The Regulations for Granting Extensions of Time to File Are Delaying the Receipt of Billions of Tax Dollars and Creating Substantial Burden for Compliant Taxpayers

August 2003

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INSPECTOR GENERAL
for TAX
ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

August 6, 2003

MEMORANDUM FOR COMMISSIONER EVERSON

Gordon C. Milbourn III

FROM: Gordon C. Milbourn III
Assistant Inspector General for Audit (Small Business and Corporate Programs)

SUBJECT: Final Audit Report - The Regulations for Granting Extensions of Time to File Are Delaying the Receipt of Billions of Tax Dollars and Creating Substantial Burden for Compliant Taxpayers (Audit # 200130032)

This report presents the results of our review of the granting of extensions of time to file individual income tax returns. The overall objective of the review was to determine the effect that the existing tax laws, tax regulations, and Internal Revenue Service (IRS) policies and practices for granting extensions of time to file are having on taxpayer compliance, timely revenue receipts, fairness for all taxpayers, taxpayer burden, and processing costs. Extensions of time to file are granted to taxpayers that require more time to file their tax returns.

In summary, based on the increasing tax payment noncompliance in recent years, the IRS regulations and related operational practices for granting extensions of time may have caused many taxpayers to lose respect for the April 15 deadline for paying income taxes. The IRS regulations and practices for granting extensions also treat taxpayers differently for the same payment noncompliance, create unnecessary taxpayer burden, increase operating costs for the IRS, and reduce current year tax receipts.

The IRS granted extensions of time to file to approximately 6.9 million[1] individual taxpayers in Calendar Year (CY) 1999. Many of these taxpayers subsequently presented the IRS with significant compliance problems. Approximately 2.1 million of

[1] The actual number of extensions granted was 7.5 million. For the purpose of our analyses, however, we excluded approximately 600,000 extensions that were granted to taxpayers who file on a fiscal year basis or reside outside of the United States since these taxpayers are subject to unique extension rules. We also excluded those taxpayers who, despite being granted an extension, chose to file by April 15.

these taxpayers did not pay their taxes by April 15[2] as required by the Internal Revenue Code (I.R.C.). This noncompliance delayed the collection of taxes totaling $12.7 billion, of which $8.5 billion was not collected in the fiscal year in which the taxes were due. Further, $1.5 billion of these taxes remained uncollected almost two and one-half years after they were due.

Extension filings are increasing at a rate of four times that of return filings. Paralleling this, the noncompliance among taxpayers with extensions of time to file is escalating rapidly. The amount of tax not paid by April 15 by taxpayers with extensions increased by 32 percent between CY 1999 and CY 2001. Based on this rate of increase in tax underpayments and the IRS' projections of growth in extension use, we estimate that in 2008, taxpayers with extensions of time to file will be responsible for approximately $46.3 billion in delinquent taxes. Of this amount, $29.8 billion will not be paid until after the end of Fiscal Year 2008.

At the root of these compliance problems is a decision by the IRS, made under authority delegated by the Congress, to grant extensions of time to file to taxpayers who have not paid their taxes by April 15 (see Appendix VI for historical background). This decision generally prevents the IRS from assessing the Delinquency Penalty[3] of 5 percent per month that would otherwise apply to the delinquent taxes of many taxpayers with extensions. The current IRS extension regulations not only prevent the IRS from assessing Delinquency Penalties in response to this noncompliance, but they also require compliant taxpayers (i.e., those who pay all their taxes by April 15) to needlessly file extension forms.

For more than a decade, various internal study groups have encouraged IRS management to improve payment compliance among taxpayers with extensions of time to file. They have sought changes in the regulations[4] for granting extensions that would provide incentive for timely payment of taxes through the assessment of the Delinquency Penalty and, at the same time, eliminate the burden of extension filing for compliant taxpayers. However, IRS management has been unwilling to change the extension regulations to meet these goals.

The tax system could be jeopardized by allowing the increasing use of extensions to delay tax payments and to prevent the assessment of significant penalties for tax underpayments. The tax system depends on all taxpayers who are voluntarily meeting their tax obligations having confidence that their neighbors are also complying. Thus, public confidence in the fairness of the tax system could be undermined if the IRS was perceived as placing unnecessary burdens on compliant taxpayers to file extension forms that, in effect, primarily serve to protect noncompliant taxpayers from penalties for late tax payments.

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[2] April 15 is the normal due date for filing most U.S. Individual Income Tax Returns (Form 1040).
[3] The Delinquency Penalty is also known as the Failure-to-File Penalty, although it could be applied to less than one-third of taxpayers who failed to file timely in CY 1999.
[4] Tax regulations are rules, having the force of law, issued by the IRS to interpret and apply laws added to the I.R.C. by the Congress.

We recommended that the IRS change the extension regulations to provide clear, quantifiable guidelines regarding the level of payment compliance needed to obtain extensions of time to file; establish October 15 as the sole extended due date; provide equitable safeguards, commonly called "safe harbors," to ensure that Delinquency Penalties are not assessed for inadvertent or minor underpayments; and require assessment of the Delinquency Penalty starting at April 16 for any delinquent tax amounts in excess of safe harbor allowances.

We also recommended that once the above changes to the IRS regulations have been implemented and improved payment compliance has been achieved through the equitable application of the Delinquency Penalty, the IRS consider changing the regulations to eliminate the requirement to send extension requests to the IRS. Finally, we recommended that the Commissioner, Wage and Investment Division, revise the tax packages mailed to taxpayers each year to include information that would help taxpayers to make informed decisions regarding tax payment and filing alternatives. This should include information similar to that contained in Truth in Lending Act[5] statements.

Management's Response: Management's response was due on July 31, 2003. As of August 4, 2003, management had not responded to the draft report.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions, or your staff may call Parker F. Pearson, Director (Small Business Compliance), at (410) 962-9637.

[5] 15 U.S.C. §§ 1601 – 1666 (2002). Truth in Lending Act statements required of commercial lenders must provide a total accounting of all financing costs to help borrowers make informed decisions about borrowing alternatives.

Table of Contents

The Regulations for Granting Extensions of Time to File Are Delaying the Receipt of Billions of Tax Dollars and Creating Substantial Burden for Compliant Taxpayers

Background

America's voluntary tax system relies on the timely filing of tax returns and the timely payment of taxes to efficiently operate. The filing of a tax return establishes a taxpayer's tax liability, as well as any overpayment that must be refunded or any underpayment that must be collected. Therefore, delaying the filing of a tax return can slow the identification and collection of underpaid tax amounts.

The Congress, through the Internal Revenue Code (I.R.C.), established April 15 as the due date for filing individual income tax returns[1] and for paying the taxes owed on these returns.[2] The I.R.C. establishes three primary sanctions for not paying taxes by April 15: a Delinquency Penalty,[3] a Failure-to-Pay (FTP) Penalty,[4] and interest.[5]

Interest and FTP Penalty assessments begin on the first day of delinquency (normally April 16 for newly filed returns) and continue until the delinquent taxes are paid. The beginning date of Delinquency Penalty assessments depends on whether the tax returns revealing delinquent taxes are considered late.

The determination as to whether a tax return filed after April 15 is late depends on whether the Internal Revenue Service (IRS) has granted the taxpayer an extension of time to file under authority delegated to it by the Congress.[6]

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[1] 26 U.S.C. § 6072(a) (2000).
[2] 26 U.S.C. § 6151(a) (2000).
[3] 26 U.S.C. § 6651(a)(1) (2000). This penalty is commonly referred to as either the Failure-to-File Penalty or the Delinquency Penalty. The penalty does not apply to taxpayers who have paid all taxes by April 15 and, thus, could be applied to less than one-third of taxpayers who failed to file timely in Calendar Year (CY) 1999. Therefore, the more accurate term of Delinquency Penalty will be used throughout this report. The Delinquency penalty is 5.0 percent per month and generally cannot exceed 25 percent of the tax liability. The Delinquency Penalty is reduced by the amount of the Failure-to-Pay Penalty if they apply concurrently.
[4] 26 U.S.C. § 6651(a)(2) (2000). The FTP Penalty is 0.5 percent per month and cannot exceed 25 percent of the taxpayer's delinquent taxes.
[5] 26 U.S.C. §§ 6621(a)(2) and (b)(2) (2000). Interest is assessed daily on unpaid delinquent taxes at rates that change each calendar quarter.
[6] 26 U.S.C. § 6081(a) (2000).

Income tax regulations[7] provide guidelines for obtaining extensions of time to file.[8] By law, an extension of time to file is not an extension of time to pay.[9]

To receive an automatic 4-month extension to August 15, an individual taxpayer must submit an Application for Automatic Extension of Time to File U.S. Individual Income Tax Return (Form 4868)[10] to the IRS by April 15. No justification is required. To receive an additional 2-month extension to October 15, an individual taxpayer must submit an Application for Additional Extension of Time to File U.S. Individual Income Tax Return (Form 2688) to the IRS by August 15. The additional extension requires an explanation of why the additional time is needed.

In CY 1999, approximately 6.9 million[11] individual taxpayers requested and were granted automatic 4-month extensions of time to file. The IRS also granted additional 2-month extensions of time to 2.4 million of these taxpayers.

To perform the audit, we extracted and computer-analyzed 4 years of IRS Individual Master File[12] data for each of the 11.7 million taxpayers who had either requested extensions of time to file Tax Year (TY) 1998 returns, or had filed these returns after April 15, 1999. To validate our observations from this time period, we analyzed TY 2001 filing and payment information for an additional 10.8 million taxpayers.

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[7] Tax regulations are rules, having the force of law, written by the IRS to interpret and apply laws added to the I.R.C. by the Congress.
[8] 26 C.F.R. § 1.6081-4 (2000).
[9] 26 U.S.C. § 6081(a) (2000) and 26 U.S.C. § 6161(a)(1) (2000).
[10] Taxpayers may also request extensions electronically, as did approximately 5.5 percent of extension filers in CY 2001.
[11] The actual number of extensions granted was 7.5 million. For the purpose of our analyses, however, we excluded approximately 600,000 extensions. We excluded extensions that were granted to taxpayers who file on a fiscal year basis or reside outside of the United States, since these taxpayers are subject to unique extension rules. We also excluded taxpayers who, despite being granted extensions, filed by April 15.
[12] The IRS database that maintains transactions or records of individual tax accounts.

The audit was performed in accordance with *Government Auditing Standards* between October 2001 and February 2003. We did not test management controls since they were not significant to our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Regulatory Changes Are Needed to Increase Taxpayer Compliance, Improve Fairness to All Taxpayers, Reduce Taxpayer Burden, and Reduce Government Costs

The growth rate in late tax payments among taxpayers with extensions of time to file individual income tax returns strongly suggests that the IRS regulations[13] and related operational practices for granting extensions have caused many taxpayers to lose respect for the April 15 deadline for paying income taxes. IRS regulations and practices also treat taxpayers differently for the same payment noncompliance, create unnecessary taxpayer burden, increase operating costs for the IRS, and reduce current year tax receipts.

The IRS granted extensions of time to file tax returns to approximately 6.9 million individual taxpayers in CY 1999. Many of these taxpayers subsequently presented the IRS with significant filing and payment compliance problems:

- Approximately 1.3 million taxpayers filed their tax returns after the extension periods had expired.
- An additional 935,000 taxpayers had not filed their tax returns by September 20, 2001 (29 months after the regular April 15, 1999, due date).
- Approximately 2.1 million taxpayers with extensions had failed to pay all of their taxes by the regular April 15 due date.
- Over 700,000 taxpayers with extensions had balance due accounts after filing their returns.

