Stronger Sanctions Are Needed to Encourage Timely Filing of Pass-Through Returns and Ensure Fairness in the Tax System

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DEPARTMENT OF THE TREASURY
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INSPECTOR GENERAL
for TAX
ADMINISTRATION

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MEMORANDUM FOR COMMISSIONER, LARGE AND MID-SIZE BUSINESS DIVISION
COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED DIVISION

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Stronger Sanctions Are Needed to Encourage Timely Filing of Pass-Through Returns and Ensure Fairness in the Tax System (Audit # 200430010)

This report presents the results of our review of the filing compliance of pass-through business taxpayers. The overall objective of this review was to determine whether the existing laws, tax regulations, and Internal Revenue Service (IRS) policies and practices are adequate, effective, and fair for promoting filing compliance among pass-through businesses. Although pass-through businesses such as partnerships[1] and S corporations[2] are not subject to income taxes, they have a significant impact on tax administration. For Tax Year (TY) 2001, over 2.1 million partnerships passed through total net income of more than $276.3 billion to their individual partners. For the same year, almost 3 million S corporations passed through nearly $200 billion in net income to their individual shareholders.

In summary, we found filing noncompliance by partnerships and S corporations is at an unacceptably high level, the effectiveness of penalties intended to prevent such noncompliance has been eroded by inflation and is generally not applicable to

[1] An unincorporated business organization in which two or more entities, called general partners, manage the business and are equally liable for its debts.
[2] A small business corporation can elect to be taxed as an S corporation if all of its shareholders consent. This election enables the business to avoid corporate income taxes by, in effect, being taxed in the same manner as a partnership. These businesses are called S corporations because Subchapter S of the Internal Revenue Code provides for such tax treatment.

S corporations, and the noncompliance by pass-through businesses adversely affects the compliance of partners and S corporation shareholders.

The incidence of late-filed returns, measured as a percentage of total returns filed, is nearly 2 to 4 times higher among partnerships and S corporations, respectively, than it is among individual taxpayers. Further, the incidence of late-filed partnership and S corporation returns is rapidly growing. Between Calendar Years (CY) 2000 and 2003, the number of late-filed partnership returns increased from almost 167,000 to approximately 203,000, or 22 percent.[3] During the same 4-year period, the growth in late-filed S corporation returns was 28 percent, increasing from about 450,000 for CY 2000 to approximately 577,000 for CY 2003. Among the pass-through businesses filing a late return for TY 2001, 21 percent of the partnerships and 33 percent of the S corporations had also filed at least 1 other return late between CYs 2000 and 2003.

Late-filed partnership and S corporation returns can have an adverse effect on the filing and reporting compliance of the individual partners and shareholders. Our computer analysis of TY 2001 tax return data for more than 817,000 individual partners and shareholders indicates that the late filing of returns by the pass-through businesses may have contributed to (1) 49 percent of the individual partners and shareholders obtaining an extension of time to file their individual income tax returns, (2) 108,587 late-filed individual income tax returns, and (3) over $1 billion in distributed ordinary income from late-filing businesses not being reported on individual income tax returns. We estimate that up to $354 million in individual income taxes may not have been paid on this unreported pass-through income.

The tax laws, tax regulations, and Revenue Procedures need strengthening to provide the IRS with the appropriate tools to encourage improved filing compliance by pass-through businesses and to ensure fairness in the tax system is provided for all similarly situated pass-through businesses. The tools currently available to the IRS to improve filing compliance among pass-through businesses are inadequate for a variety of reasons.

First, the Revenue Procedures allow partnerships made up of 10 or fewer partners that file late returns to qualify for reasonable cause exceptions and have the late-filing penalties abated. Since 182,235 (97 percent) of the 187,744 partnerships that filed a late return for TY 2001 met the criteria of 10 or fewer partners, the vast majority of partnerships that file late returns either are not assessed delinquency penalties or have the penalties subsequently abated by the IRS. Only 30,665 (16 percent) of the 187,744 partnerships that filed their TY 2001 returns late actually incurred a financial cost for their noncompliance.

