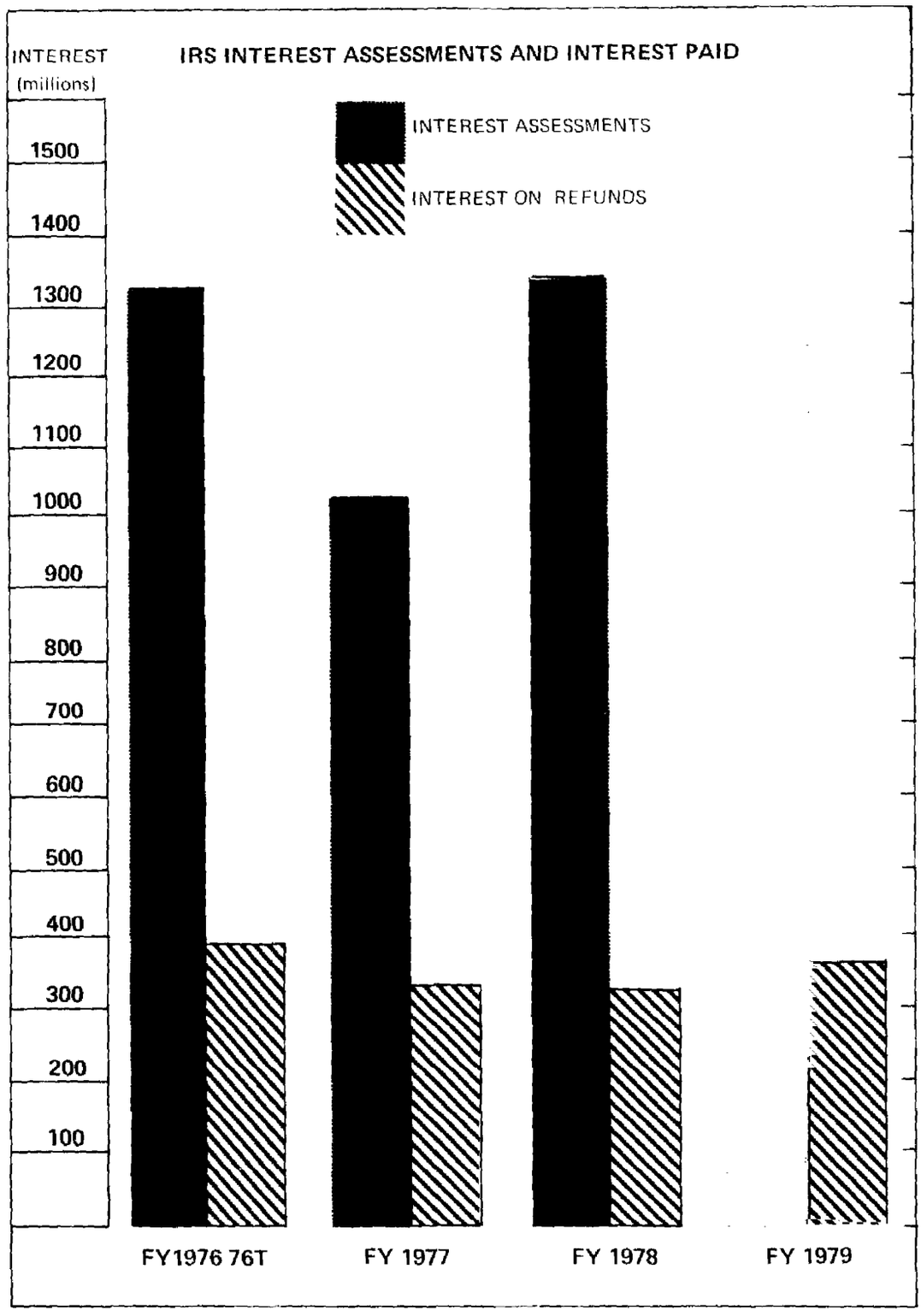
The Congress has considered the use of separate interest rates to be assessed on delinquent taxes and to be paid on tax refunds. However, in deliberations on this subject, separate interest rates were determined to be inequitable to the taxpayer, and therefore the consideration was dropped.

The chart on the following page shows the amounts of interest IRS assessed and paid taxpayers from fiscal years 1976 through 1979.

OBJECTIVES, SCOPE, AND METHODOLOGY

The objective of this review was to determine if the interest rate assessed on unpaid taxes adequately compensated the Government for the expenses it incurs as a result of these taxes. The application of this interest rate was also reviewed to insure that both the Government and the taxpayer were treated consistently and fairly.

Our review was conducted from August 1979 through April 1980 at Department of the Treasury and IRS headquarters, Washington, D.C.; IRS' Chicago regional and district offices; and IRS' Kansas City service center. Headquarters' discussions centered on the law dealing with interest and the cost of administration. In the other offices, we discussed the problems of applying the law and the effects of possible recommendations we might make.


IRS INTEREST ASSESSMENTS AND INTEREST PAID
INTEREST (millions)
INTEREST ASSESSMENTS
INTEREST ON REFUNDS
1500
1400
1300
1200
1100
1000
900
800
700
600
500
400
300
200
100
FY1976 76T
FY 1977
FY 1978
FY 1979

To establish the criteria with which to compare IRS' interest rate, we held discussions with officials from selected Federal agency headquarters in Washington, D.C., commercial banks, and finance companies that assess interest on various types of loans. These discussions dealt with their interest rates and the factors they considered when determining those rates. The sound business practices followed by these institutions formed the criteria with which we compared the IRS interest rate.

We reviewed IRS and GAO studies dealing with the effect of interest rates on late payments. In addition, we reviewed other Federal agency documents dealing with interest rates on delinquent accounts. We did not evaluate IRS' tax processing procedures.

Because of accounting system limitations, IRS was unable to provide us with certain information requested, such as the amount of data processing operations cost attributable to late payment, or the effect different interest rates would have had on the amounts assessed by IRS. Where information was unavailable, we developed estimates based on comments and statistics provided by IRS officials. Estimates are identified in the body of this report, with supporting explanation in the appendixes as necessary.

Finally, we discussed with Office of Management and Budget officals working on the Debt Collection Task Force the concept that since interest is compensatory in nature, IRS should recover the Government's cost associated with late tax payments through the interest rate. This task force is looking into the problems of delinquent accounts throughout the Government and believes that this interest concept may have application in relation to other Government delinquent accounts.

CHAPTER 2

IRS' INTEREST RATE DOES NOT RECOVER COSTS OR ENCOURAGE PROMPT PAYMENT

The interest rate assessed by IRS fails to properly reflect two elements necessary to any interest rate determination--the cost of the lender's funds and the cost of the lender's credit administration. Also, since IRS' rate is currently lower than the rate at which most taxpayers can borrow money, it provides little incentive for taxpayers to pay taxes promptly.

A new formula is needed that calculates an interest rate for unpaid taxes which includes the Government borrowing rate plus an overhead factor for administrative costs. Not only would this new formula appropriately compensate the Government for the costs related to unpaid taxes, it would provide a greater incentive for taxpayers to pay taxes promptly.