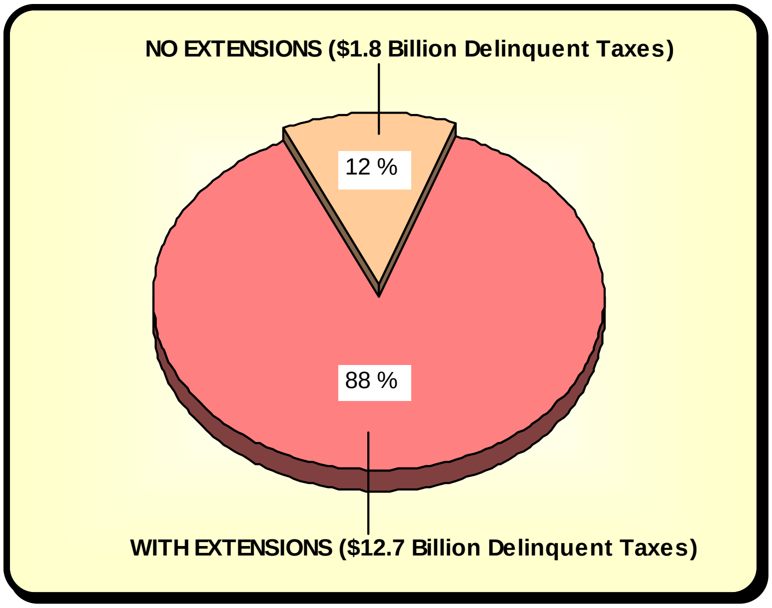
Only 52 percent of the taxpayers with extensions had both paid all of their taxes by April 15 and filed their tax returns by their extended due dates. In contrast, 99 percent of the taxpayers **not** obtaining extensions had either paid all of

[13] 26 C.F.R. § 1.6081-4 (2000).

their taxes by April 15 or filed their returns by April 15 to report their underpayments.

Figure 1 demonstrates the economic impact of the payment noncompliance among taxpayers with extensions of time to file. Taxpayers with extensions accounted for 88 percent of all delinquent taxes reported on individual income tax returns filed after the regular April 15, 1999, due date. This information presents an early indication that the filing of extensions may be the strategy of choice for taxpayers who are unable or unwilling to pay their taxes by April 15.

Figure 1: TY 1998 Delinquent Taxes on Individual Income Tax Returns Filed After April 15, 1999



Source: Treasury Inspector General for Tax Administration (TIGTA) Analysis of IRS Individual Master File Data.

This information also suggests that the existing sanctions for penalizing the tax underpayments by taxpayers with extensions are ineffective for achieving compliance and are hampering the IRS' efforts to carry out its commitments to America's taxpayers.

The IRS mission statement conveys the IRS' commitment to helping taxpayers *"understand and meet their tax responsibilities by applying the tax law with...fairness to all."* To help taxpayers understand the importance of compliance, the I.R.C. authorizes the IRS to penalize taxpayers who fail to timely file their tax returns and/or timely pay their tax liabilities.

Supporting the mission statement that the IRS will apply the tax law with fairness to all is IRS Penalty Policy P-1-18 that states:

> *In the interest of an effective tax system, the Service uses penalties to encourage voluntary compliance by: (1) helping taxpayers understand that compliant conduct is appropriate and that noncompliant conduct is not; (2) deterring noncompliance by imposing costs on it; and (3) establishing the fairness of the tax system by justly penalizing the noncompliant taxpayer.*

The IRS is not meeting its mission statement's commitment to taxpayers, since the regulations and related operational practices for extensions of time to file are preventing the proper operation of tax laws requiring the timely payment of taxes and the assessment of appropriate penalties for late payments.[14] As a result, taxpayers with extensions are not being justly penalized for their payment noncompliance. Instead, the granting of an extension by the IRS prevents the assessment of the Delinquency Penalty[15] during the extension period regardless of the amount of taxes that were underpaid at April 15.

Without the Delinquency Penalty of 5.0 percent per month, the only sanctions against taxpayers with extensions of time to file are interest charges and the FTP Penalty. In CY 1999, however, these two sanctions produced a maximum combined penalty of only 4.7 percent for taxpayers with 4-month extensions and only 7.1 percent for

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[14] 26 U.S.C. § 6072(a) requires payment by April 15 regardless of extensions of time to file, while 26 C.F.R. § 1.6081-4 provides extensions to taxpayers who have not paid by April 15 and prevents the assessment of the Delinquency Penalty in 26 U.S.C. § 6651(a)(1).

[15] On grounds other than the amount of unpaid taxes, the IRS can declare an extension void during a tax return examination and retroactively assess the Delinquency Penalty against the taxpayer.

taxpayers with 6-month extensions. By January 2003, the combined sanctions had fallen to 3.7 percent and 5.5 percent, respectively.

Prior to 1993, the regulations provided for granting extensions of time to file only to those taxpayers who had attested, under the penalty of perjury, that their anticipated tax liability was full paid by April 15. If the IRS subsequently determined that the taxpayers had not provided a "reasonable estimate" of their tax liabilities, the extensions could be considered null and void and the Delinquency Penalty could then be assessed against any underpayments. In actual practice, however, the IRS infrequently assessed the Delinquency Penalty against taxpayers who had been granted extensions even if the taxpayers had substantially misstated their tax liabilities or had substantially underpaid their taxes by April 15.

The negative effects of this practice were identified in 1993 when the IRS' Inspection Service (now the TIGTA) reported[16] that, *"…the continued taxpayer abuses of the extension privilege and laxity in enforcement that exists under the current regulations have combined to delay the collection of billions of dollars in individual income taxes."* The report estimated that taxpayers who had been granted extensions of time to file their TY 1989 returns had failed to pay $5.5 billion in taxes that were owed by the April 15, 1990, payment due date. The report, as had some IRS studies, recommended assessing the Delinquency Penalty against noncompliant taxpayers and eliminating the requirement for compliant taxpayers to file applications for extensions of time to file.

Management at the IRS initially planned to make these changes. However, the changes were never implemented due primarily to concerns expressed by the tax practitioner community. Instead, in 1993, the IRS announced[17] that it was eliminating the requirement to pay all taxes due by

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[16] *Follow-Up Review: The Processing of Extensions of Time to File* (Reference Number 030303, dated April 5, 1993).
[17] Notice 93-22, 1993-1 C.B. 305, April 7, 1993.

April 15 to qualify for an extension (see Appendix VI for historical background).

The IRS subsequently revised its regulations,[18] thereby exempting taxpayers with extensions of time to file from the Delinquency Penalty regardless of the amount of taxes that were unpaid on April 15. The instructions on the extension forms now tell taxpayers that while an extension of time to file is not an extension of time to pay, they do not need to pay their taxes by April 15 unless they choose to do so.

A recent study[19] by the Joint Committee on Taxation (JCT) stated that complex or ambiguous tax laws can create uncertainty that can reduce taxpayer perceptions of fairness in the Federal tax system in the following ways:

- The disparate treatment of similarly situated taxpayers can lead individual taxpayers to believe that they bear a disproportionate tax burden.
- Taxpayers may feel that certain tax laws confer an advantage to taxpayers who are willing and able to obtain professional advice on reducing their tax liabilities.
- Confusing tax provisions may lead to inadvertent noncompliance and cynicism among taxpayers, which ultimately can lead to intentional noncompliance.

The following are the significant effects of the IRS' revised extension regulations and related operational practices:

- Delinquent taxes owed by taxpayers with extensions of time to file are rising as the respect these taxpayers have for the April 15 payment deadline is apparently declining.
- Fairness to all taxpayers is not being achieved since similarly situated taxpayers are assessed

[18] TD 8703, 1997-8 I.R.B. 18.
[19] JCT, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS-3-01), April 2001.

significantly different penalty amounts for delinquent taxes.

- Taxpayer burden is being created since the extension requirements are ambiguous and complex for taxpayers who do not receive professional tax advice.
- Federal Government costs are being incurred to process unnecessary forms, and the Government is losing the benefits normally derived from the prompt collection of tax revenues.

The cumulative effect of these problems could erode public confidence in the fairness of the tax system. The tax system depends on all taxpayers who are voluntarily meeting their tax obligations having confidence that their neighbors are also complying. The tax system will be further undermined if taxpayers increasingly use extensions of time to file to also delay the payment of their taxes and prevent the assessment of significant penalties for the late payments.

The following is a detailed analysis of each of the effects that the IRS extension regulations and practices have on tax administration.

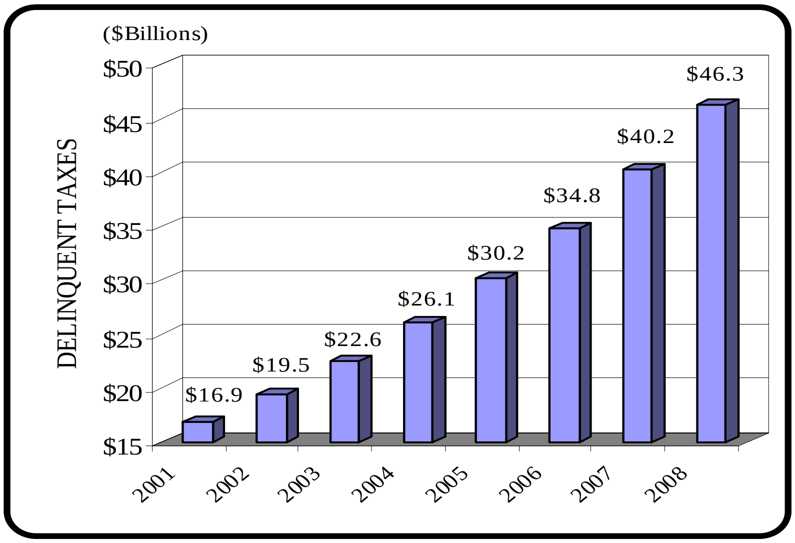
Payment delays have been increasing in dollar volume since implementation of the 1993 changes to the extension regulations

Following the 1993 elimination of tax payments as a condition for obtaining extensions of time to file, the number of extension requests has grown over four times as fast as tax return filings. Over one-third of the taxpayers granted extensions in CY 1999 eventually filed returns reporting taxes that were not paid by April 15. Nearly one-half of these taxpayers were also underpaid in other tax years, delaying the collection of $25.6 billion in taxes between 1998 and 2001. The frequency and magnitude of tax underpayments among taxpayers with extensions of time to file pose a danger to the tax system, particularly if increasing numbers of taxpayers are inclined to obtain extensions to delay tax payments.

The increasing use of extensions of time to file has been accompanied by increasing tax payment delinquencies. In CY 1999, taxpayers with extensions of time to file failed to pay $12.7 billion in taxes by April 15. The amount of delinquent taxes owed by taxpayers with extensions then increased by 32 percent between 1999 and 2001.

Figure 2 shows that if the growth rate in late tax payments continues at the same rate experienced between 1999 and 2001, taxpayers with extensions of time to file will be responsible for approximately $46.3 billion in delinquent taxes in 2008.