Second, the tax system is not fair in that the law provides no penalty for late-filed S corporation returns, whereas the law does provide penalties when other types of returns are filed late. For TY 2001, the total operating profits reported on late-filed

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[3] Except when used in performing calculations, all percentages expressed in this report are rounded to the nearest whole number.

S corporation returns exceeded those on late-filed partnership returns. The average shareholder's pass-through share of the operating profits from late-filing S corporations was more than double that for late-filing partnerships, and S corporations filed nearly 2.7 times more late returns than partnerships.

Third, the 5-month limit on the penalty for late-filed partnership returns does not allow the IRS to address the most egregious filing delays. For TY 2001, 27 percent of the late-filed partnership returns were delinquent by more than 5 months, including 6 percent that were delinquent by more than 1 year.

Fourth, the tax law provides no penalties for the late submission of payee statements[4] to the IRS by partnerships or S corporations. Delays in receiving payee statements can needlessly delay or complicate the IRS' process of matching reported income to individual income tax returns, consuming limited resources of the IRS that could be more effectively used for other activities.

In addition, the burden of proof is on the IRS to show pass-through businesses that file late returns also untimely distributed payee statements to their partners and shareholders. As a result, the IRS could not routinely assess any penalties[5] for the late distribution of payee statements to the 1.7 million partners and shareholders in pass-through businesses that filed a late return for TY 2001, even though many of these taxpayers likely did not receive payee statements in time to timely and accurately report $36 billion in operating profits or other items of income or loss on their tax returns.

Finally, the deterrent effect of the various fixed-dollar penalties provided by law for the late filing of pass-through returns and payee statements has eroded over time. For instance, the $50 (per partner per month) penalty for a late-filed partnership return, established by the Congress in 1978, was worth only $17.22 in 2004 dollars.

To address these issues, we recommended the Commissioner, Large and Mid-Size Business Division, and the Commissioner, Small Business/Self-Employed Division (SB/SE), coordinate with the Office of Chief Counsel to amend the tax regulations and/or develop legislative proposals for the IRS Commissioner to submit to the Department of the Treasury. The regulatory and statutory changes we recommended would eliminate the automatic "reasonable cause" exception for late-filed partnership returns involving 10 or fewer partners; more severely restrict or eliminate the reasonable cause exceptions for late-filing penalties for partnership returns filed after the extended due date; and make the penalty for late-filed returns applicable to S corporations as well as partnerships. The changes would also remove the 5-month limitation on the number of months of delinquency the late-filing penalty is assessed on partnership returns; permit the IRS, when a partnership or an S corporation return is filed late, to

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[4] A partnership return includes a Partner's Share of Income, Credits, Deductions, etc. (Schedule K-1) that must be provided to each partner on or before the due date of the partnership return. Similarly, an S corporation is required to provide a Shareholder's Share of Income, Credits, Deductions, etc. (Schedule K-1) to each shareholder on or before the day on which the S corporation is required to file its return.

[5] 26 U.S.C. § 6722 (2003) provides for a penalty of $50 for each payee statement that is not timely provided to an investor in a partnership or an S corporation.

automatically assess the penalty for the failure to timely furnish payee statements to the IRS; permit the IRS, when a partnership or an S corporation return is filed more than 7 days after the return due date, to automatically assess a penalty for the failure to timely provide payee statements to the individual partners or shareholders; and increase the penalty applicable to late-filed returns and payee statements from $50 to $200 (at a minimum) to compensate for inflation. In summary, these steps would result in the assessment of penalties totaling $600 per investor for the first month of filing delinquency for a pass-through business and an additional $200 penalty per investor for each additional month of filing noncompliance. We further recommended the Commissioner, SB/SE Division, conduct a study to determine whether fixed-dollar penalties set at a $200 level in Internal Revenue Code (I.R.C.) Sections (§§) 6698, 6721, and 6722[6] will be effective in ensuring future compliance or whether other penalty types and/or higher amounts would be more effective.