THE GOVERNMENT SHOULD BE COMPENSATED FOR COSTS ASSOCIATED WITH UNPAID TAXES

The criteria GAO applied in this review was that the Government should recover, to the extent practicable, the full costs of providing special benefits or services to individuals or groups by those receiving such benefits or services. An example of the application of this criteria is in the Tax Reform Act of 1969 where Congress imposed a tax on exempt private foundations to cover IRS' administrative costs of determining whether such a foundation should continue to qualify for an exemption.

An unpaid tax obligation is, in effect, a loan from the Government to the taxpayer. From the due date to the date of payment, delinquent taxpayers derive benefits from money that belongs to the Government. Since delinquent taxpayers constitute a group receiving this special Government benefit, they should compensate the Government for the cost of the benefit. We believe IRS should recover, through its interest rate, the full cost of its unintentional loans to taxpayers, just as any money lending institution recovers such cost. Some of the costs that interest rates quoted by commercial banks and finance companies must recover include

--interest on funds borrowed to finance loans,

--loan processing and collection costs, and

--the cost of loans which are written off as uncollectible.

The law provides that IRS' interest rate shall be 90 percent of the prime interest rate. This rate resulted in interest assessments of $1.251 billion in fiscal year 1979. However, depending on which administrative costs were considered in establishing a more appropriate rate, we estimate that in fiscal year 1979, the Government's costs relating to unpaid taxes were about $1.537 billion. 1/

These costs included

--$1.305 billion in interest costs for funds to borrow an amount equal the unpaid taxes; and

--$232 million to process and collect unpaid taxes.

IRS' interest rate should recover financing costs

In fiscal year 1979, financing costs were the largest expense the Government should have recovered. In this year, IRS assessed interest on $31.9 billion of unpaid taxes. If IRS' interest rate had been periodically adjusted--for example, semiannually--to recover only the Department of the Treasury's cost for borrowing funds to replace these unpaid taxes, we estimate that IRS would have assessed $1.305 billion in fiscal year 1979. (See app. I.)

This estimate is based on yields for 1-year Treasury bills. Treasury bill rates were selected because they represent the market prices which the Government pays for money. The 1-year Treasury bill fairly represents rates for Government borrowing over time periods similar to those most IRS unpaid taxes remain outstanding. In September 1979, the 1-year Treasury bill rate was 9.89 percent. We

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1/Present law also provides that overdue tax refunds are to receive interest income at the same interest rate assessed on tax delinquencies. A change in the interest rate would affect the amount paid to taxpayers in the form of tax refund interest. The proposed interest rate increase would increase interest payments to taxpayers. This increase may be considered an offset to the Government's costs mentioned above, but has not been included in the calculations used in this report.

believe this rate should form the base for fairly compensating the Government. To this base should be added a factor for IRS' administrative expenses.

IRS incurs additional costs to process and collect unpaid taxes

Because many taxpayers do not pay their taxes accurately or on time, IRS incurs additional expenses for tracking and collecting their accounts. IRS has over 30 programs which deal to some extent with unpaid taxes. These programs cross several of the activities performed by IRS, and may include Collections, Data Processing Operations and Examinations. It is conceivable that other IRS activities, such as Criminal Investigation, relate directly to unpaid taxes. However, we were unable to obtain estimates of what portion of IRS' budget should be allocated and have therefore not included these other activities in our overall cost estimate.

The Collections activity estimated that of its $295 million spent in fiscal year 1979, $224 million was spent to collect and prevent unpaid taxes. We estimate that the Data Processing Operations activity incurred costs of at least $8 million for fiscal year 1979 because of unpaid taxes. Of this, $4.3 million was spent sending out balance due notices, and $3.7 million was spent to maintain and process balance due accounts. These costs can be clearly identified as directly related to collecting unpaid taxes.

Fiscal year 1979 appropriation activity	Total amount spent	Estimated amount spent as a result of unpaid taxes
	(millions)	
Data Processing Operations	$ 522	$ 8
Collections	295	224
Other activities	1,314	-
Total	$2,131	$232

IRS' interest rate should recover borrowing and operating costs

To recover its costs, we estimate IRS' rate should be adjusted to 11.06 percent, rather than the 12 percent rate adopted on February 1, 1980. We estimated this rate from two components--one for borrowing costs, the other for operating costs. The borrowing cost component, 9.89 percent, was based on the September 1979, rate for 1-year Treasury bills. The operating cost component, 1.17 percent, was based on our estimate of IRS' additional costs ($232 million) due

to unpaid taxes. We calculated the operating cost component by dividing the operating costs, $232 million, by our estimate of the total amount of unpaid taxes $31.854 billion (outstanding an average of 7.49 months) and converted this to a yearly percentage rate. 1/

Other costs are related to unpaid taxes

It is clear that the above costs result directly from unpaid taxes. However, there are two other major cost items which may be considered as related to unpaid taxes. These items are a portion of Examinations costs and taxes written off as uncollectible.

Although a portion of the Examinations activity's costs may also be considered related to the collection of unpaid taxes, the relationship is not as clear as with the previously mentioned costs, since similiar examination costs are not incurred by commercial banks and finance companies. The Examinations activity, which audits tax returns, found deficiencies in 70 percent of the examined returns. Because returns to be examined are not selected randomly but are usually selected on the basis of their error potential, 70 percent of the Examinations activity costs, or about $505 million in 1979, may be considered as a cost relating to unpaid taxes.

In 1979, IRS wrote off unpaid taxes valued at $444 million 2/ that could no longer be collected because the statute of limitations had expired. If IRS does not recover these unpaid taxes from delinquent taxpayers, it must recover them from all taxpayers. Banks and finance companies include the expected costs of uncollectible loans in their interest rates.

1/Using Principal x Rate x Time = Interest, we arranged the formula so

(Interest / Principal) x (1 / Time) = Rate
($0.232 billion / $31.854 billion) x
(12 months / 7.49 months) = Rate
(.007283) x (1.602136) = 1.17 percent

2/Information available only for calendar year. This information was used to approximate fiscal year.

We are not recommending that these other costs be incorporated into an interest rate calculation. However, we do point out that the costs are substantial and do indirectly result from unpaid taxes.

IRS' INTEREST RATE PROVIDES LITTLE INCENTIVE FOR TAXPAYERS TO COMPLY WITH TAX LAWS

The Senate report on Public Law 93-625 notes that increasing the IRS interest rate and providing a formula for adjusting it would make it less profitable for taxpayers to, in effect, borrow money by not paying taxes when due. The report also notes that a taxpayer may claim a questionable deduction on the theory that IRS would assess an interest rate lower than the market rate if it later disallowed the questionable deduction.

Also, when the interest rate assessed by IRS is less than prevailing money market rates, it provides taxpayers little incentive to pay taxes promptly. During fiscal years 1978 and 1979, when money market rates were rising rapidly, taxpayer delinquencies and filings for extensions increased. IRS headquarters and field office personnel attributed this increase to IRS' low 6-percent interest rate. In addition, an IRS official stated that studies provide evidence that the rate of interest charged on delinquent accounts has an effect on the number of delinquent accounts.

IRS' interest rate is less than prevailing money market rates

In contrast to the 6-percent IRS rate, taxpayers would have had to pay between 12 and 30 percent to borrow money during 1979. Even the prime interest rate, the rate quoted by most banks to their best commercial customers for short-term loans, ran well above the IRS interest rate. Very few borrowers are offered the prime rate and generally those who do receive it must maintain a compensatory balance, thus increasing the effective cost of the loan. The table on the following page compares the IRS interest rate to typical market rates during 1979.