Figure 2: Estimated Delinquent Taxes Owed by Taxpayers with Extensions of Time to File - 2001 to 2008[20]



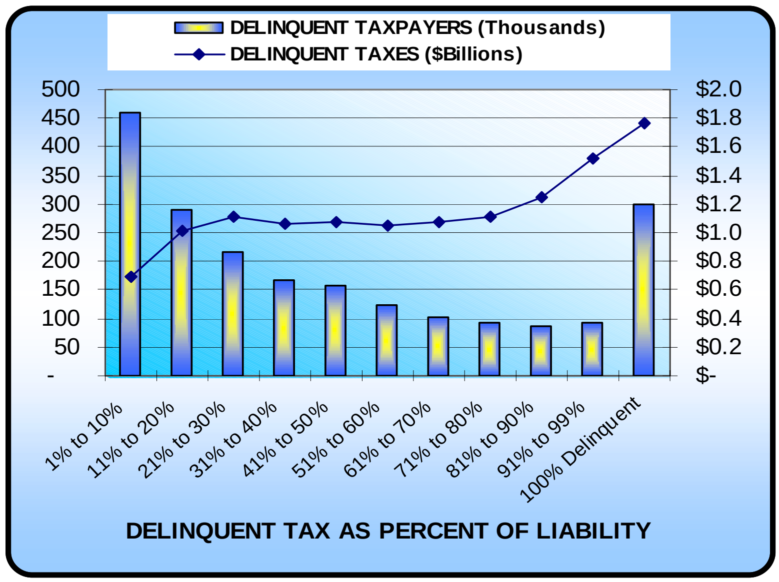
Source: TIGTA Analysis of IRS Individual Master File Data and IRS Projections of Growth in Extension Filing.

Contributing to the growth in delinquent tax dollars is the degree to which many taxpayers with extensions of time to file underpay their taxes. As shown in Figure 3, many taxpayers with extensions made little or no effort to pay their taxes by April 15, 1999. For example, the far right column of Figure 3 shows that 301,000 taxpayers who had

[20] Assumes no changes to the current extension regulations, that the actual delinquency growth rate experienced between 1999 and 2001 will continue at a rate of one-half the 2-year rate per year, and the IRS' projections of the number of extensions to be requested materialize.

made no tax payments at all by April 15 owed $1.8 billion in delinquent taxes. In all, 800,000 taxpayers with extensions had paid less than one-half of their tax liabilities by April 15, 1999.

Figure 3: Delinquent Taxes as a Percentage of Tax Liability

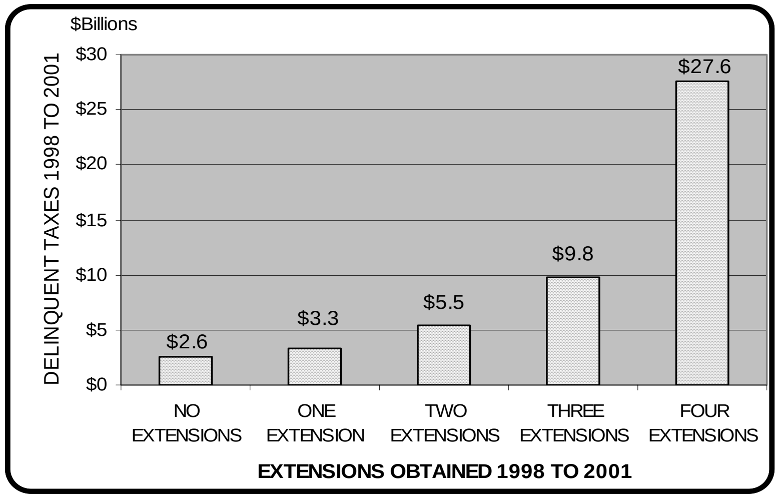


Source: TIGTA Analysis of IRS Individual Master File Data.

While it is understandable that some taxpayers who obtain extensions of time to file may not know their exact tax liabilities before their returns are completed, these figures seem to indicate a lack of concern or due care regarding tax payments.

Figure 4 presents a 4-year history of the taxpayers who filed their tax returns after the regular April 15, 1999, due date – with or without obtaining extensions. It shows that the taxpayers who had obtained extensions in 3 or more years accounted for almost 77 percent of the delinquent taxes. This strong relationship between delinquent taxes and the frequency of extension use suggests that some extension filers are indifferent to both the importance of timely tax payments and the impact of current penalties for late tax payments.

Figure 4: Relationship Between Extension Use and the Amount of Delinquent Taxes Owed



Source: TIGTA Analysis of IRS Individual Master File Data.

A group of approximately 1.0 million taxpayers was responsible for $25.6 billion (68.4 percent) of the $37.4 billion in late tax payments shown in the 2 far right columns of Figure 4. These 1.0 million taxpayers were granted extensions of time to file in at least 3 years between 1998 and 2001 and failed to pay their taxes on time at least twice during the 4-year period.

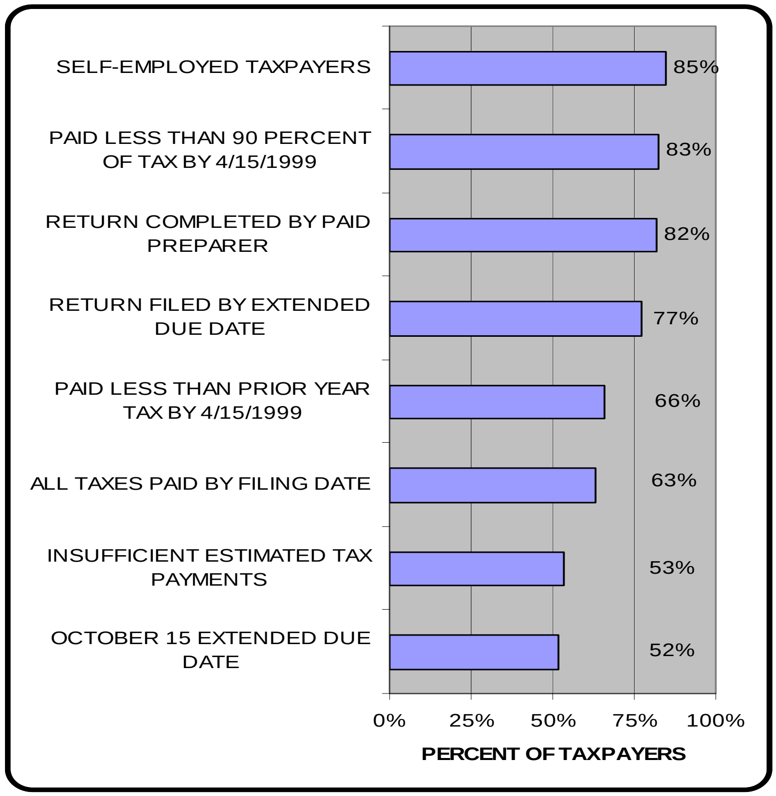
In 1998, the average income for this group of 1.0 million chronically noncompliant taxpayers was $104,000,[21] or 2.4 times higher than the national average for that year. Most of these taxpayers had at least some self-employment income and had their tax returns prepared by paid preparers.

As a group, these taxpayers had underpaid their taxes at April 15, 1999, by an average of approximately $8,000. Approximately 174,000 of these taxpayers had made no tax payments at all by April 15. Over 7,800 taxpayers were underpaid by more than $100,000 each, while 169 taxpayers were underpaid by more than $1.0 million each.

Figure 5 shows common characteristics of these 1.0 million chronically noncompliant taxpayers.

[21] Taxpayer income figures represent the total income on the tax return before adjustments to income.

Figure 5: Characteristics of Chronically Noncompliant Taxpayers That Obtain Extensions (TY 1998 Data)



Source: TIGTA Analysis of IRS Individual Master File Data.

In summary, there is evidence that a core group of taxpayers with relatively substantial income has taken advantage of the IRS extension regulations and practices to delay the payment of taxes that are due by April 15. The assessment of interest and FTP Penalties does not appear to provide these taxpayers with sufficient incentive to pay their tax obligations by the payment due date. If extension use continues to grow at a rate that is over four times as fast as that of tax return filings,[22] we believe that the apparent indifference to making timely tax payments among taxpayers with extensions will likely grow as well.

[22] The growth in extension filings from 1993 through 2001 was 4 times the growth of return filings. The IRS projects future extension growth at 2.6 times that of return filings. We did not review the assumptions or methodology for the lower IRS projections, but relied on them for TIGTA estimates of future extension activity throughout this report.

The Regulations for Granting Extensions of Time to File Are Delaying the Receipt of Billions of Tax Dollars and Creating Substantial Burden for Compliant Taxpayers

Fairness to all taxpayers is not achieved since similarly situated taxpayers are assessed significantly different penalty amounts

The current extension process does not promote fairness to all taxpayers since similarly situated taxpayers should be treated in a like manner. Further, fairness to all taxpayers suggests that all taxpayers should be confident that other taxpayers are compliant and that, when noncompliance occurs, appropriate penalties will be assessed. As shown in the following hypothetical example, the current extension process does not accomplish these results.[23]

Table 1: Identical Delinquent Taxes, Identical Payment Dates, Identical Filing Dates, Extension Protects Taxpayer A

	Taxpayer A	Taxpayer B
Taxes Owed on 4/15/99	$10,000	$10,000
Extended Due Date	**10/15/1999**	**None**
Date Return Filed	10/15/1999	10/15/1999
Tax Paid with Return	$10,000	$10,000
Interest (8 percent)	$409	$501
FTP Penalty	$300	$300
Delinquency Penalty	$0	$2,250
Total Interest and Penalties	**$709**	**$3,051**

Source: TIGTA Analysis.

In this hypothetical example, both taxpayers owed the same amount of taxes on April 15 and both filed their returns on October 15 with full payment of the taxes owed. The only difference between these similarly situated taxpayers is that Taxpayer A had requested and obtained extensions of time to file until October 15 and Taxpayer B had not. As a result, Taxpayer B was charged over $2,300 more than Taxpayer A in interest and penalties for not requesting and obtaining an extension. This seems to be a severe penalty given that

[23] For Tables 1 and 2, it is assumed that the taxpayers paid less than 90 percent of their tax by April 15. Interest is computed daily over a 365-day year. Amounts are rounded to nearest dollar.

The Regulations for Granting Extensions of Time to File Are Delaying the Receipt of Billions of Tax Dollars and Creating Substantial Burden for Compliant Taxpayers

extension forms do nothing to establish a taxpayer's compliance with timely payment requirements.

Table 2 demonstrates how identical payment timing by two taxpayers with different extended due dates results in unequal treatment.

Table 2: Identical Delinquent Taxes, Identical Payment Dates, Identical Filing Dates, Taxpayer C Penalized for Obtaining Only a 4-Month Extension

	Taxpayer A	Taxpayer C
Taxes Owed on 4/15/99	$10,000	$10,000
Extended Due Date	**10/15/1999**	**8/15/1999**
Date Return Filed	10/15/1999	10/15/1999
Tax Paid on 10/15/1999	$10,000	$10,000
Interest (8 percent)	$409	$421
FTP Penalty	$300	$300
Delinquency Penalty	$0	$900
Total Interest and Penalties	**$709**	**$1,621**

Source: TIGTA Analysis.

In this hypothetical example, both taxpayers obtained an extension, filed their returns by October 15, and paid their delinquent taxes on October 15. However, Taxpayer C is assessed over $900 more in interest and penalties for not filing by the August 15 extended due date. Taxpayer C could have avoided this situation by submitting a request for an additional 2-month extension to October 15.

While Taxpayers B and C both filed tax returns beyond their respective due dates, it is noteworthy that Taxpayer C was charged $1,350 less for paying late. This is because taxpayers who have been granted extensions are exempt from the Delinquency Penalty for the period of the extension regardless of whether they choose to file by the extended due date.