Management's Response: The Commissioner, SB/SE Division, disagreed with our recommendation to eliminate reasonable cause exceptions that are based solely on the number of partners in a partnership. The Commissioner stated the existing statutory provision does not permit a partnership composed of a certain number of partners to automatically avoid the I.R.C. § 6698 penalty; Revenue Procedure 84-35[7] was issued to provide the reasonable cause exceptions consistent with Congressional intent. The Commissioner believes our recommendation essentially called for the reversal of Revenue Procedure 84-35. The Commissioner stated this Revenue Procedure provides for a reasonable cause standard to apply when a partnership has 10 or fewer partners, all of whom have included their share of the partnership income in their income tax returns. If any partner fails to correctly or timely file his or her individual income tax return, the partnership would not be entitled to the reasonable cause exception. The Commissioner believes this Revenue Procedure actually encourages partners to correctly and timely file individual returns so their partnership may qualify for the reasonable cause exception.

The Commissioner, SB/SE Division, disagreed with our recommendation to eliminate reasonable cause exceptions for late-filing penalties when a partnership files its return after the extension date has passed. The Commissioner believes the reasoning in the report is that an entity that receives an extension of time to file, then fails to file by the extended due date, has committed "repetitive noncompliance." However, under current law, a partnership that is granted an extension of time to file is in compliance with the law. A partnership that received an extension of time to file a return and nevertheless filed an inaccurate or untimely return may still meet the reasonable cause exception of the I.R.C. The fact that the partnership files its return after the extension of time to file has passed has no bearing on whether the partnership is entitled to the reasonable cause exception. The failure to file a timely or correct return after receiving an extension to file does not represent a repetitive act of noncompliance. The

[6] 26 U.S.C. § 6698 (2003); 26 U.S.C. § 6721 (2003); 26 U.S.C. § 6722 (2003).
[7] Rev. Proc. 84-35, 1984-1 C.B. 509.

Commissioner further stated there was a lack of information or statistics to demonstrate that adopting this recommendation would result in increased compliance.

The Commissioner, SB/SE Division, stated the decision to implement any of the remaining recommendations requires not only further study but also input and concurrence from the Department of the Treasury Office of Tax Policy. The Commissioner, SB/SE Division, stated the IRS will consult with the Department of the Treasury Office of Tax Policy regarding the value and merit of conducting a study of the current penalty structure, related to the filing of pass-through returns, to determine if changes to the levels and types of penalties would be effective in increasing filing compliance. The decision as to whether to take further action will be made jointly with the Department of the Treasury.

The Commissioner, SB/SE Division, stated that, after reviewing the potential benefits described in Appendix IV of the report, it appeared two important points have not been fully considered. First, the majority of the outcome measures are the result of proposed increases in penalties. If the IRS adopts the audit recommendations, the objective should be to improve the timeliness of pass-through return filings. If the IRS is more effective in improving filing compliance, there would be fewer penalties assessed, thus there would be decreases in the outcome measures results over time. Second, and even more fundamental, the IRS believes penalties should be viewed as a means to encourage compliance, not as a means to raise revenue. Management's complete response to the draft report is included as Appendix V.

Office of Audit Comment: We continue to have concerns about the IRS' efforts to encourage filing compliance for pass-through businesses. First, regarding our recommendation to eliminate reasonable cause exceptions that are based solely on the number of partners in a partnership, we agree it is IRS Revenue Procedure 84-35, not I.R.C. § 6698, that permits 97 percent of late-filing partnerships to potentially qualify for reasonable cause exceptions to the I.R.C. § 6698 late-filing penalty based solely upon the number of partners. However, we disagree that the Revenue Procedure reflects the intent of the Congress when it established the late-filing penalty present in I.R.C. § 6698.

While the IRS contends reasonable cause exceptions are available only when all partners have timely and accurately reported their pass-through income, if a partnership claims that its partners have met this requirement, the burden of proof for establishing the veracity of such a statement is effectively shifted to the IRS. As this is an unreasonable and costly administrative burden for the IRS to undertake on a universal basis, it is unlikely the IRS will challenge the assertion of compliance by a pass-through business except under extraordinary circumstances. Furthermore, we do not believe the number of partners participating in a partnership accurately reflects the economic ramifications of late filing by the partnership. As demonstrated on page 18 of the report, the highest economic ramifications are reflected in partnerships with the fewest number of partners. For these reasons, we continue to believe the IRS should seek Congressional assistance in codifying in the I.R.C. the proper basis for exceptions to the I.R.C. § 6698 penalty.