1979 Interest rates	Low	High
	(percentages)	
IRS' interest rate	6.0	6.0
Corporations:		
Best business customers (prime)	11.5	15.6
Other customers (short-term commercial and industrial loans, weighted average) (note a)	12.3	15.8
Individuals:		
Personal loans (note b)	13.9	14.6
Credit cards (note b)	17.1	17.1
Finance companies (note c)	16.0	30.0

a/From Federal Reserve statistical release G-14 (Now E-2).
b/From Federal Reserve statistical release G-10 (Now E-12).
c/From interviews with finance companies, November 1979.

In 1978 IRS studied the effect of its interest rate on business taxpayers. Although not conclusive, the study found cases where lower IRS rates may have increased tax delinquencies. This increase in delinquencies is not surprising because during the time that IRS' interest rate was only 6 percent, February 1978 to January 1980, widely publicized tax advice suggested that owing money to IRS was cheaper than paying overdue taxes with costly borrowed funds. IRS personnel said that they believe taxpayers actually followed this tax advice and delayed paying taxes because the IRS interest rate was lower than prevailing money market rates.

IRS personnel related several instances of taxpayers who may have taken advantage of the low IRS interest rate. For example, one taxpayer who owed $15,000 in employer's tax payments was able to find enough money to remodel his business. Another example occurred when IRS' interest rate was scheduled to double in 1980, apparently reversing the incentives for some taxpayers who had not been able to afford full payment while IRS' rate was only 6 percent. A taxpayer, with an installment agreement to pay $24,000 in back taxes, upon hearing about the higher interest rate asked for an accelerated payment schedule before the IRS rate increased. When an IRS revenue officer looked into this case he found the taxpayer was able to pay back the entire amount immediately. Faced with interest rates near commercial borrowing rates, the taxpayer found little advantage in delaying payment.

Interest rates related to delinquent accounts at other agencies

In our report entitled, "The Government Needs To Do A Better Job of Collecting Amounts Owed by the Public" (FGMSD-78-61, Oct. 20, 1978), we reported that Federal agencies which levied high interest rates usually collected accounts promptly. For example, the imposition of a substantial rate of interest (1 percent per month during 1978) on accounts not paid within 30 days helped one agency obtain prompt payment on 95 percent of its bills.

On the other hand, interest rates on delinquent accounts due most agencies were well below the rates of interest that businesses or individuals can earn on investments or must pay to borrow funds. Therefore, debtors had little incentive to pay these agencies promptly. To illustrate, the Geological Survey did not impose interest on late oil and gas royalty payments, and nearly 50 percent of its payments were delinquent. In contrast, the Bureau of Indian Affairs charged 1.5 percent a month (18 percent a year) on certain late oil and gas royalty payments; only 13 of 4,824 royalty payments were received late.

CONCLUSIONS

IRS' interest rate for underpayments should allow the Government to be compensated for the costs it incurs because of unpaid taxes, as well as encourage taxpayers to pay accurately and promptly. The present rate of 90 percent of the prime does not consider the Government's costs associated with unpaid taxes. Moreover, the statutory rate has not given taxpayers the intended incentive to pay promptly.

AGENCY COMMENTS AND OUR EVALUATION

In a joint response to a draft of this report, the Assistant Secretary of the Treasury for Tax Policy and the Commissioner of IRS pointed out that our proposed interest rate is technically deficient because it would not recoup the desired administrative costs. The agency explained that this is because some of the administrative costs are paid twice: first when the actual administrative costs are paid and second as a result of the use of our proposed formula for calculating interest rates, which includes a factor for administrative costs, when such interest is paid to taxpayers who overpaid their taxes.

We agree that the proposed interest rate would have the above mentioned problem. However, we do not agree that

there is a technical deficiency which requires adding an additional factor to the proposed rate. The administrative costs factor included in the interest paid on refunds results from the expressed desire of the Congress and IRS to maintain a single interest rate for delinquent taxes and tax refunds. (See pp. 2 and 29.) We agree that a single rate should be maintained, for the present time, but do not agree that this action necessitates increasing the interest rate assessed to delinquent taxpayers.

In commenting further, the Assistant Secretary and the Commissioner also disagreed with our proposal to base the interest rate for delinquent taxes on the elements of cost which the Government incurs as a result of these taxes. Although concurring in the use of an interest rate that matches the prevailing market rate to the extent possible, the agency did not concur with the use of the 1-year Treasury bill rate as the proper basis to accomplish this. The agency believes that in order to encourage prompt payment by taxpayers, the rate used should reflect private as well as Government borrowing costs. They added that although the prime interest rate and the rates on Government securities tend to move in parallel fashion, the rates for Government securities are lower than for private borrowing and thus, basing the rate on Treasury borrowing cost would, generally, result in a slight reduction in the statutory rate.

Also, the agency noted that the rate should be based on the "deepest" market not the "thinnest," which would minimize the extent to which technical disturbances in the market place would affect future statutory rates. Finally, the agency notes that a more appropriate IRS interest rate would be 100 percent of the prime.

In our report we do not suggest that the statutory rate be based solely on 1-year Treasury bill rates. To the contrary, we suggest that the rate should be based on the actual cost to the Government of collecting delinquent taxes. To this extent the rate should be not only based on the 1-year Treasury bill rate but also on the costs incurred by IRS in administering the collection of delinquent accounts. Adding these factors, as recommended in our report, will amount to an interest rate which is close to the prime. We therefore believe that the rate which we have suggested in the report meets the requirements which the Internal Revenue Service says should be included in the statutory interest rate.

When Treasury officials commented on Senate Bill S.999, which dealt with IRS' interest rate, they pointed out that:

> "The payment of interest is an economic concept, it is not a punitive one. Interest is a charge for the use of money; the borrower's intent in taking out a loan is irrelevant. When a taxpayer does not pay his tax on time--for whatever reasons--the taxpayer has, in effect, borrowed money from the government upon which interest is due."

We also believe that interest is an economic concept and therefore requires the use of sound business principles in its application.

In our opinion, Government policy and sound business principles require that a new formula be used to calculate the interest rate assessed by IRS on delinquent taxes. This interest rate should not be a rate that is simply lower than what most taxpayers obtain when borrowing money and higher then they obtain when lending money. Instead, this rate should fairly compensate the Government for the costs of financing and administering delinquent taxes. If the costs for this special benefit--estimated to be $1.537 billion--are not recovered from delinquent taxpayers, they must be recovered from all taxpayers.

RECOMMENDATION

We recommend that the Congress amend the Internal Revenue Code to establish IRS' interest rate at an appropriate Government borrowing rate plus a factor for administrative expenses. (See app. III.)