In conclusion, Tables 1 and 2 show that the extension regulations and practices do not promote fairness to all taxpayers. In each example, similarly situated taxpayers are treated differently based only on the penalty protection provided by the extension of time to file.

Taxpayer burden is created because the extension requirements cause taxpayers to incur unnecessary costs, are overly complex, and create uncertainty

Reducing taxpayer burden is a significant concern for the IRS, the Congress, tax practitioners, and taxpayers. However, IRS extension regulations and practices contribute to taxpayer burden because they increase the time and cost of filing and increase the complexity and uncertainty involved in meeting tax obligations.

Taxpayers incur unnecessary time and dollar costs

The Paperwork Reduction Act[24] seeks to ensure that Federal agencies balance their need to collect information with the paperwork burden imposed on the public in complying with the collection. The Office of Management and Budget (OMB) measures paperwork burden in terms of the time and financial resources the public devotes to complying with information requests.

The filing of extension forms does not promote timely tax payments. For taxpayers with delinquent taxes, applying for extensions of time to file serves only to prevent the assessment of the Delinquency Penalty. For taxpayers who have paid all taxes due by April 15, extensions of time to file serve no purpose since the Delinquency Penalty applies only to taxes that were not paid by April 15.

In addition, the filing of extension forms does not ensure that taxpayers will timely file their tax returns by the extended due date. Of the taxpayers granted extensions in CY 1999, only about two-thirds subsequently filed their returns by the extended due date.

Despite the questionable tax administration value of the extension forms, the IRS continues to require them, creating significant time and cost burdens for the public. For example, the IRS instructs taxpayers to submit two separate forms to obtain the maximum extension of time to file. The

[24] 44 U.S.C. Chapter 35 (2003).

IRS estimates that it takes 65 minutes[25] to request a 4-month extension and 46 minutes[26] to request an additional 2-month extension.

If all taxpayers with extensions of time to file in 1999 had prepared their own extension forms, it would have taken them 9.6 million hours. However, only 22 percent of the taxpayers who obtained extensions personally undertook the task of preparing the required extension forms. The remaining 78 percent turned to paid tax preparers for assistance.[27]

If the IRS changed the regulations to establish October 15 as the sole extended due date and to eliminate the requirement for taxpayers to apply for extensions, we estimate that between 2004 and 2008:

- Approximately 11.5 million taxpayers would save $636.8 million in reduced fees charged by paid tax preparers for extension form preparation and filing.
- Approximately 3.6 million taxpayers would be relieved of the burden of preparing and filing their own extension forms, saving the taxpayers an estimated $170.1 million.[28]

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[25] Per the Form 4868 used for TY 2000. Time estimate includes 26 minutes for record keeping, 12 minutes to learn about the law or the form, 17 minutes to prepare the form, and 10 minutes to copy, assemble, and mail the form to the IRS.

[26] Per the Form 2688 used for TY 2000. Time estimate includes 13 minutes to learn about the law or the form, 16 minutes to prepare the form, and 17 minutes to copy, assemble, and mail the form.

[27] Paid preparer percentage is based on the percentage of tax returns with extended due dates for which IRS records indicated preparation by paid tax preparers. It is assumed that these percentages also exist in the volume of extensions granted for which returns were not subsequently filed.

[28] This estimate is based on the IRS' taxpayer burden estimates printed on extension forms for TY 2000, the IRS' projections of future extension growth, the OMB estimate of the cost-per-hour of taxpayer burden ($26.50), and the percentage of extension filers preparing their own returns in CY 1999.

Taxpayer uncertainty can lead to increased penalties and taxpayer debt

The April 2001 JCT report identified several factors that contribute to complexity in the Federal tax system. Two of the complexity factors are apparent in the IRS' regulations and practices regarding extensions. These factors are:

1. The extent to which a provision makes it difficult for taxpayers to estimate and understand their tax liabilities.
2. The extent to which a tax provision creates uncertainty.

Estimating and paying the proper amount of taxes by April 15 should be of paramount importance to any taxpayer needing additional time to file a tax return. Only with the knowledge that the proper amount of tax has been paid can the taxpayer be certain to avoid unanticipated interest and penalties.

However, such certainty is not provided by IRS regulations and practices for granting extensions of time to file. As a result, some taxpayers may be making uninformed and costly decisions regarding tax return filings, extension requests, and related tax payments.

The extension process can cause difficulty and uncertainty, particularly for taxpayers without access to professional advice. For example:

- Extension forms are not provided in the tax packages that are annually mailed to taxpayers. Internet-proficient taxpayers can obtain the forms on-line from the IRS. Other taxpayers must find an alternate source.
- Confusing instructions for estimating tax liabilities are provided on extension forms. Taxpayers are instructed to "properly estimate" their tax liability and are advised that, if their estimate is not "reasonable," their extension may later be considered void. The terms "proper" and "reasonable" are not defined.

- Ambiguous instructions regarding the need for timely tax payments are provided on the extension forms. While taxpayers are advised that an extension of time to file is not an extension of time to pay, they are also told they do not need to pay the amount they owe in order to obtain the extension.

- Vague instructions regarding the consequences of paying taxes after April 15 are provided on the extension forms. By comparison, the Truth in Lending Act[29] statements required of commercial lenders must provide a total accounting of all financing costs to help borrowers make informed decisions about borrowing alternatives.

  While the instructions on the extension forms discuss various penalties that may or may not apply to the taxpayer, they do not state the total cost of delaying tax payments – information critical for decision-making. In 1999, for example, filing on October 15 after obtaining an extension added a total of 7.1 percent to delinquent tax amounts, whereas filing on October 15 without obtaining an extension added a total of 30.5 percent to delinquent tax amounts. Taxpayers should be provided with similar information that would allow them to compare the relative costs of their filing and payment decisions.

- No instructions are provided to guide taxpayers in minimizing the penalties and interest charged for the late payment of taxes. The existing instructions for obtaining an extension of time to file do not advise taxpayers who are unable to pay their taxes that filing on April 15 and paying the taxes in future installments is significantly cheaper than filing the extension form and delaying payment. Such information could help these taxpayers avoid compounding their debts.[30]

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[29] 15 U.S.C. §§ 1601 – 1666 (2003).
[30] This assumes that the savings available from installment agreements are not offset by paid preparer fees for arranging the agreement or by the $43 user fee charged by the IRS for obtaining an installment agreement.

In CY 1999, for instance, taxpayers with an extension who filed their tax returns on October 15 would be assessed interest and penalties totaling 7.1 percent of the taxes that were not paid by April 15. If the same taxpayers had filed on April 15 and paid the taxes in installments by December 15, the interest and penalties would have totaled only 4.1 percent.

There is evidence that taxpayers would make this decision since 50 percent of the taxpayers that filed after April 15, 1999, and owed taxes after filing did enter into installment agreements. If all such taxpayers had filed on April 15 and entered into 8-month installment agreements to pay their remaining tax liabilities, they would have reduced the interest and penalties they were assessed by over 90 percent and saved over $1.4 billion.

For taxpayers to make informed tax decisions, they must be aware of any unpaid taxes, the various payment and filing alternatives available, and the relative costs of those alternatives. This information is particularly important for taxpayers who are unable to pay their taxes at April 15. While such taxpayers may delay filing tax returns as a means to delay payment of their tax liabilities, such delays can compound their financial problems. Knowledge that filing on April 15 and paying taxes in installments is much cheaper than delayed filing may encourage some taxpayers to avoid further debt by filing on April 15.

Federal Government costs are increased and Government opportunities are lost

The IRS incurs a significant and costly burden to process extension applications each year. For example, we estimate that the IRS' costs to process the 9.7 million extension requests received in CY 1999 were approximately $6.3 million. Between 2004 and 2008, the IRS could save

$42.1 million by eliminating the processing of 64.7 million extension requests.[31]

While the IRS' extension processing costs are expected to average $8.4 million per year, the costs the IRS incurs to collect the delinquent taxes owed by taxpayers with extensions of time to file are even higher. Of the 2.1 million taxpayers with extensions who failed to pay $12.7 billion in taxes due by April 15, 1999, 732,000 (35 percent) still owed taxes totaling $4.4 billion after filing their returns. Further, $1.5 billion of these taxes remained unpaid two and one-half years after they were due.

We estimate that the IRS will have incurred $11.9 million in collection costs by the time it resolves all of the delinquent taxes owed by taxpayers with extensions who, in addition to not paying all of their taxes by April 15, 1999, also failed to full pay their taxes when they eventually filed their returns. Nearly two-thirds of these costs will be incurred for personal contacts to collect the delinquent taxes of 27,000 taxpayers with extensions who have not paid their taxes in response to lower-cost letters and telephone calls from the IRS.

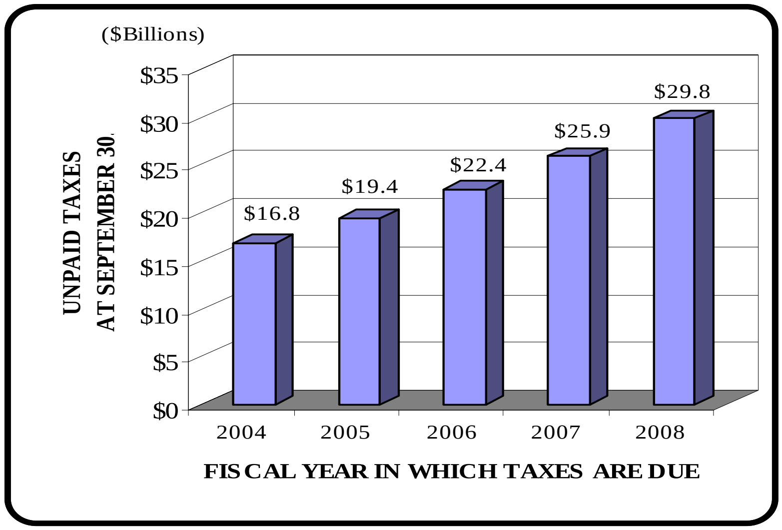
In addition to providing opportunities for lowering IRS processing and collection costs, changes to IRS extension regulations and practices could provide further financial benefits to the Federal Government. These benefits involve changes that both speed the flow of tax revenues received from taxpayers with extensions of time to file and slow Federal Government outlays.

In CY 1999, taxpayers with extensions of time to file failed to pay $12.7 billion in taxes by April 15, of which $8.5 billion was not paid by September 30, 1999, the end of the Federal Government's Fiscal Year (FY) 1999. Figure 6 presents our estimate that, for FYs 2004 through 2008 under the current IRS extension regulations, taxpayers with extensions of time to file will delay the payment of an

[31] Based on IRS projections of extension forms to be filed.

estimated $114.3 billion until after the end of the fiscal year in which the taxes are due.[32]

Figure 6: Tax Payments Delayed Past the End of the Fiscal Year by Taxpayers With Extensions of Time to File



Source: TIGTA Analysis of IRS Individual Master File Data and IRS Projections of Growth in Extension Filings.

Increasing tax receipts or decreasing Federal Government expenditures during a fiscal year makes additional funds available for the Government's use. These additional funds can be used to reduce existing or planned Federal Government debt or to procure additional vital goods and services without incurring debt.

The Federal Government would be presented with such opportunities if more of the taxes shown in Figure 6 could be collected in the same fiscal year in which they were actually due. For example, if all of the money shown in the far right column of Figure 6 was timely collected by April 15, 2008, and used to reduce existing Federal

[32] Assumes no changes to the current extension regulations, that the actual delinquency growth rate experienced between 1999 and 2001 will continue at a rate of one-half the 2-year rate per year, and that IRS projections of extensions to be requested materialize.