Second, regarding our recommendation to eliminate reasonable cause exceptions for partnerships that file after their extended due dates, we agree that obtaining an extension of time to file does not represent a violation of tax law. While our discussion on pages 6 through 8 provided examples of flagrant noncompliance as well as examples of repetitive noncompliance, it was Figure 6 that demonstrated the repetitive noncompliance of pass-through businesses over several years. The data presented in Figure 4 regarding businesses with extended due dates covered only 1 year and demonstrated that 45 percent of late-filed partnership returns and 38 percent of late-filed S corporations returns had failed to file by their extended due dates. While these are not repetitive acts of noncompliance, they are multifaceted acts of noncompliance. We believe failure by a pass-through business to file a timely return after being granted the privilege of an extension of time to file simultaneously demonstrates a failure to honor the terms of the extension privilege, a lack of respect for the statutes that require the timely filing of returns, and a lack of concern for the ability of its partners or shareholders to be able to file timely and accurate returns. Although the IRS stated such failures meet the reasonable cause exception of the I.R.C., as the IRS pointed out in its response, it is Revenue Procedure 84-35, not the I.R.C., that provides for the reasonable cause exceptions. For these reasons, we believe the IRS should seek Congressional assistance in codifying in the I.R.C. the proper basis for exceptions to the I.R.C. § 6698 penalty.

We are encouraged the IRS plans to discuss with the Department of the Treasury whether to study the remaining recommendations that would increase various fixed-dollar penalties from the current $50 level to $200 to counteract inflation that has occurred since the establishment of the current penalty levels; remove the 5-month limit on the assessment of the I.R.C. § 6698 penalty; subject S corporations to the I.R.C. § 6698 penalty; subject partnerships and S corporations to penalties for not filing timely Schedules K-1 with the IRS; and simplify the assessment criteria for failure to timely provide Schedules K-1 to partners or S corporation shareholders.

However, from preliminary discussions it was our understanding that these recommendations would receive prompt attention and that further study would involve only determinations of whether fixed-dollar penalties set at a $200 level, in accordance with our recommendations, would be sufficient to achieve and maintain filing compliance among pass-through businesses. The IRS written response indicates no changes in the treatment of late-filing pass-through businesses will be acted upon unless it is decided that a future study is warranted. We believe the need for at least some immediate action is highlighted on page 25 of the report, where we point out that the $50 late-filing penalty for partnerships established by the Congress in 1978 had the economic equivalent of only $17.22 in 2004. Given the serious levels of noncompliance discussed in the report, we believe immediate action, not potential future study, is warranted.

Finally, regarding IRS concerns about the revenue that would be generated by our recommendations, we agree with the IRS that penalties should be viewed as a means to encourage compliance. As was discussed in the IRS Penalty Policy Statement

P-1-18, additional revenue is a by-product of the effort to achieve voluntary compliance, not a goal in itself. We also agree that such additional revenue will decrease over time as compliance improves. It is for that reason that increasing compliance and decreasing penalty revenues were reflected in the computations supporting our outcome measures in Table 4 of report Appendix IV.

While we still believe all of our recommendations are worthwhile, we do not intend to elevate our disagreement concerning these matters to the Department of the Treasury for resolution.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Philip Shropshire, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs), at (215) 516-2341.

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Background

Certain businesses that are not subject to income tax, such as partnerships and small business corporations, are often referred to as "pass-through" or "flow-through" entities. In general, this means that the profits or losses from these businesses pass through to the individual partners or shareholders who must report their shares of the profits or losses on their U.S. Individual Income Tax Returns (Form 1040).