CHAPTER 3

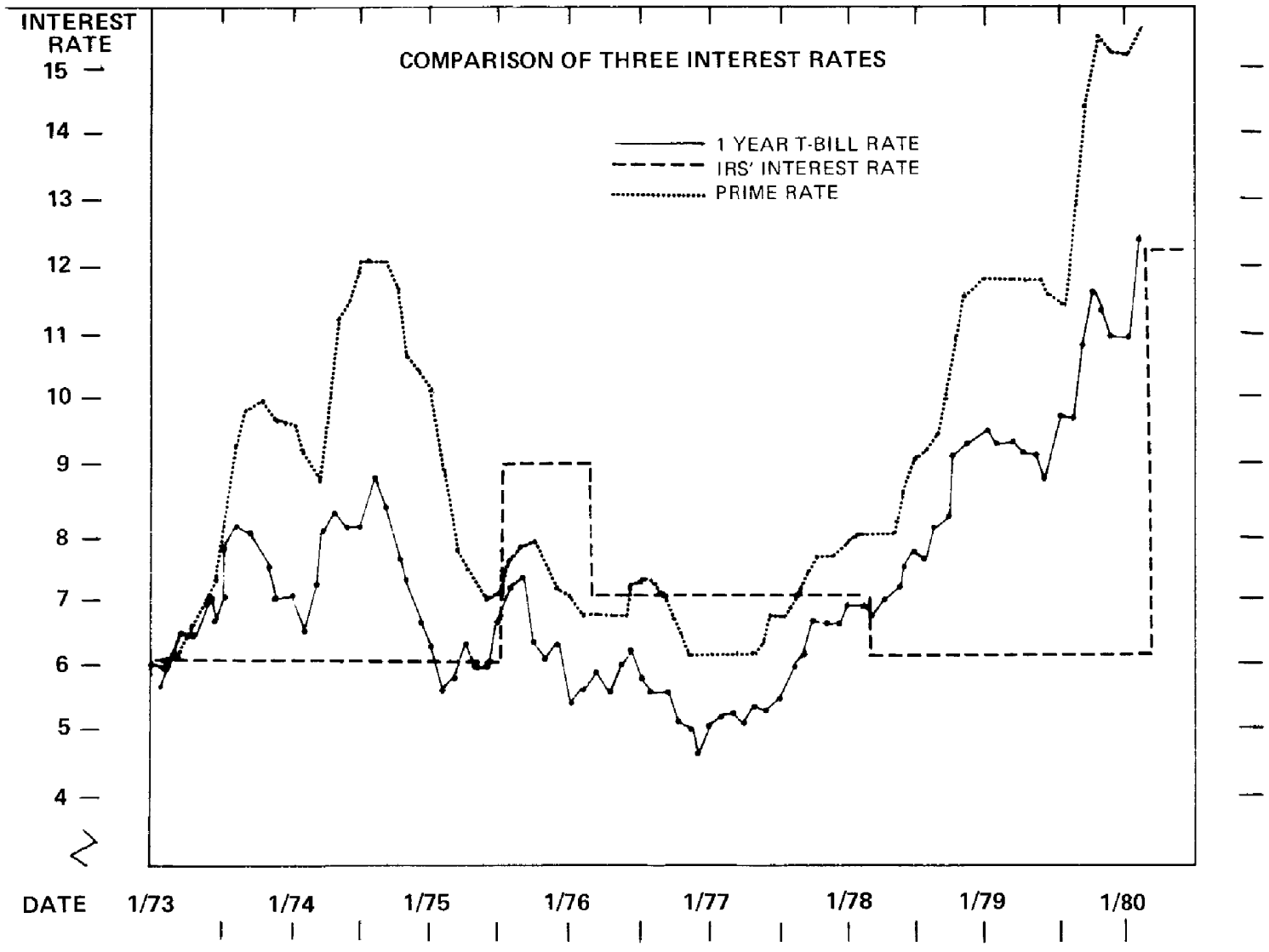
CURRENT PROVISIONS OF THE IRS INTEREST RATE FORMULA PREVENT THE INTEREST RATE FROM BEING IN LINE WITH MONEY MARKET RATES

Current provisions of the Internal Revenue Code have failed to keep IRS' interest rate in line with money market rates and the Government's costs to borrow funds. Two provisions of the law prevent IRS' rate from rising and falling with money market rates. First, Treasury can adjust IRS' rate only every other year; second, the rate must be rounded to the nearest whole percent.

IRS' INTEREST RATE HAS NOT KEPT PACE WITH MONEY MARKET RATES

IRS' interest rate is defined under current law as a function of the prime rate, a rate banks charge their best commercial customers for short-term loans. But while IRS' rate cannot change for 2 years, the prime rate and the Treasury bill rate can change dramatically in a few months. For instance, the prime rate rose from 6.00 to 9.86 percent in 8 months during 1973 and, more recently from 11.54 to 15.55 percent in 5 months during 1979. Similarly, the Treasury bill rate went from 10.96 to 13.53 in only 2 months during 1980.

IRS' interest rate was comparatively low in fiscal year 1979 because it was established just before a major rise in the prime rate. IRS' rate was based on the September 1977 prime rate but applied to IRS interest from February 1, 1978 to January 31, 1980. By the time the 6-percent rate took effect, the prime rate had already climbed to 8 percent. It reached 9.94 percent by October 1978 and 14.39 percent by October 1979 and was still rising. As the prime rate rose, so did the Government's cost for financing unpaid taxes. The 1-year Treasury bill rate went up to 8.45 in October 1978 and 11.51 in October 1979. As shown on the following page, the prime rate and the 1-year Treasury bill rate were substantially higher than the IRS rate during most of 1978 and 1979.


INTEREST RATE
COMPARISON OF THREE INTEREST RATES
1 YEAR T-BILL RATE
IRS' INTEREST RATE
PRIME RATE
15
14
13
12
11
10
9
8
7
6
5
4
DATE
1/73
1/74
1/75
1/76
1/77
1/78
1/79
1/80

In early 1980, the prime and Treasury bill rates were again rising dramatically. However, by mid-year the interest rates had settled down with the prime rate at 11.5 percent and the 1-year Treasury bill rate at 7.1 percent.

IRS' INTEREST RATE SHOULD BE ADJUSTED SEMIANNUALLY

Under current law, Treasury can change IRS' interest rate every other year. Ideally, IRS' rate should change as fast as market rates, but administrative considerations limit the frequency of such changes. The two methods by which IRS calculates interest amounts, by computer and by hand, limit the practical frequency of changes.

IRS personnel can generally have interest assessments calculated by computers. However, computers must be reprogrammed for each interest rate change. Programming these changes is not difficult or time consuming, but because these calculations are imbedded in IRS' most critical programs, changes must be thoroughly tested before they are put into use. Since IRS rewrites and tests other sections of its programs annually, it could readily include interest rate adjustments among these changes. More frequent change adjustments would require IRS data processing personnel to perform special testing.

IRS employees compute interest manually when they cannot get access to a computer. More frequent interest rate adjustments would increase the complexity of each manual calculation. This complexity occurs because the balance outstanding is assessed interest each period at the interest rate then in effect. (See app. II.)

According to those who normally perform these computations, annual interest rate adjustments would certainly be manageable, and semiannual adjustments are feasible. If Treasury had been able to adjust IRS' interest rate annually, IRS could have assessed an additional $78 million in fiscal year 1979. By adjusting the interest rate semiannually, IRS could have assessed $119 million in additional interest, or $41 million more than it would have assessed with annual interest adjustments. IRS has made only a portion of the interest assessments for unpaid taxes due in 1979, so the eventual loss in 1979 will be much higher. Officials estimate the cost of making each additional interest rate change would be less than $100 thousand. This figure

includes, not only additional programming and testing costs, but also the cost of new interest tables, news releases, and memos explaining the change.