Government debt, Government interest expenses would be reduced by up to $2.4 billion.[33]

The earlier collection of taxes could be brought about by revising the IRS' extension regulations to: 1) provide clear, quantifiable guidelines regarding the level of payment compliance needed to obtain extensions of time to file, 2) require the assessment of the Delinquency Penalty starting at April 16 for delinquent tax amounts, 3) provide equitable safeguards, commonly called "safe harbors," to ensure that the Delinquency Penalty is not assessed for inadvertent or minor underpayments, and 4) establish October 15 as the sole extended due date.

With such changes, we estimate that between FYs 2004 and 2008:

- Taxpayers seeking to meet new safe harbor allowances[34] would increase the amount of taxes they pay by April 15, thus incrementally increasing current year Federal Government receipts in each of the fiscal years. This would increase the April 15 tax receipts by an estimated $13.5 billion over the 5-year period. Approximately $8.2 billion of these accelerated receipts would be taxes collected in the same fiscal years in which they are actually due, rather than in subsequent fiscal years.

- Taxpayers increasing their payments by April 15, as well as those taxpayers currently assessed Delinquency Penalties who would benefit from the new safe harbors, would save $7.7 billion in interest and penalties as compared to those they would be assessed under the current IRS regulations.

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[33] Estimate is based on the rate of interest paid on Federal Government debt in 2002 per the Bureau of Public Debt.

[34] The Delinquency Penalty would not be assessed if taxpayers filing by October 15 paid, by April 15, an amount at least equal to the prior year's tax liability or an amount at least equal to 90 percent of the current year's tax liability. If a taxpayer does not meet one of these "safe harbors" but files by October 15, no Delinquency Penalty would be assessed on the first 10 percent of the current year's tax liability.

- Noncompliant taxpayers would be assessed Delinquency Penalties of $6.9 billion. These penalties would decrease incrementally over the 5-year period as payment compliance improves.
- Some taxpayers with extensions of time to file who traditionally wait until the current August 15 extended due date to request refunds would wait until the new October 15 extended due date to request refunds. Annually, an average of 643,000 such taxpayers would be likely to delay their refund requests until October 15, thereby deferring current-year Federal Government refund outlays by an estimated $6.8 billion over the 5-year period.

Recommendations

To improve taxpayer compliance, ensure fairness to all taxpayers, and relieve taxpayer burden:

1. The IRS Commissioner should revise the tax regulations applicable to individual taxpayers to:

   a) Eliminate the requirement that taxpayers must make “reasonable” or “proper” estimates of their tax liabilities in order to remove the uncertainty about whether the qualifications for an extension have been met. The revised regulations should specify that taxpayers will qualify for extensions of time to file only if the prescribed percentage (see Recommendation 1.b.) of the prior year’s tax liability or the current year’s tax liability (as determined by the tax return, when filed) was paid by the normal due date for filing the return.

   b) Grant extensions of time to file only to payment-compliant taxpayers. Under the authority granted in I.R.C. Section 6081(a) for granting reasonable extensions of time to file of up to 6 months, extensions should be granted only to taxpayers whose payments by April 15 either:

1. Are at least as much as the taxpayer's prior year's tax liability, or
2. Are at least as much as 90 percent of the taxpayer's current year's tax liability.

c) Establish October 15 as the sole extended due date for individual taxpayers, replacing the current automatic 4-month (to August 15) and optional 2-month (to October 15) extended due dates. This action would reduce the complexity of the current system that requires the submission of two forms to obtain an extension to October 15. This action should be taken under authority granted in I.R.C. Section 6081(a) for granting reasonable extensions of time to file of up to 6 months.

d) Establish safeguards, commonly called "safe harbors," to protect reasonably compliant taxpayers from unwarranted assessment of the Delinquency Penalty.[35] Under authority granted in I.R.C. Section 6651(a)(1) for determining reasonable cause in relation to the Delinquency Penalty, reasonable cause for post-April 15 filing should be assumed for all taxpayers filing by October 15, whether or not an extension to file has been formally requested, if:

1. By April 15, a taxpayer has paid at least as much as their prior year's taxes or at least 90 percent of their current year's taxes. These safe harbors ensure that all like-situated taxpayers will be subject to the same penalties for the same payment noncompliance.
2. By October 15, a taxpayer has filed a tax return but has not met either of the payment requirements, the Delinquency

[35] For taxpayers who file on a fiscal year basis, April 15 would mean their regular tax return due dates and October 15 would mean 6 months after the regular tax return due date.

Penalty should be assessed only on the underpaid tax amount that exceeds 10 percent of the taxpayer's current year tax liability. This would supplement the first safeguard by preventing a taxpayer from being harshly penalized for missing the 90 percent payment requirement by an insignificant amount.

e) For taxpayers filing after October 15, provide for the assessment of the Delinquency Penalty on all taxes not paid by April 15, since such lengthy delays in compliance indicate that the taxpayers have taken no prudent steps to meet either their tax payment or tax filing obligations. Therefore, these taxpayers have not earned the safeguards that are provided to taxpayers who are making a reasonable effort to comply.

2. Once the above changes to the IRS regulations have been implemented to ensure the objective and equitable treatment of taxpayers for payment noncompliance, the IRS Commissioner should consider changing the regulations to eliminate the requirement for taxpayers to file an application, either on paper or electronically, with the IRS in order to receive extensions of time to file tax return. This action should be taken under authority granted in I.R.C. Section 6081(a) for granting reasonable extensions of time to file of up to 6 months.

3. The Commissioner, Wage and Investment Division, should revise the tax package instructions to include:

   a) A worksheet to assist taxpayers in determining whether they have met the new requirements to pay 90 percent of the current year taxes, or 100 percent of the previous year's taxes, by April 15.

   b) Statistics that stress the economic advantages of filing by April 15 and arranging for installment payments of taxes owed as compared to filing after April 15 and incurring interest and penalties.

c) Information on the total interest and penalty costs of delaying the payment of taxes, expressed as percentages and dollar amounts for a limited number of simple, common situations. For instance, taxpayers should be provided enough information to compare the total costs of filing on October 15 both with and without meeting safe harbor requirements by April 15.

Management's Response: Management's response was due on July 31, 2003. As of August 4, 2003, management had not responded to the draft report.

Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to determine the effect that the existing tax laws, tax regulations, and Internal Revenue Service (IRS) policies and practices for granting extensions of time to file are having on taxpayer compliance, timely revenue receipts, fairness for all taxpayers, taxpayer burden, and processing costs.

To accomplish this objective, we:

I. Determined the intended role of extensions and related IRS penalty enforcement in ensuring successful tax administration.

   A. Identified the historical changes made to the Internal Revenue Code and Treasury Regulations regarding penalties for underpayment of taxes shown on an original individual income tax return.

   B. Reviewed available IRS studies, reports, and general statistics regarding extension processing, related penalty enforcement, and nonfiling among taxpayers with extensions of time to file.

II. Determined the level of taxpayer burden presented by extension filing requirements.

   A. Obtained IRS statistics on the volume of extensions filed, including historical volumes and IRS projections of future filings.

   B. Quantified the cost of extension filing for the taxpaying public in time, money, and other resources.

III. Determined the effect of extension filing and related IRS penalty enforcement on taxpayer behavior by securing and analyzing a Master File[1] extract of individual taxpayer account data. The extract consisted of taxpayers that (1) received extensions in Calendar Year (CY) 1999, or (2) filed a return after its CY 1999 due date, or (3) filed a timely return in CY 1999 but had not paid all taxes due by the return due date. The extract contained a 4-year history on each taxpayer and reflected Tax Year (TY) 1998 returns filed between April 23, 1999, and September 20, 2001.

   A. Identified the overall characteristics of the taxpayers that obtained extensions of time to file.

      1. Determined whether extension filing tended to be a single-year event or whether there was a core of repetitive extension filers.

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[1] The IRS database that maintains transactions or records of individual tax accounts.

2. Determined how many extension filers met tax payment requirements by the return due date.

3. Determined how many extension filers submitted their returns by the extended due date of the return.

B. Quantified the level of noncompliance among extension filers.

1. Determined the amount of tax that was not paid by the original return due date.

2. Determined how many IRS collection actions were required to collect the amount owed.

3. Determined how long it took for underpaid extension filers to fully pay their taxes.

4. Determined how many IRS collection actions were required to secure returns not voluntarily filed by taxpayers.

5. Determined how many taxpayers repeated their noncompliance.

6. Determined the level of payment compliance among taxpayers filing extension requests in CY 2001 for TY 2000. This analysis required a second extract of IRS Master File information that consisted of all individual taxpayer accounts with extensions of time to file, whether filing returns or not, and all other taxpayers filing TY 2000 returns between April 24, 2001, and December 31, 2001.

C. Compared the consequences faced by extension filers who underpay their taxes to the consequences faced by other taxpayers who underpay.

1. Compared penalties and interest assessed against noncompliant extension filers to the penalties and interest assessed against nonextension timely and late filers.

2. Determined whether the penalties assessed against noncompliant extension filers provide sufficient deterrence against the underpayment of taxes.

IV. Explored the demographics of noncompliant extension filers by analyzing an Individual Return Transaction File[2] extract that provided tax return data on the taxpayers included in our Master File extracts.

A. Searched for trends in taxpayer income levels or income types (e.g., high vs. low adjusted gross income, wages vs. self-employment income, etc.).

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[2] An IRS file containing data transcribed from each tax return as well as computer-generated information used to verify the accuracy of the transcribed data.

B. Compared compliance on self-prepared returns to compliance on practitioner-prepared returns.

V. Evaluated the burden of the extension process on the Department of the Treasury.

A. Determined the borrowing costs incurred by the Department of the Treasury to secure funds equal to the late tax payments from noncompliant extension filers.

B. Determined the processing costs incurred by the IRS to process extension forms.

C. Computed the amount of Delinquency Penalties that would have been assessed against noncompliant taxpayers if they had not requested extensions.

Appendix II

Major Contributors to This Report

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Appendix III

Report Distribution List

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Commissioner, Wage and Investment Division W
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Deputy Commissioner, Wage and Investment Division W
Director, Compliance, Small Business/Self-Employed Division S:C
Director, Compliance, Wage and Investment Division W:CP
Director, Payment Compliance, Small Business/Self-Employed Division S:C:CP:P
Director, Filing and Payment Compliance, Wage and Investment Division W:CP:FPC
Director, Customer Account Services, Small Business/Self-Employed Division S:CAS
Director, Customer Account Services, Wage and Investment Division W:CAS
Director, Submission Processing, Small Business/Self-Employed Division S:CAS:SP
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Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O
Office of Management Controls N:CFO:AR:M
Audit Liaisons:
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    GAO/TIGTA Liaison, Wage and Investment Division W:S:PA

Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will accrue from 2004 through 2008 and will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measures:

- Increased Revenue – Potential; $6.9 billion (see page 3). Increased Delinquency Penalty assessments for noncompliant taxpayers.
- Taxpayer Rights and Entitlements – Potential; $7.7 billion (see page 3). Reduced interest and penalties assessed against taxpayers paying increased taxes by April 15 or benefiting from new safe harbor requirements.
- Funds Put to Better Use – Potential; $42.1 million (see page 3). Reduction in the Internal Revenue Service's (IRS) processing costs from elimination of extension filing.
- Taxpayer Burden – Potential; $636.8 million, 11.5 million taxpayer accounts affected (see page 3). Reduced tax preparation fees resulting from elimination of extension filing.
- Taxpayer Burden – Potential; $170.1 million, 3.6 million taxpayer accounts affected (see page 3). Reduced time burden for taxpayers who will no longer need to file their own extension forms.