A partnership is a type of unincorporated business organization in which two or more individuals or businesses join to carry on a trade or business, with each partner contributing money, property, labor, or skill and each expecting to share in the profits and losses of the business. Partnerships are required by Internal Revenue Code (I.R.C.) Section (§) 6031(a)[1] to file a return for each taxable year. The normal due date for domestic partnerships to file a U.S. Return of Partnership Income (Form 1065) is the 15th day of the 4th month following the close of the tax year of the partnership.[2]

A small business corporation can elect to organize as an S corporation[3] if all of its shareholders consent.[4] As is the case with partnerships, the election to organize in this manner results in taxes on the business profits being paid by the shareholders. I.R.C. § 6037(a)[5] requires an S corporation to file a return for each taxable year. The normal due date for filing a U.S. Income Tax Return for an

[1] 26 U.S.C. § 6031(a) (2003).
[2] Generally, partnerships that need more time to file a return may request an automatic 3-month extension by filing an Application for Automatic Extension of Time To File U.S. Return for a Partnership, REMIC, or for Certain Trusts (Form 8736) by the regular due date of the partnership return. An additional 3-month extension can be obtained by filing an Application for Additional Extension of Time To File U.S. Return for a Partnership, REMIC, or for Certain Trusts (Form 8800).
[3] These businesses are called S corporations because I.R.C. Subtitle A, Chapter 1, Subchapter S, provides for such tax treatment.
[4] To qualify as an S corporation, a small business corporation must not have more than 75 shareholders, must not have corporate shareholders, must not have nonresident aliens as shareholders, and must not have more than 1 class of stock.
[5] 26 U.S.C. § 6037(a) (2003).

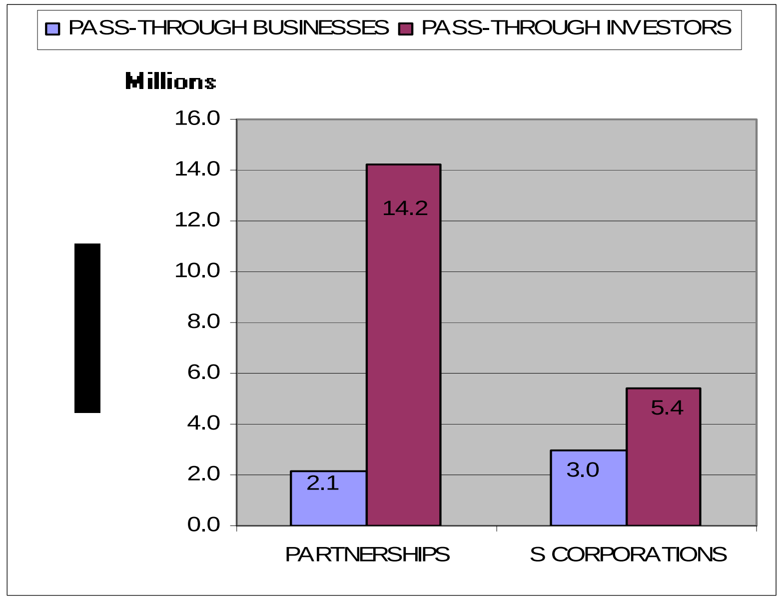
S Corporation (Form 1120S) is the 15th day of the 3rd month following the close of the corporation's tax year.[6]

Partnerships and S corporations have a significant impact on tax administration. From 1994 to 2001, the number of partnerships increased by an average of 5 percent[7] per year. For Tax Year (TY) 2001, Figure 1 shows there were over 2.1 million partnerships with a total of more than 14.2 million partners. These partnerships had total assets of $8.4 trillion. In addition, the returns filed by these partnerships passed through total net income of more than $276.3 billion to their individual partners. For the same year, Figure 1 shows there were almost 3 million S corporations that had a total of nearly 5.4 million shareholders. The returns filed by these S corporations passed through nearly $200 billion in net income to their individual shareholders.

[6] An S corporation may request an automatic 6-month extension of time to file Form 1120S by submitting an Application for Automatic Extension of Time To File Corporation Income Tax Return (Form 7004) to the IRS by the normal tax return due date.

[7] Except when used in performing calculations, all percentages expressed in this report are rounded to the nearest whole number.

Figure 1: Number of Pass-Through Businesses TY 2001



Source: Internal Revenue Service (IRS) Statistics of Income (SOI) function reports.