IRS' INTEREST RATE SHOULD NOT BE ROUNDED OFF TO A WHOLE PERCENT

The result of rounding IRS' interest rate to the nearest whole percent, as required by the Internal Revenue Code, can be expensive and does little to advance the stated purpose, administrative convenience. Even if the Department of the Treasury had been allowed to adjust IRS' interest rate semi-annually, rounding would have cost the Government at least $45 million in fiscal year 1979. IRS' computers can be programmed to calculate interest with equal ease regardless of whether IRS rounds its interest rate. Manual interest computations are rarely quicker with rounded interest because IRS procedures require an employee to refer to a table for the appropriate interest factor. The factor used for computation is a nine-place decimal, based on the number of days the taxes were outstanding. (See app. II.)

Even though rounding cost the Government at least $45 million in fiscal year 1979 because of rounding down, taxpayers could as easily have been over-assessed by a similar amount had it been necessary to round the rate up. For instance, at the time of computation, 90 percent of the prime was 6.42 percent. Had 90 percent of the prime been 6.58 percent, the law would have required IRS to round the rate up to 7 percent, and taxpayers would have been over-assessed by a similar amount. Although, over time, the under- and over-assessments may balance out, rounding off to a whole percent seems to serve no purpose and at least in the short run assures that either the Government will be under-compensated or the taxpayer over-assessed. Therefore, we believe IRS should state its rate to two decimal places.

IRS' INTEREST RATE SHOULD NOT REFLECT INSIGNIFICANT CHANGES IN GOVERNMENT COSTS

If IRS' interest rate is stated to two decimal places, the result could be rate adjustments of only hundredths of a percent. However, because of the costs involved and the increased chance of errors in the rewriting of computer interest programs and in manual computations, we believe insignificant changes in the interest rate are not justified. Therefore, we conclude that a change of 0.25 percent should be the minimum change required of IRS.

CONCLUSIONS

Rapidly changing money market rates have made the current provision of the Internal Revenue Code for calculating the interest rate on refunds and underpayments only once every 2 years outdated. Further, the rounding off required by the current statute serves no purpose and either undercompensates the Government or over-assesses the taxpayer. However, a change should not be made if the change is less than 0.25 percent because such a small change would have little effect on actual interest assessments on delinquent accounts.

AGENCY COMMENTS AND OUR EVALUATION

In a joint response to a draft of this report, the Assistant Secretary of the Treasury for Tax Policy and the Commissioner of IRS disagreed with our proposals to adjust IRS' interest rate semiannually and to state the rate to two decimal places.

The agency believes that, in terms of efficient administration, the statute should not allow a change in the interest rate more frequently than once a year. In amplifying this statement, the agency noted that they disagreed with the semiannual adjustments because of the increased potential for manual computation errors and the lead time necessary for programming, system testing, changing handbooks, sending news releases, etc.

We agree that there is an increased potential for manual computation errors because of the possible need to apply different interest rates to tax delinquencies outstanding. (See p. 16.) However, this is inevitable regardless of whether the interest rates are adjusted semiannually as suggested by us or annually as favored by IRS. Additionally, modern inexpensive calculators and computer aids now available to IRS employees for calculating interest payments should help reduce this potential.

Our report does not advocate any change in the lead time for programming, handbooks, etc. Currently the interest rate is determined in October and becomes effective the following February. This timeframe is identical to our suggestion. The only change we are advocating is that this determination take place on a semiannual basis as well. As evidence of the extent of these changes, IRS officials have estimated that programming, testing, changing handbooks, etc., could be done for less $100,000. This should be compared to

the estimated under-assessment for fiscal year 1979 of $119 million. (See p. 16.)

Treasury and IRS also believe that stating the interest rate to two decimal places as suggested by the report is an unnecessary complication, since IRS' rate is an approximation of the market place. The agency added that this change may be costly in terms of administrative cost and taxpayers' time spent on making calculations.

Our recommended interest rate is not meant to be an approximation of the market interest rate but an exact calculation of the Government's cost of administering delinquent accounts. Therefore, the rate should be as precise as possible. Any deviation would either over- or undercompensate the Government. We estimate that in fiscal year 1979 the Government was undercompensated by $45 million as a result of rounding off the interest rate. (See p. 17.)

As stated in our report, manual interest computations are rarely quicker with rounded interest rates, because interest is assessed on an exact basis using a nine-place decimal. (See p. 17.) This is demonstrated in an example presented in appendix II. Further, although taxpayers may calculate interest on a delinquent tax in order to pay it off before receiving a bill from IRS, we were unable to identify any case where a taxpayer must compute the amount of interest owed the Government.

RECOMMENDATIONS

We recommend that the Congress amend the Internal Revenue Code to establish semiannual adjustments of IRS' interest rate, stating it to two decimal places, as a practical means of maintaining the rate in line with Government borrowing rates. Also, changes should be limited to 0.25 percent or more. (See app. III.)

INTEREST PROJECTIONS

Every year IRS assesses millions of dollars in interest against taxpayers. To show the effect of varying IRS' interest rates and adjustment frequencies, we estimated interest assessments that would have been made through fiscal year 1979 if the Congress had adopted different rate rules when it provided an adjustable IRS rate by its 1975 amendment to the Internal Revenue Code (Public Law 93-625).

Approach

We projected interest assessments using the following alternative rate conditions:

--More frequent rate adjustment, e.g., annually, semiannually.

--Different rate levels, e.g., 90 percent of the prime rate (unrounded).

To calculate the effect of varying IRS' interest rate and frequency of rate adjustment, we needed data about the amounts and ages of unpaid tax when interest was assessed. IRS provided comprehensive data on quarterly interest assessments for fiscal years 1974 through 1979. However, it could not readily provide the times used to compute interest assessments. To estimate the time over which IRS computed interest we made the following assumptions:

--Interest on current assessments (i.e., those not resulting from IRS audits) was for delinquencies not more than 1 year overdue. Each assessment period was assumed to run from the April 1 prior to the assessment date.

--Interest on deficiency assessments (i.e., those resulting from audits) was for amounts between 25 and 36 months prior to the assessment date. Each assessment was assumed to run from April 1 to 2 years prior to the assessment date.

On the basis of the above assumptions and known assessment data, we first estimated an aged profile of unpaid tax amounts. Using this profile, we then estimated the assessment impact of alternate IRS interest rates. Our estimates assume that taxpayers would have paid their outstanding tax liabilities at the same time regardless of hypothetical changes to IRS' interest rate. The following table illustrates projected interest figures for fiscal year 1979.

Fiscal Year 1979 Interest Assessments at Various Rates and Rate Adjustment Frequencies (note a)

Rate	Frequency of rate adjustment	
	Annual	Semiannual
	(millions)	
90% prime (rounded)	$ 1,329	$ 1,370
90% prime	1,404	1,415
100% prime	1,560	1,573
1 year T-bill	1,295	1,305

a/Because the actual amount of unpaid taxes and time periods used for interest computations were unavailable, the figures in this table may differ from interest IRS would have assessed under any of the alternatives in the table. Actual interest assessed by IRS in fiscal year 1979 was $1,251,061,000.

Discussion of Assumptions

To check the accuracy of our assumptions, we invited IRS officials to comment on them. Officials' comments and our responses to them are discussed below.