Methodology Used to Measure the Reported Benefits:

The following is a general summary of the methodologies used to measure the reported benefits. All references to "taxpayers" and "returns" are to *individual taxpayers* and *individual income tax returns*, respectively. All references to 1999 are to extensions granted, returns due, payments made, or returns filed for Tax Year (TY) 1998. All references to 2001 are to extensions granted, returns due, payments made, or returns filed for TY 2000.

Increased Revenue: The volumes of extension filers and nonextension filers for future years were based on the IRS' projections of increases in return and extension filings. Growth rates for dollar items were based on actual increases between those returns due in 1999 and those due in 2001. We assumed that the proportions of certain taxpayer behaviors among post-April 15 return filers in the future would reflect the actual proportions of taxpayers with April 15, 2001, due dates. Therefore, we assumed that 79.4 percent of extensions would result in return filings and that 35.7 percent of the returns with extended due dates would reflect delinquent taxes.

To determine the amount of delinquent taxes attributable to taxpayers with extensions of time to file, the return volume was multiplied by the average delinquency amount. The average delinquency amount was based on the 1999 average of $6,094, increased annually by one half of the actual 2-year 23.0 percent increase in average delinquencies on returns with extended due dates between 1999 and 2001.

For non-extension taxpayers, we assumed that 3.8 percent of the returns that the IRS projected to be filed would be post-April 15 returns, as they were in 2001. We further assumed that 26.1 percent of these non-extension post-April 15 returns would reflect delinquent taxes. To determine the amount of delinquent taxes, the return volume was multiplied by the average delinquency amount. The average delinquency amount was based on the 1999 average of $1,961, increased annually by one half of the actual 2-year increase of 46.3 percent in average delinquencies on such returns between 1999 and 2001.

We assumed that taxpayers with extended due dates who owed delinquent taxes and filed returns by the extended due date, thus meeting the conditions of current extension regulations and avoiding the Delinquency (also known as Failure-to-File) Penalty, would pay the lesser of 90 percent of the current year tax or an amount equal to last year's tax by April 15 to comply with revised extension regulations and avoid the Delinquency Penalty.

We used computer programs to compile applicable statistics on taxpayers who filed returns by their extended due dates, but did not pay enough taxes by April 15 to avoid the Delinquency Penalty under the safe harbors recommended in this report. The delinquent taxes of these taxpayers amounted to 38.7 percent of all delinquent taxes on all post-April 15, 1999, returns. For these taxpayers, 55.9 percent of their total delinquent taxes exceeded proposed safe harbors. Therefore, to meet the proposed safe harbors, their timely payments would have to increase by an amount equal to 55.9 percent of their total delinquent taxes under current regulations. These percentages were applied to subsequent fiscal years to determine the increase in funds that could be collected by April 15, thereby decreasing interest and penalty amounts.

In recognition that all taxpayers would not adapt to new safe harbors immediately, we assumed a 5-year phase-in period. To determine annual accelerated tax payments, we multiplied the total amounts in excess of harbor allowances by the percentage of taxpayers expected to be in compliance with new safe harbors each year. We assumed that, at the end of 5 years, the payment compliance level among these taxpayers would reach 97 percent, the level of payment compliance present in the non-extension taxpayer population in 1999.

Table 3: Estimate of Delinquent Taxes Owed by Taxpayers With Extensions of Time to File[1]

	2004	2005	2006	2007	2008	Totals
Return Filers (per IRS, Feb. 2002)	136.1	138.4	140.4	142.6	144.4	701.9
Extension Taxpayers (Form 4868 volumes per IRS, Feb. 2002)	8.9	9.2	9.5	9.9	10.2	47.6
Extension Taxpayers Filing Returns	7.0	7.3	7.6	7.8	8.1	37.8
Extension Returns with Delinquent Tax	2.5	2.6	2.7	2.8	2.9	13.5
Non-extension Post-April 15 Returns with Delinquent Tax	1.4	1.4	1.4	1.4	1.5	7.0
Average Delinquent Tax, Extensions	$10,382	$11,575	$12,904	$14,385	$16,037	N/A
Average Delinquent Tax, No Extension	$5,355	$6,594	$8,119	$9,998	$12,311	N/A
Total Delinquent Tax, Extensions	$26.1	$30.2	$34.8	$40.2	$46.3	$177.6
Total Delinquent Tax, No Extension	$7.3	$9.2	$11.4	$14.3	$16.5	$60.1
Total Delinquent Tax, All Post-April 15 Returns	$33.4	$39.3	$46.3	$54.5	$64.2	$237.7
Delinquent Taxes of Taxpayers Filing by Extended Due Date but Failing Proposed Safe Harbors	$12.9	$15.2	$17.9	$21.1	$24.8	$91.9
Amount of Delinquent Taxes in Excess of Safe Harbors	$7.2	$8.5	$10.0	$11.8	$13.9	$51.4
Assumed Level of Compliance with Proposed Safe Harbors	25%	50%	70%	85%	97%	N/A
New Tax Payments by April 15 with Proposed Safe Harbors	$1.8	$4.3	$7.0	$10.0	$13.5	$36.6

Source: Treasury Inspector General for Tax Administration (TIGTA) Analysis of Internal Revenue Service (IRS) Master File Data

We used computer programs to total the Delinquency Penalties that were actually assessed against all post-April 15,1999, return filers, thereby determining that the Delinquency Penalties were 5.3 percent of the total delinquent taxes. This percentage was applied to the estimated delinquent taxes for future years to produce a baseline of Delinquency Penalties that would be assessed if no changes were made to current extension regulations or Delinquency Penalty criteria.

[1] Volumes in millions, dollars in billions (except averages, which are actual). Details may not add to totals due to rounding.

Computer programs were then used to re-compute the Delinquency Penalties on all post-April 15, 1999, delinquencies based on the new safe harbors proposed in this report. The Delinquency Penalty was computed for all taxpayers not meeting the new safe harbor criteria, producing increases in Delinquency Penalties amounting to 7.6 percent of all delinquent taxes. This percentage was applied to future years to provide estimates of the gross potential Delinquency Penalty increases that related to the new safe harbors if taxpayers did not change their payment behavior.

To determine the impact of changes in taxpayer payment behavior in reaction to the proposed new safe harbors, we used computer programs to identify Delinquency Penalty increases related to taxpayers who filed returns by their extended due dates in 1999 but did not pay enough taxes by April 15, 1999, to meet the proposed new safe harbors. The Delinquency Penalty increases for these taxpayers represented 87.2 percent of the gross potential Delinquency Penalty increases with the proposed safe harbors. This percentage was applied to future years to determine the maximum avoidable gross Delinquency Penalty increases.

To determine how much of the Delinquency Penalty increases would be avoided each year, we multiplied the gross penalty increases by the percentage of taxpayers expected to be in compliance with the proposed safe harbors each year. For each year, we then computed the net increase in Delinquency Penalty assessments by subtracting the annual amounts avoided from the gross potential increases.

Table 4: Increased Delinquency Penalties Due to Proposed New Safe Harbors[2]

	2004	2005	2006	2007	2008	Totals
Total Delinquent Taxes, All Post-April 15 Returns	$33.4	$39.3	$46.3	$54.5	$64.2	$237.7
Gross Possible Delinquency Penalty Increases with Proposed Safe Harbors	$2.5	$3.0	$3.5	$4.2	$4.9	$18.1
Delinquency Penalty Increases of Taxpayers Likely to Respond to Proposed Safe Harbors	$2.2	$2.6	$3.1	$3.6	$4.3	$15.8
Assumed Level of Compliance with Proposed Safe Harbors	25%	50%	70%	85%	97%	N/A
Delinquency Penalty Increases Avoided by Improved Payment Compliance	$0.6	$1.3	$2.2	$3.1	$4.1	$11.2
Net Delinquency Penalty Increases with Proposed Safe Harbors	$2.0	$1.7	$1.4	$1.1	$0.8	$6.9

Source: TIGTA Analysis of IRS Master File Data

[2] Dollars in billions. Some items may not total due to rounding.

At the request of IRS management, we estimated the effect of assessing these additional Delinquency Penalties on IRS processing costs. First, we analyzed the 1999 accounts of the taxpayers that would have been assessed additional Delinquency Penalties under our proposed recommendations and determined that only 16 percent would receive a new notice. The remaining 84 percent of the taxpayers had already received a balance due notice for taxes, other penalties, and/or interest. Secondly, we assumed that 25 percent of the taxpayers assessed additional Delinquency Penalties would contact the IRS to complain, and that, in response to these complaints, the IRS would experience the same negligible 0.3 percent abatement rate for reasonable cause, as shown in the IRS Data Book (2001) for ES Penalties, since the recommended Delinquency Penalty safe harbors are nearly identical to those for ES Penalties.[3]

Based on these factors, we estimate that the IRS would incur an average of $414,000 per year in additional processing costs to potentially collect an average of $1.4 billion per year in new Delinquency Penalties from 2004 through 2008. By 2008, we expect that the IRS costs for mailing additional collection notices and responding to taxpayer complaints will fall below $25,000 due to improved taxpayer payment compliance.

Taxpayer Rights and Entitlements: Using computer programs, we determined that taxpayers who were assessed the Delinquency Penalty under the current regulations would have reductions in Delinquency Penalties equaling 1.2 percent of their delinquent taxes under the proposed new safe harbor criteria. This percentage was applied to future years to estimate reductions in Delinquency Penalties that are due solely to the criteria for the safe harbors, not changes in taxpayer payment behavior.

To determine changes that would result from taxpayers increasing the amount of tax payments made by April 15, we used computer programs to determine the actual amount of Failure-to-Pay (FTP) Penalties and interest charges related to taxpayers who would be likely to change their payment behavior to comply with the new safe harbors. For these taxpayers, the actual FTP Penalties and interest were 5.5 percent and 7.6 percent, respectively, when compared to their total delinquent taxes. We, therefore, assumed that any increase in timely tax payments would reduce actual FTP Penalties by 5.5 percent of the payment amount and would reduce interest by 7.6 percent of the payment amount.

To determine the overall reductions in FTP Penalties and interest, we multiplied the amount of new April 15 revenue by these percentages for taxpayers increasing their payments to meet the new safe harbors. We then totaled all Delinquency Penalty decreases, FTP Penalty decreases, and interest decreases.

[3] 26 U.S.C. § 6654(d)(1)(B) (2000).

Table 5: Effect of New Safe Harbors on Penalty and Interest Assessments[4]

	2004	2005	2006	2007	2008	Totals
Total Delinquent Tax, All Post-April 15 Returns	$33.4	$39.3	$46.3	$54.5	$64.2	$237.7
Delinquency Penalty Decreases with New Safe Harbors	$0.4	$0.5	$0.6	$0.7	$0.8	$2.9
New Tax Payments by April 15 with New Safe Harbors	$1.8	$2.4	$2.8	$3.0	$3.4	$13.5
Decreased FTP Penalties with New Safe Harbors	$0.1	$0.2	$0.4	$0.5	$0.7	$2.0
Decreased Interest with New Safe Harbors	$0.1	$0.3	$0.5	$0.8	$1.0	$2.8
Total Decreased Interest and Penalties with New Safe Harbors	$0.6	$1.0	$1.5	$2.0	$2.5	$7.7

Source: TIGTA Analysis of IRS Master File Data

Funds Put to Better Use: To determine the IRS' processing cost savings, we relied on the IRS' projections of future extension volumes and the costs contained in the IRS' Cost Estimate Reference 3.30.10-40. The processing costs for Application for Automatic Extension of Time to File U.S. Individual Income Tax Return (Form 4868) were $0.65 each. We assumed the same processing costs for Application for Additional Extension of Time to File U.S. Individual Income Tax Return (Form 2688).