This review was performed during the period April through October 2004 in accordance with *Government Auditing Standards*. We did not visit any IRS offices to perform this audit. Instead, we computer-analyzed the IRS Business Master File (BMF)[8] to identify those partnerships and S corporations with 1 or more late-filed[9] returns during the 4-year period of Calendar Years (CY) 2000 through 2003.[10] We did not test management controls since they were not significant to our audit objective. Some of the data used in this report came from various IRS reports. We did not verify the accuracy of the information from those sources.

Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

[8] The IRS database that consists of Federal tax-related transactions and accounts for business taxpayers.
[9] Throughout this report, a late-filed return refers to one received by the IRS after the normal due date or extended due date, if applicable.
[10] Involves returns for TYs 1999 through 2002.

Stronger Sanctions Are Needed to Encourage Timely Filing of Returns by Pass-Through Businesses

The incidence of late-filed returns is significantly higher among partnerships and S corporations than it is among individual taxpayers. The number of returns filed late by partnerships and S corporations is also growing at a rapid pace and frequently involves flagrant and repetitive noncompliance.

Late-filed partnership and S corporation returns can have an adverse effect on the filing and reporting compliance of the individual partners and shareholders. For TY 2001 alone, over $1 billion in pass-through income from late-filed partnership and S corporation returns was not reported on individual income tax returns. We estimate that nearly $354 million in individual income taxes was not paid on this unreported pass-through income.

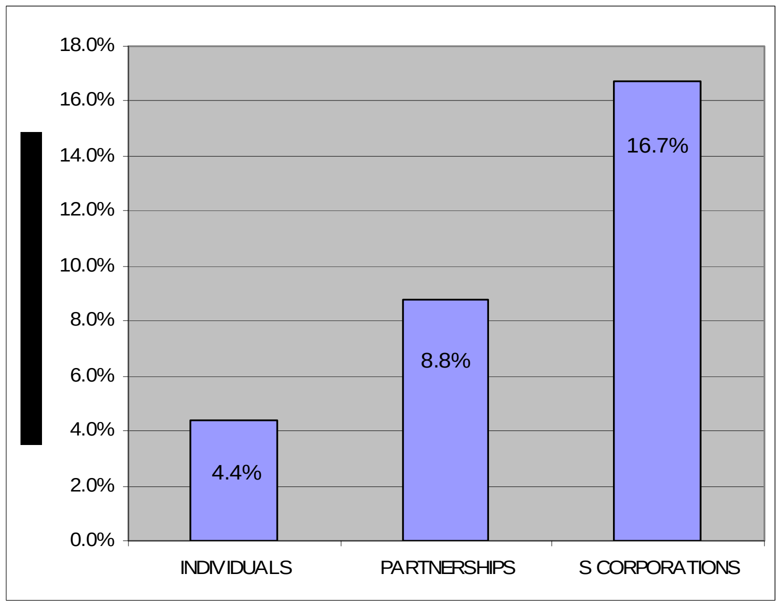
The existing tax laws, tax regulations, and Revenue Procedures need strengthening to provide the IRS with the appropriate tools to encourage improved filing compliance by pass-through businesses and to ensure fairness in the tax system is provided for all similarly situated pass-through businesses. Under the existing tax laws and regulations, delinquency penalties are successfully avoided by most late-filing partnerships and are not even imposed on late-filing S corporations. In addition, the delinquency penalties that are charged to late-filing partnerships have little deterrent effect and do not impose significant costs on egregious noncompliance.

The late filing of returns by pass-through businesses is a large and significantly growing problem

According to IRS statistics for TY 2001, partnerships and S corporations passed through the following tax-altering items to their owners: $471 billion in profits and $215 billion in losses from business operations, $86 billion in profits and $37 billion in losses from real estate rentals, $97 billion in interest income, $26 billion in dividend income, $57 billion in net capital gains, and $25 billion in other net income.

The timeliness of the reporting of such large sums to the owners of the pass-through businesses has significant tax implications. However, nearly 188,000 partnerships and nearly 500,000 S corporations filed returns for TY 2001 after their due dates (as extended). As shown in Figure 2, the late-filing rate for partnership returns, measured as a percentage of total returns filed, was twice that of individual income tax returns, while the late-filing rate for S corporation returns was nearly four times as high as that of individual returns.