One IRS official suggested that our profile of unpaid current tax amounts (those not discovered by IRS audit) would be inaccurate because delinquent business taxpayers are often more than 12 months overdue. If this criticism was accurate and significantly affected our estimates, both our current unpaid tax figures and resulting projected interest amounts would be overstated.

We examined other available IRS data on delinquencies and found that unpaid business taxes were generally not older than unpaid individual taxes. Furthermore, IRS data indicates that over 80 percent of the delinquent tax inventory is less than 1 year old. We, therefore, concluded that our current interest assumptions were consistent with available data.

Another IRS official suggested that our initial assumption about the ages of unpaid taxes discovered by audits (i.e., deficiencies) might be too high. He explained that average times between due dates and assessments were 18 to 24 months for individual taxpayers and 22 to 28 months for business taxpayers. Under our initial assumptions, the average deficiency remained unpaid 30 months.

We found no reason to reject IRS' information about the age of deficiencies. However, we did not modify our initial assumptions about deficiencies' ages because the effect of overestimating the ages by a few months would have been to underestimate both deficiency amounts and related interest projections at higher or more frequently adjusted rates.

A third IRS official noted that we assumed all tax due dates fell on an April 1. Although he found this acceptable for individual taxpayers, he pointed out that business taxpayers face tax due dates that may be quarterly or occur at other times of the year. We agree that our assumptions did not explicitly recognize the variety of business tax due dates. However, we could not adjust our initial assumptions because interest data provided by IRS did not permit segregation of unpaid individuals' taxes from unpaid businesses' taxes. Even if unpaid tax data could be segregated by type of taxpayer, we believe it would not adversely affect our estimates because of the following.

--An IRS age profile of the unpaid current tax inventory showed only a slight difference between individual and business taxpayers; 88.7 percent of the unpaid business taxes were less than 1 year old, compared to 83.4 percent for individuals.

--IRS information showed that average business deficiencies (22 to 28 months old) were somewhat older than individual deficiencies (18 to 24 months old), but both less than the average age (30 months) of deficiencies we computed from our original assumptions.

Our interest estimates under alternative rate structures assumed that taxpayer behavior would have been unaffected by the interest level. An IRS official said IRS' studies indicate that taxpayer behavior is affected by interest levels, but that IRS has not been able to quantify the relationship. The official agreed it is reasonable to assume that small changes over time would not significantly affect taxpayer behavior patterns.

APPENDIX II

IRS INTEREST COMPUTATIONS

IRS charges taxpayers interest on tax not paid by the due date. IRS calculates interest by multiplying the amount of unpaid taxes, the interest rate, and the length of time the taxes are overdue. Because IRS periodically changes its interest rate, interest computations may involve more than one interest rate.

For example, assume a taxpayer failed to pay $5,000 in taxes due on March 31, 1977, but on May 31, 1978 (14 months later) he paid the overdue taxes. The IRS interest rate, however, changed from 7 percent to 6 percent on February 1, 1978. Therefore, the interest must be computed in two portions--one for each interest rate in effect.

To compute the amount of interest, IRS employees locate interest factors for the appropriate number of years, months and/or days at various interest rates in tables. (See tables p. 24.) These factors are then multiplied by the amount of unpaid taxes to determine the interest amount. For the following example, interest would be:

Period and Rate	Factor	Unpaid taxes		Interest
10 months @ 7 percent	.058333	$5,000	=	$291.67
4 months @ 6 percent	.020000	$5,000	=	100.00
Total interest				$391.67

APPENDIX II

6 PERCENT							
YEAR	MONTH		RATE	DAY	RATE	DAY	RATE
	1	-	.005	1	.00016 4383	16	.00263 0136
	2	-	.01	2	.00032 8767	17	.00279 4519
	3	-	.015	3	.00049 3150	18	.00295 8903
	4	-	.02	4	.00065 7534	19	.00312 3286
	5	-	.025	5	.00082 1917	20	.00328 7670
	6	-	.03	6	.00098 6301	21	.00345 2053
	7	-	.035	7	.00115 0684	22	.00361 6437
	8	-	.04	8	.00131 5068	23	.00378 0820
	9	-	.045	9	.00147 9451	24	.00394 5204
	10	-	.05	10	.00164 3835	25	.00410 9587
	11	-	.055				
1			.06	11	.00180 8218	26	.00427 3971
2			.12	12	.00197 2602	27	.00443 8354
3			.18	13	.00213 6985	28	.00460 2738
4			.24	14	.00230 1369	29	.00476 7121
	etc.			15	.00246 5752	30	.00493 1505

7 PERCENT							
YEAR	MONTH		RATE	DAY	RATE	DAY	RATE
	1	-	.00583 3333	1	.00019 1781	16	.00306 8493
	2	-	.01166 6667	2	.00038 3562	17	.00326 0274
	3	-	.0175	3	.00057 5342	18	.00345 2055
	4	-	.02333 3333	4	.00076 7123	19	.00364 3836
	5	-	.02916 6667	5	.00095 8904	20	.00383 5616
	6	-	.035	6	.00115 0685	21	.00402 7397
	7	-	.04083 3333	7	.00134 2466	22	.00421 9178
	8	-	.04666 6667	8	.00153 4247	23	.00441 0959
	9	-	.0525	9	.00172 6027	24	.00460 2740
	10	-	.05833 3333	10	.00191 7808	25	.00479 4521
	11	-	.06416 6667				
1			.07	11	.00210 9589	26	.00498 6301
2			.14	12	.00230 1370	27	.00517 8082
3			.21	13	.00249 3151	28	.00536 9863
4			.28	14	.00268 4932	29	.00556 1644
	etc.			15	.00287 6712	30	.00575 3425

PROPOSED AMENDMENT

UNITED STATES GENERAL ACCOUNTING OFFICE

CHANGES IN THE DETERMINATION OF THE RATE OF INTEREST ON OVERPAYMENTS, UNDERPAYMENTS, NONPAYMENT OR EXTENSIONS OF TIME FOR PAYMENT OF TAX

We propose the following amendment to the Internal Revenue Code:

"Section 6621. DETERMINATION OF RATE OF INTEREST.--

"(a) In General.-- The annual rate established under this section shall be such adjusted rate of interest as established by the Secretary under subsection (b), or in the absence of such adjusted rate of interest, the rate in effect at the date of this amendment.

(b) Adjustment of Interest Rate.-- The Secretary shall establish an adjusted rate of interest for the purpose of subsection (a) to consist of (1) an annual adjustment for collection costs, established no later than October 15 of each year; and (2) a semiannual adjustment for borrowing costs, established no later than April 15 and October 15 of each year.

(c) Definitions. --

(i) Adjusted rate of interest.-- The term "adjusted rate of interest" means the sum of the adjustment for collection costs and the adjustment for borrowing costs.

(ii) Adjustment for collection costs.-- The term "adjustment for collection costs" means a percentage equal to the Secretary's estimate of the preceding fiscal year costs allocable to the collection of underpayments as described in subchapter A of this chapter divided by the Secretary's estimate of annual collections of such underpayments. The costs shall include allocable collection costs relating to data processing operations, collections, and prevention of nonpayment of taxes in the preceding year. The adjustment for collection costs shall not exceed 7 percent and shall remain in effect for at least 1 year.