We assumed no reductions related to electronic filing of extensions since the volume of electronically filed extensions was immaterial during the period of our review and there is no clear incentive for taxpayers to file extension forms electronically in the future. Financial benefits for taxpayers to use electronic filing of extension forms is not evident from the fees advertised on the Internet for electronically filed extensions. In addition, the 2.5 percent "convenience fee" related to obtaining extensions via electronic payments is a possible impediment to future growth since it exceeds the amount of the FTP Penalty for taxpayers filing by August 15. Public recognition of the lack of savings from electronic filing of extension requests, in conjunction with the size of "convenience" fees, could lead to stagnated or decreased use of extension-related electronic filing in the future.

[4] Dollars in billions. Some items may not total due to rounding.

Table 6: Estimated Processing Cost Savings from Eliminating Extension Forms[5]

	2004	2005	2006	2007	2008	Totals
Forms 4868 Per IRS (Feb. 2002)	8.9	9.2	9.5	9.9	10.2	47.6
Forms 2688 Per IRS (Feb. 2002)	3.1	3.3	3.4	3.6	3.7	17.1
Total Extension Forms Filed	12.0	12.5	12.9	13.4	13.9	64.7
IRS Processing Cost ($0.65 each)	$7.8	$8.1	$8.4	$8.7	$9.0	$42.1

Source: TIGTA Analysis of IRS Data.

Taxpayer Burden: We assumed that, if a tax return with an extended due date was prepared by a paid tax preparer, any related extension forms were also prepared by paid preparers. We also assumed that extensions submitted for taxpayers who did not subsequently file returns would reflect the same proportions as on returns actually filed. We assumed that the proportions of self-prepared and professionally-prepared returns with extended due dates actually present on returns due on April 15, 1999, would be maintained in future years. Therefore, we assumed that 78 percent of all Forms 4868 were professionally prepared and 87 percent of all Forms 2688 were professionally prepared. We relied on the IRS' projections of extension volumes to determine the volume of extensions in future years. For reasons cited in discussing the IRS processing cost reductions, we assumed no burden reductions related to the electronic filing of extensions.

We assumed that taxpayers preparing and submitting their own extension forms would take the full 65 minutes that the IRS estimates as burden time for Forms 4868 and the full 46 minutes that the IRS estimates for burden time for Forms 2688 before the elimination of extensions. We further assumed that, after the elimination of 27 minutes for form preparation and mailing, these taxpayers would require only 38 minutes each year for estimating their taxes after the elimination of extension forms. We computed the taxpayer burden for self-prepared extensions by multiplying the hours expended on self-prepared extensions by the Office of Management and Budget hourly burden rate of $26.50 per hour. This calculation was performed for both pre-extension-elimination and post-extension-elimination hours.

[5] Volumes in millions, dollars in millions. Details may not add to totals due to rounding.

Table 7: Value of Taxpayer Time Saved by Eliminating Extension Forms[6]

	2004	2005	2006	2007	2008	Totals
Forms 4868 (Per IRS, Feb. 2002)	8.9	9.2	9.5	9.9	10.2	47.6
Forms 2688 (Per IRS, Feb. 2002)	3.1	3.3	3.4	3.6	3.7	17.1
Self-Prepared Forms 4868	1.9	2.0	2.1	2.2	2.2	10.5
Self-Prepared Forms 2688	0.4	0.4	0.4	0.5	0.5	2.2
Cost of Taxpayer Time to Request Extension with Forms 4868 (65 Minutes per Form, $26.50 Per Hour)	$56.0	$58.0	$60.1	$62.2	$64.3	$300.6
Cost of Taxpayer Time to Prepare Forms 2688 (46 Minutes Per Form, $26.50 Per Hour)	$8.2	$8.6	$9.0	$9.5	$9.9	$45.2
Total Cost of Self-Preparation Time with Current Regulations	$64.2	$66.6	$69.1	$71.7	$74.2	$345.8
Cost of Self-Preparation with Forms Elimination (38 Minutes per Extension per Year, $26.50 per Hour)	$32.7	$33.9	$35.1	$36.4	$37.6	$175.7
Reduction in Cost of Self- Preparation w/Forms Elimination	$31.5	$32.7	$34.0	$35.3	$36.6	$170.1

Source: TIGTA Analysis

We assumed that paid tax preparers would require only 30 minutes to prepare and submit extension forms prior to the elimination of the forms, and only 15 minutes to estimate a client's tax liability after the elimination of the form. We computed the cost of professional preparation by multiplying the number of hours expended by $38.07 per hour, which is the average gross income per employee hour for accounting firms, as reflected in 1999 statistics from the U.S. Census Bureau Statistical Abstract of the United States. This calculation was performed for both pre-extension-elimination and post-extension-elimination hours. We assumed that the cost of hours expended by paid tax preparers would be passed on to the taxpayer, either directly or as a component of the tax return preparation fees.

[6] Volumes in millions, dollars in millions. Details may not add to totals due to rounding.

Table 8: Estimated Tax Preparation Fee Reductions From Eliminating Extension Forms[7]

	2004	2005	2006	2007	2008	Totals
Paid Preparer Extension Forms Under Current Regulations	9.6	10.0	10.4	10.8	11.2	52.0
Extension Preparation Fees Under Current Regulations (30 Minutes Per Form, $38.07 Per Hour)	$183.1	$190.5	$197.9	$205.6	$213.0	$990.1
Taxpayers Using Paid Preparers	6.9	7.2	7.4	7.7	7.9	37.1
Fees with Form Elimination (15 Minutes Per Client, $38.07 Per Hour)	$65.8	$68.2	$70.6	$73.1	$75.5	$353.3
Fee Reduction With Extension Form Elimination	$117.3	$122.3	$127.3	$132.4	$137.4	$636.8

Source: TIGTA Analysis

To determine the number of taxpayers impacted by the elimination of extension forms, it was necessary to compensate for taxpayers filing extensions in multiple years. To do so, we relied on our computer extract of IRS records that contained four years of account data on each taxpayer who filed TY 1998 tax returns after the April 15, 1999, deadline (regardless of whether or not they obtained an extension for TY 1998). We determined the frequency of extension use for each taxpayer in the extract who had obtained an extension in at least 1 of the 4 years from Calendar Years 1998 through 2001. This analysis, in conjunction with IRS projections of future extension filing, was used to estimate the number of taxpayers who would experience reduced extension form preparation fees or reduced self-preparation time following the elimination of extension forms.

[7] Volumes in millions, dollars in millions. Details may not add to totals due to rounding.

Table 9: Estimated Number of Taxpayers Affected by Eliminating Extension Forms[8]

Extensions Filed by Taxpayer in Four Years:	**One**	**Two**	**Three**	**Four**	**Totals**
Tax Return Filers in 1999 Filing at Least One Extension from 1998 through 2001	1.8	1.4	1.4	1.9	6.5
Extensions Obtained (1998 to 2001)	1.8	2.9	4.1	7.8	16.5
Percentage of All Extensions	11%	18%	25%	47%	100%
Percentage of Years in Which Extension Obtained From 1998 Through 2001	25%	50%	75%	100%	N/A
Average Extensions Per Taxpayer in Five Years	1.25	2.5	3.75	5.0	N/A
Extensions To Be Filed 2004 to 2008 (47.6 million total per IRS projections of Form 4868 volumes)	5.1	8.4	11.7	22.4	47.6
Taxpayers Filing Extensions from 2004 to 2008 (total extensions divided by average extensions per taxpayer)	4.1	3.3	3.1	4.5	15.1
Percentage of Taxpayers with Paid Preparer in 1999	70%	77%	77%	81%	N/A
Taxpayers with Paid Preparer Affected	2.9	2.6	2.4	3.6	11.5
Other Taxpayers Affected	1.2	0.8	0.7	0.8	3.6

Source: TIGTA Analysis

[8] Volumes in millions (except averages which are whole numbers). Details may not add to totals due to rounding.

Appendix V

Implications of Recommendations on the Federal Government's Budget Process

This appendix presents detailed information on the measurable impact that our recommended actions will have on additional funds available for the Federal Government's use from 2004 through 2008. Increasing tax revenues or decreasing refund outlays in a fiscal year makes additional funds available for the Government's use. However, since such benefits are not expressly addressed in the Inspector General Act,[1] the following measurable benefits of our recommendations will not be listed in our Semiannual Report to the Congress as funds put to better use.

Type and Value of Benefits:

- Accelerated Tax Revenues – Potential; $8.2 billion (see page 3). Changes in taxpayer payment patterns that increase current year tax revenues.
- Delayed Refund Outlays – Potential; $6.8 billion (see page 3). Changes in taxpayer filing patterns that delay certain refund outlays, thus decreasing expenditures of current year tax revenues.

Methodology Used to Measure the Reported Benefits:

The following is a general summary of the methodologies used to measure the reported benefits. All references to "taxpayers" and "returns" are to *individual taxpayers* and *individual income tax returns*, respectively. All references to 1999 are to extensions granted, returns due, payments made, or returns filed for Tax Year (TY) 1998. All references to 2001 are to extensions granted, returns due, payments made, or returns filed for TY 2000.

Accelerated Tax Revenues: As discussed in Attachment IV, we estimated the increased amount of taxes that would be paid by April 15 by taxpayers seeking to comply with the safe harbor requirements recommended in this report. We used computer programs to determine that 61.0 percent of the delinquent taxes that exceeded the safe harbor requirements were not paid by the end of Fiscal Year 1999. This percentage was applied to subsequent fiscal years to determine the amount of accelerated tax receipts that would represent increases in revenue in the fiscal years in which the taxes were actually due. We computed both annual gross and incremental increases in current-fiscal-year revenues in recognition that increases in current-year receipts cause a corresponding decrease in the subsequent fiscal year.

[1] 5 U.S.C. Appx. § 5 (2003).

Table 10: Changes in Taxpayer Payments Due to Proposed New Safe Harbors[2]

	2004	2005	2006	2007	2008	Totals
New Tax Payments by April 15 with Proposed Safe Harbors	$1.8	$4.3	$7.0	$10.0	$13.5	$36.6
New Current Year Tax Revenue with Proposed Safe Harbors	$1.1	$2.6	$4.3	$6.1	$8.2	$22.3
Annual Incremental Increases in Current-Year Revenue	$1.1	$1.5	$1.7	$1.8	$2.1	$8.2

Source: Treasury Inspector General for Tax Administration (TIGTA) Analysis of Internal Revenue Service (IRS) Master File Data

Delayed Refund Outlays: We determined by computer analysis that 39.4 percent of the taxpayers with extended due dates who filed returns for TY 1998 filed refund returns with an August 15, 1999, extended due date. This percentage was applied to the estimated volume of returns with extended due dates for future years to estimate the volume of August 15 refund returns each year.