Figure 2: Comparison of Late Return Filing Rates Among Individuals, Partnerships, and S Corporations TY 2001[11]



Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of IRS Individual Master File (IMF)[12] and BMF data.

Further, the incidence of late-filed partnership and S corporation returns is rapidly growing. Between CYs 2000 and 2003, the number of late-filed partnership returns increased from almost 167,000 to approximately 203,000, or 22 percent. During the same 4-year period, the growth in late-filed S corporation returns was even higher, increasing by 28 percent from about 450,000 in CY 2000 to approximately 577,000 in CY 2003.

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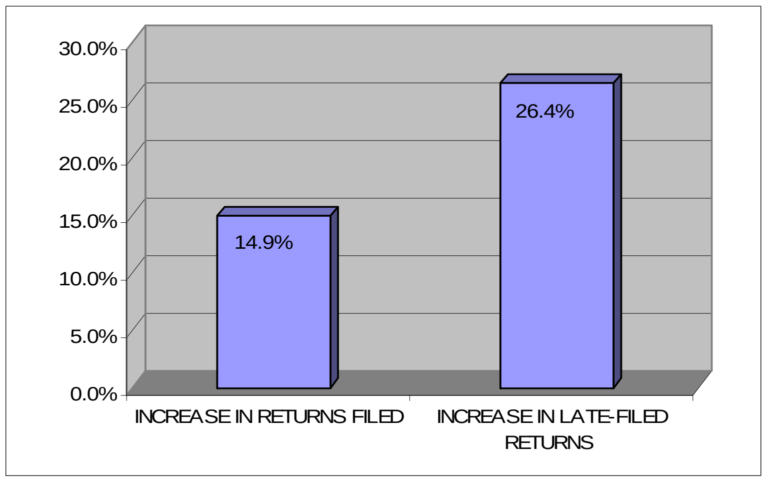
[11] Pass-through returns were considered late if filed more than 7 days beyond the later of the normal return due date, extended due date, or disaster due date.

[12] The IRS database of Federal tax-related transactions and accounts for individual taxpayers.

Figure 3 shows the overall growth of late-filed pass-through returns is nearly twice the growth in the total number of pass-through returns filed.

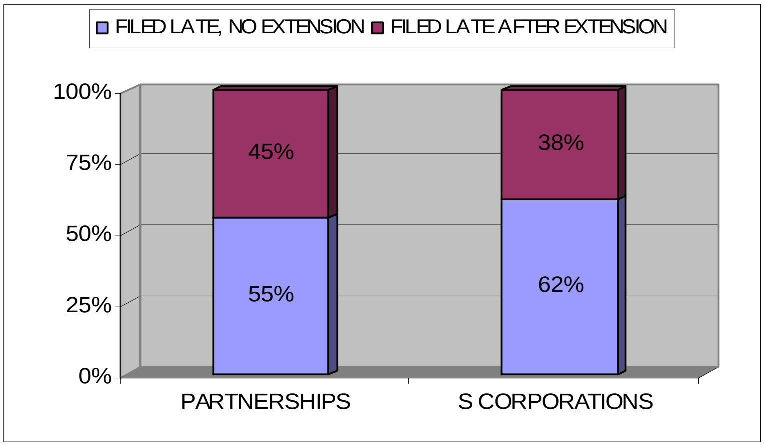
Figure 3: Growth in Total Returns Filed and Late-Filed Returns for Partnerships and S Corporations CYs 2000 – 2003



Source: TIGTA analysis of IRS BMF data.

Filing noncompliance among pass-through businesses is not only a large and growing problem, it also involves many examples of flagrant and repetitive noncompliance. For TY 2001, Figure 4 shows that 45 percent of the late-filed partnership returns and 38 percent of the late-filed S corporation returns were late even though the businesses had obtained extensions of time to file.