(iii) Adjustment for borrowing costs.-- The term "adjustment for borrowing costs" means the average rate of interest on 1-year Treasury bills as published by the Board of Governors of the Federal Reserve System. The adjustment established by April 15 of each year shall be based on the preceding 3-month average rate; the adjustment established by October 15 of each year shall be based on the preceding three month average rate.

(d) Limitations of Rate Adjustments.-- The adjusted rate of interest costs shall be rounded to the nearest hundredth of a percent. If the adjusted rate of interest differs from the last preceding rate of interest by less than 0.25 percent, the adjusted rate of interest shall be the rate then in effect.

(e) Effective Date.-- The adjusted rate of interest established by April 15 of each year shall become effective on August 1 of that year. The adjusted rate of interest established by October 15 of each year shall become effective on February 1 of the immediately suceeding calendar year."

APPENDIX IV

THE DEPARTMENT OF THE TREASURY
WASHINGTON D.C. 20220

ASSISTANT SECRETARY

15 AUG 1980

Dear Mr. Anderson:

We are pleased to have this opportunity to offer our comments and suggestions on your draft report entitled "A New Formula is Needed to Calculate the Interest Rate on Unpaid Taxes." Since the issues raised in the Report involve tax policy as well as tax administration, the Commissioner of Internal Revenue has referred your July 1 request for comments to the Assistant Secretary of the Treasury for Tax Policy, and this joint response reflects the views of the Office of the Assistant Secretary for Tax Policy as well as the Internal Revenue Service.

Our opinions on the recommendations proposed in the Report are as follows:

a. We believe that in terms of efficient administration the statute should not allow a change in the interest rate more frequently than once a year.

b. We concur in the use of an interest rate that matches the prevailing market rate to the extent possible.

c. We oppose the use of an interest rate carried to two decimal places rather than to whole percentage points as the law now stipulates.

d. We do not believe that the statutory interest rate should reflect the Government's examination and collection costs plus the amounts of potential tax revenues that are written off as uncollectible. It is, however, possible that the Congress might wish to consider this recommendation as part of the system of tax penalties. [See GAO note (1) at end of letter.]

e. We oppose a change that would deny interest on tax overpayments until 45 days after an amended return or claim for refund is filed. [See GAO note (2) at end of letter.]

We agree with GAO that, to the extent possible, the interest rate charged or paid by the Internal Revenue Service should reflect the current interest rates in the market. In the Report, GAO suggests that the statutory rate be adjusted semiannually. While the Treasury Department would not object to an annual adjustment, we would object to making adjustments more frequently than once a year, as suggested in the Report, because of:

a. The lead time necessary for reprogramming and systems testing.

b. The increased potential for error when manual computations are required. With semiannual adjustments, a deficiency could be subject to three different rates during any one year. Calculating interest on longer term underpayments and overpayments--such as those arising from computations of net operating losses, investment credits, etc.,--would be even more complicated.

c. The lead time necessary for changing publications, manuals, handbooks, notices, news releases, etc.

We agree with the statement that "... IRS computers can be programmed to calculate interest with equal ease regardless of whether IRS rounds its interest rate." However, this statement is applicable only in computer processing areas. Many interest computations are performed manually, e.g., computations by collection officers on field assignments. These computations, even with the use of tables, are extremely complex, involving determining different interest rates for each of several different payments and covering different numbers of months and days at each rate. Taxpayers usually do not have access either to the computers or to such tables and would be at an even greater disadvantage than at present. Also, if more taxpayers overpay deficiencies due to errors in computing the interest, the Service's administrative costs to refund those overpayments would be increased.

More importantly, we believe that computing the interest rate to the nearest one-hundredth of 1 percent is conceptually inappropriate and unnecessary. The prime rate on which the current interest rate is based and the one-year Treasury bill rate upon which this Report suggests that it should be based are averages for an entire month. In the market, both rates fluctuate, with the bill rate changing almost hourly, and very large fluctuations are possible within a few months. Because the basis for the statutory rate of interest is not a precise reflection of the market rate during the period for which interest is charged, any attempt to refine the statutory rate beyond whole percentage points is wasted in terms of equity and costly in terms of Government and taxpayer time spent on making the calculations.

We object to the proposal that would deny payment of interest on tax overpayments until 45 days after an amended return is filed. As noted in the Report, both the Treasury and the Congress objected to a similar GAO recommendation in 1968 based on the belief that the Government should pay for the use of the taxpayers' money. Frequently, audits of

tax returns uncover overpayments as well as underpayments of tax. The effect of this proposal would be to allow interest on overpayments of tax which are credited against underpayments of tax but deny interest on overpayments which are claimed as refunds. [See GAO note (1) at end of letter.]

Another potential problem arises in trying to interpret the draft language in Appendix III which proposes a change to section 6611(e). It is not clear what would constitute an "... other form of claim for refund (other than a return)." Would a judgment from a district court which reverses a deficiency assessment by IRS constitute a "form of claim for refund?" If so, a taxpayer who wins an appeal could lose interest on the deficiency and interest paid--payment of which is required before the case can be appealed in the district courts.

In addition, the proposed amendment to section 6611 would amend only subsection (e), thereby disallowing interest on refunds of subtitle A taxes if made within 45 days from the date claimed, but would not so limit interest on other internal revenue taxes. Section 6611(b)(2) provides that interest shall be allowed and paid on refunds of any internal revenue tax from the date of overpayment to a date preceding the date of the refund check by not more than 30 days. While such a change to subsection (e) may not directly conflict with subsection (b)(2), the language obfuscates rather than clarifies the intent of this section.

Therefore, for the following reasons, we cannot endorse this proposal which would deny interest on tax underpayments within 45 days after a claim is filed: (1) it would abrogate the policy of providing a fair rate of interest for the use of money whether by the taxpayer or by the Government; (2) it would produce inequitable results between taxpayers who claim refunds of their tax overpayments and those who receive credits of an overpayment against an underpayment; (3) it would also result in inequities between taxpayers overpaying subtitle A taxes and those overpaying other types of taxes; (4) it would cause additional administrative complexity for taxpayers and for IRS.

We fully agree that the interest rate charged on tax underpayments and paid on overpayments should be close to prevailing market rates to discourage taxpayers from using the U.S. Government to finance their investment activities by underpaying taxes when the statutory rate is too low or overpaying taxes as an investment when the statutory rate is too high. However, no single market interest rate is appropriate for all taxpayers. What is reasonable for some taxpayers is punitively high for others. The Report concentrates upon fixing a single, high rate to discourage underpayments of tax and, in the event this high rate encourages taxpayers to overpay their taxes, proposes to deny payment of interest on overpayments claimed as refunds.

Another possible answer would be to have two interest rates; one for overpayments and another for underpayments. However, Treasury's long-established position has been to utilize only one rate of interest. Imposition of different rates would be an administrative nightmare and would spur taxpayer animosity when overpayments were credited against underpayments. Treasury policy has been to view interest as a reasonable

APPENDIX IV

charge for the use of money by either the taxpayer or the Government. Under this policy, ancilliary issues are easier to resolve. If the rate is reasonable, there is no penalty for making honest mistakes. If the mistake is in the Government's favor, the taxpayer receives interest on funds utilized by the Government until the error is discovered. If the error is in the taxpayer's favor, the Government is compensated for not having use of amounts legitimately owed. The tone of the Report seems to imply that interest arises as the result of taxpayer misconduct, either delinquencies or intentional overpayments. It is important to emphasize that not all, or even most, interest payments arise because of misbehavior by taxpayers. A large portion results from honest errors and legitimate disagreements between taxpayers and the Government about tax liabilities. These differences are inherent in our system of very complex tax laws. Interest is paid as rough compensation to one party or the other for the loss of use of the money; it is not meant either as a reward or a penalty.