For taxpayers with extensions who filed refund returns, we used computer programs to determine the number of refund returns filed between April 24, 2001, and August 7, 2001, that had an August 15 due date. We determined the average daily volume and assumed that refund returns in excess of this average filed within one week before or after August 15 were from taxpayers who were motivated to file by the filing deadline rather than being motivated by quickly obtaining a refund. We assumed that, if October 15 became the only extended due date, the taxpayers would again procrastinate filing their returns until within one week before or after the new filing deadline, thereby delaying those refund outlays until the fiscal year following the one in which the refunds could actually have been claimed.

The volume of taxpayers who could be expected to file on October 15, 2001, rather than August 15, 2001, represented 21.6 percent of all taxpayers who filed refund returns on August 15, 2001. This percentage was applied to the volumes of estimated August 15 refund filers to determine the number of taxpayers who would likely change filing dates in each future year if October 15 became the sole extended due date.

To determine the amount of delayed refund outlays, the taxpayer volume was multiplied by the average refund amount on extended due date August 15 refund returns. The average refund amount was based on the 1999 average of $4,496, increased annually by one half of the actual 2-year 18.5 percent increase in average extended due date August 15 refunds between 1999 and 2001. We computed annual incremental decreases in current year refund outlays in recognition

[2] Dollars in billions (except averages, which are whole dollars). Details may not add to totals due to rounding.

that decreases in current year outlays cause a corresponding increase in outlays in the subsequent fiscal year.

Table 11: Estimated Changes in the Timing of Refund Requests With October 15 as the Sole Extension Date[3]

	2004	2005	2006	2007	2008	Totals
Refund Filers with August 15 Extended Due Date	2.7	2.9	3.0	3.1	3.2	14.9
Average Refund Amount for August 15 Refund Filers	$6,955	$7,600	$8,305	$9,075	$9,917	N/A
August 15 Refund Filers Expected to Delay Filing to October 15	0.6	0.6	0.6	0.7	0.7	3.2
Total Decrease in Current-Year Refund Outlays	$4.2	$4.7	$5.3	$6.0	$6.8	$27.1
Annual Incremental Decrease in Current-Year Refund Outlays	$4.2	$0.6	$0.6	$0.7	$0.8	$6.8

Source: TIGTA Analysis of IRS Master File Data

[3] Volumes in millions, dollars in billions (except averages, which are whole dollars). Details may not add to totals due to rounding.

Appendix VI

Historical Perspective on Extensions of Time to File Returns

The primary function of filing extension requests with the Internal Revenue Service (IRS) is to protect those taxpayers filing after April 15 from the Delinquency Penalty on any tax underpayments. Prior to 1993, IRS regulations permitted the granting of extensions only to those taxpayers who attested, under penalty of perjury, that their taxes had been paid by April 15. In 1989, an IRS task force pointed out that many taxpayers provided inaccurate information about their tax payments on the extension requests in order to obtain protection from the Delinquency Penalty. A 1989 Tax Court decision[1] upheld the right of the IRS to consider void any extension granted under such conditions and to retroactively assess the Delinquency Penalty.

The IRS task force recommended automatically voiding extensions and assessing the Delinquency Penalty against any taxpayer who had not paid sufficient taxes by April 15, as determined by computer analysis of payments posted to the taxpayer's IRS account. Fully paid and overpaid taxpayers would not be affected because the Delinquency Penalty is assessed only as a percentage of any tax underpayments. Thus, the IRS task force proposal paved the way for the elimination of the extension forms since they served no purpose for compliant taxpayers and would no longer prevent assessment of the Delinquency Penalty against underpaid taxpayers.

The proposal resulted in strenuous objections from the tax preparer community. For example, one organization of tax return preparers informed the IRS that, *"We feel, based on our experience with our own clients, that there would be a significant number of taxpayers who would be retroactively assessed failure to file[2] penalties under the proposed rules."* [Our current review confirmed that this is a significant issue for tax return preparers. Returns completed by paid preparers accounted for 88 percent of all late tax payments reported on Tax Year 1998 individual income tax returns with extended due dates.] In response to the pressure from the paid tax preparer community, IRS management cancelled its plans to strengthen its enforcement of the Delinquency Penalty and cancelled its plans to eliminate the extension forms.

In 1992, the IRS Inspection Service (now the Treasury Inspector General for Tax Administration), citing $5.5 billion in tax underpayments by taxpayers with extended due dates, urged IRS management to reconsider their decision and implement the strengthened compliance efforts.[3] IRS management responded to the draft report in November 1992 by committing to increased compliance efforts only on a case-by-case basis. The plans for these compliance efforts were abandoned in December 1992.

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[1] O.B. Crocker, 92 T.C. No. 57.

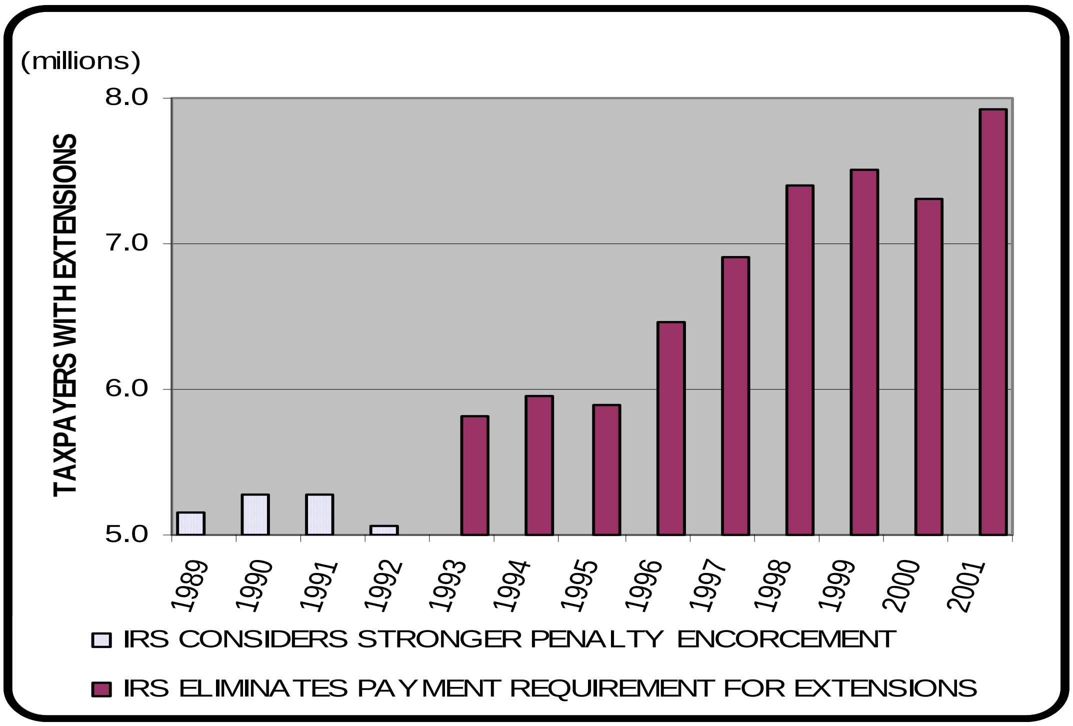
[2] The Delinquency Penalty is also known as a Failure-to-File Penalty, although it could be applied to less than one-third of taxpayers who failed to file timely in Calendar Year 1999.

[3] *Follow-Up Review: The Processing of Extensions of Time to File* (Reference No. 030303, dated April 5, 1993).

In April 1993, the IRS publicly announced that it would grant extensions of time to file regardless of whether taxpayers had paid their taxes.[4] Thus, there was no longer a need for taxpayer deception regarding payment compliance in order to receive an extension, no need to void extensions based on underpayments, and no need to retroactively assess the Delinquency Penalty.

Figure 7 demonstrates the increase in extension use following the 1993 decision.

Figure 7. Volume of Extensions, 1989-2001



Source: IRS Compliance Research Division.

In 1995, the IRS studied the impact of its new extension policy. The resulting report contained statistics indicating that there had been an immediate 12.8 percent increase in extension filings with virtually no change in the number of compliant taxpayers with extensions who had paid their taxes by April 15. There had also been, however, an immediate 27.6 percent increase in underpaid returns with extended due dates.

Based on this information, the IRS National Director, Submission Processing, concluded that, *"The data suggest that the decision to not require payment with the extension has had very little to no effect. The extension filing and payment patterns seem to have remained relatively unchanged."* In reference to whether the new extension policy encouraged more taxpayers to

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[4] Notice 93-22, 1993-1 C.B. 305, April 7, 1993.

file returns, the Director stated *"Did the decision bring more people into the system? Once again, it's difficult to say from the data above."*

The Director recommended that the Office of Chief Counsel proceed with regulatory changes (submitted to IRS officials for comment in the previous year) to make the new extension policy permanent. Temporary regulations to make the IRS' administrative policy official were issued in January 1996[5] and public comment was invited.

The new regulations, which also eliminated the requirement for taxpayers to sign the extension forms under the penalties of perjury, were issued in final form in December 1996,[6] following the consideration of public comments. One national organization of tax preparers commented that the change was welcome because, *"Even when full payment was required, in most cases, the collection process could be delayed by two to four months by filing an extension without payment. We do not believe there is anything wrong with this since the government was well-compensated for any delay in payment by interest and the penalty for late payment."* For perspective, it should be noted that interest and the Failure-to-Pay Penalty, as of January 2003, now total just 5.5 percent of underpaid taxes for a taxpayer with a 6-month extension.

In 1998, an IRS task force, under the auspices of the Vice President of the United States and the Treasury Secretary,[7] recommended that the IRS conduct a study to consider eliminating extension filing for taxpayers who had paid all taxes by April 15. The IRS assembled a study group in response to the recommendation. The member of the study group from the Office of Chief Counsel advised against proposing the re-establishment of payment requirements for extensions and recommended expanding electronic filing options for extensions rather than eliminating the filing of extension forms.

The study group's report,[8] issued in June 1999, recommended that extension filing continue, extension regulations remain unchanged, and taxpayer burden be reduced by expanding electronic filing options. The report rejected the possibility of re-establishing penalties for tax underpayments, stating that paying the proper amount of taxes by April 15 *"was, and will continue to be a major problem for a small, but well-connected, segment of the public."* In rejecting the elimination of extension filing for compliant taxpayers, the report stated that, *"We consider the benefits of the current system also outweigh the inconvenience to the taxpayer."*

The Assistant Commissioner (Forms and Submission Processing), the then IRS executive responsible for processing extension requests, rejected the recommendations of the study group when transmitting it to other IRS offices for their comments on July 1, 1999. Among the objections of this IRS executive was that the recommendations were based on *"potential, but unquantifiable, adverse impacts on compliance."* The IRS executive stated his intention to

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[5] 61 FR 260, TD 8651, January 4, 1996.
[6] 61 FR 69027, TD 8703, December 31, 1996.
[7] Reinventing Service at the IRS, Publication 2197 (3-98), Catalog Number 25006E.
[8] Study on the Feasibility of Eliminating the Requirement to File Application for Automatic Extension of Time to File U.S. Individual Income Tax Return (Form 4868) Except When a Payment is Due (June 18, 1999).

eliminate extension filing by saying *"I believe, however, that the potential benefits to taxpayers and the Service far outweigh the possible problems that could arise from revising the extension filing requirements. I am, therefore, proposing to proceed with the actions necessary to revise extension filing requirements unless there are compelling reasons to keep the current requirements."*

Three months later, the responsibility for planning new extension filing alternatives was re-assigned to the then Assistant Commissioner (Electronic Tax Administration). The IRS continues to pursue expansion of electronic filing options for easing the burden of extensions.