As noted, the basic problem lies in determining what is a reasonable interest rate. We are currently considering a proposal to adjust the interest rate annually based on 100 percent, rather than the present 90 percent, of the prime rate in the month of September. While most taxpayers do pay more than the prime rate to borrow money and do receive less than the prime rate when lending money, the prime rate does reflect free market interest rates (affecting both Government and private borrowers) and continues to be an appropriate basis for the statutory interest rate.

The Report suggests that since the statutory interest rate should reflect the Government's cost of money, the rate should be based on the interest rate for one-year Treasury bills. First, in order to encourage prompt payment by taxpayers, the statutory rate should reflect private as well as Government borrowing costs. For this purpose, the prime rate is superior. Second, the prime interest rate and the rates on Government securities tend to move in parallel fashion, with the rates for Government borrowing being somewhat lower than for private borrowing. Thus, there would be little practical difference if the base for the statutory rate were shifted to the rate on Government securities.

Over the 20-year period from 1960 through 1979, the prime rate averaged 6.69 percent, and 90 percent of the prime rate averaged 6.02 percent. Over the same period, the average coupon equivalent rate for one-year Treasury bills was 5.73 percent, and for six-month Treasury bills was 5.56 percent. Thus, basing the rate on Treasury borrowing costs would, generally, result in a slight reduction in the statutory rate. Third, if the statutory rate were to be based on Government borrowing costs, basing the rate on the "deepest" markets, not on one of the "thinnest," would minimize the extent to which technical disturbances in the market place would affect future statutory rates. Accordingly, the rates for three- or six-month bills would be more appropriate

than for one-year bills. We conclude that basing the statutory rate on Government borrowing costs rather than on the prime interest rate would yield no significant benefits and, thus, would represent a change just for the sake of change.

The Report proposes that the statutory interest rate be set at a high enough level to enable the Government to recover (a) the administrative costs of examining (auditing) tax returns and of collecting unpaid accounts and (b) the lost revenue from tax accounts written off as uncollectible. The Treasury strongly disagrees with this proposal. The Report correctly points out that private lenders set their interest rates to cover these costs, and the Treasury believes that to the extent possible it should handle its various programs in a business-like manner. However, in this situation the analogy to private lenders is false. The Government's role in administering a tax system and in collecting tax revenue is qualitatively different than that of a private creditor. [See GAO note (2) at end of letter.]

As recognized in some portions of the Report, the interest paid or collected by IRS is supposed to serve as reimbursement for the lost use of money. It is not appropriate for a risk premium to be built into the interest rate because the costs and risks involved are those of tax collection, not of lending. Such costs are appropriately divided among the entire population of taxpayers. This recommendation would make taxpayers whose taxes are paid late but eventually are paid bear the cost of IRS examination and collection activities for those who are late but do not pay. Another effect would be to penalize taxpayers who may have made honest mistakes or are pursuing resolution of issues yet undecided by the courts. They would be forced to pay for the actions of other taxpayers' delinquent and even fraudulent actions. It would not be proper to have this single group of taxpayers bear the burden of uncollectible accounts since some of these accounts are written off solely because of the Government's decision that the costs imposed in collecting the revenue in question were unacceptably high.

Even if a decision were made to require those who pay their taxes late to bear the burden of audit and collection activities, it would not be appropriate to build these costs into the interest rate. Often, audit and, especially, collection costs are not closely associated with the amount of unpaid liability or the length of time of the underpayment. Thus, building these costs into the interest rate would make those with large interest payments bear a disproportionately large share of the administrative costs. Similarly, taxpayers with little interest would bear too small a share. Neither of these results would be equitable or desirable. These administrative costs are more appropriately recouped and delinquencies prevented through separately imposed penalties. Alternatively, they should be shared by all taxpayers rather than those who happen to owe interest at the time. Finally, it would be possible, although difficult, to charge taxpayers directly for some types of collection costs attributable to them.

To the extent that IRS would continue to pay interest on overpayments, there are three other problems with the GAO proposal to include administrative costs in the interest rate. First, if taxpayers were charged, either directly or through the interest rate, for audit and collection costs, they might press harder for legislation to reimburse them for the expenses they incur when they are audited and no deficiencies are found. In fact, by building IRS administrative costs into the interest rate, the proposal would provide some reimbursement for taxpayer costs whenever interest payments were made to taxpayers. Second, the GAO proposal is technically deficient in setting the interest rate. The proposal would not recoup the desired administrative costs, because some of these costs would be paid twice, i.e., once for actual costs and another when paying interest on overpayments. While the Report conceded this result in the footnote on page 5, it does not include an upward adjustment in the statutory interest rate to take account of this effect. This leads to the third problem. GAO wants to discourage taxpayers from investing with the U.S. Government by intentionally overpaying taxes. However, raising the interest rate to include administrative costs and uncollectible taxes will have precisely that effect, especially if the rate is raised further as mentioned above.

The Report does not address what is to be done to the other Title 26 rates which are tied to the Section 6621 rate, e.g., Sections 6654 and 6655--relating to underpayments of estimated tax, Section 644--relating to the tax imposed on certain gains, and Section 6343--relating to wrongful levies. On page 25, the draft proposed amendment to Section 6621 uses the language of Subsection (a) prior to its amendment by P.L. 96-167. This law eliminated specific reference to other Code sections to which the Section 6621 rate applies. We assume that GAO's use of this language was an oversight and is not intended to restrict application of this rate to the specific sections enumerated. [See GAO note (3) at end of letter.]

Because neither the administrative cost figures nor the estimates and projections of interest paid or lost which are contained in the Report are integral to our conclusions, we have not validated the figures stated in the Report.

As in many other facets of the Federal tax system, the determination of the statutory rate of interest involves trade-offs between simplicity, equity, and certainty. Often, there is no single "correct" way of doing something. Rather, there are several reasonable alternatives, each of which reflects a different weighting of various benefits and costs. In this instance, it is possible that some marginal improvements in equity could be achieved at the cost of substantially increased complexity. If we were implementing the tax system from scratch, it is

possible that we would have opted for a different interest computation. However, at this point we would generally recommend against changes which impose additional complexity and the possibility of more errors for the sake of very minor gains in equity.

Sincerely yours,

Donald C. Lubick
Assistant Secretary
(Tax Policy)

Jerome Kurtz
Commissioner of
Internal Revenue

Mr. William J. Anderson
Director
General Government Division
U.S. General Accounting Office
Washington, DC 20548

GAO notes: The following changes were made after receiving agency comments on a draft of this report.

1. These two elements--examination cost and uncollectibles--are discussed as indirect costs of unpaid taxes and not included in the recommended interest rate.

2. This recommendation does not appear in the final report because after consideration of agency comments and internal discussion this does not seem to pose a problem.

3. Our proposed amendment was changed to conform to P.L. 96-167.

(268086)

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