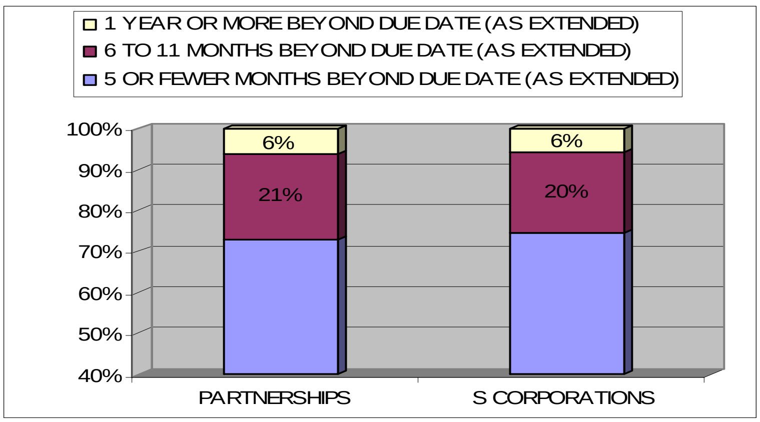
Figure 4: Frequency of Extensions of Time to File Among Delinquent Partnership and S Corporation Returns TY 2001



Source: TIGTA analysis of IRS BMF data.

Figure 5 shows that over 25 percent of the late-filed partnership and S corporation returns were 6 months or more delinquent.

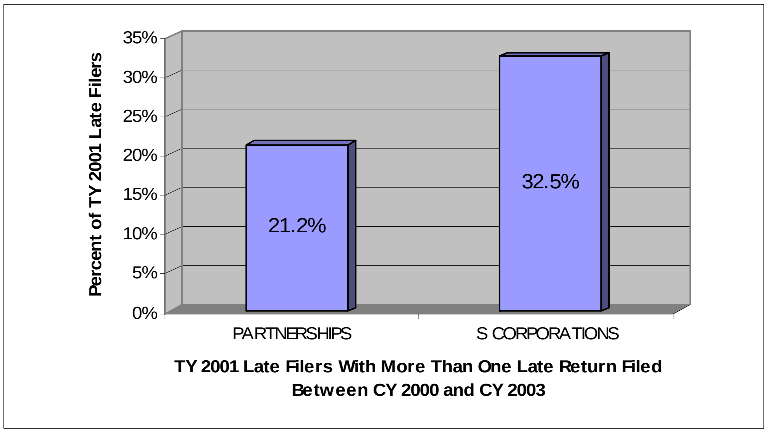
Figure 5: Late-Filed Partnership and S Corporation Returns by Range of Months of Delinquency TY 2001



Source: TIGTA analysis of IRS BMF data.

Figure 6 shows that late filing of returns is not an isolated one-time occurrence for many partnerships and S corporations. For example, 21 percent of the partnerships that filed a late return for TY 2001 also filed at least 1 other late return during the 4-year period of CYs 2000 through 2003. Similarly, 33 percent of the S corporations that filed a late return for TY 2001 also filed at least 1 other late return during the same 4-year period.

Figure 6: Pass-Through Businesses With More Than One Late Return Filed Between CYs 2000 and 2003



Source: TIGTA analysis of IRS BMF data.

The late filing of pass-through returns appears to also affect filing and reporting compliance by the individual partners and shareholders

The importance of the timely filing of returns by pass-through businesses can be easily overlooked since these businesses rarely incur any tax liabilities. However, the profits or losses of pass-through businesses can significantly influence the individual income tax liabilities of their partners and shareholders.

To comply with the normal April 15 deadline for filing individual income tax returns, the individual partners and shareholders in partnerships and S corporations, respectively, need to receive timely, accurate, and complete payee statements on their pass-through income or losses. A partnership return includes a Partner's Share of Income, Credits, Deductions, etc. (Schedule K-1) that must be provided to each partner on or before the due date of the partnership return. Similarly, I.R.C. § 6037(b)[13] requires an S corporation to provide a Shareholder's Share of Income, Credits, Deductions, etc. (Schedule K-1) to each shareholder on or before the day on which the S corporation is required to file its return.

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[13] 26 U.S.C. § 6037(b) (2003).

Although much more elaborate, a Schedule K-1 serves the same purpose for a partner or shareholder as a Wage and Tax Statement (Form W-2) does for an individual employee. The Schedule K-1 contains information on each investor's share of the profit or loss from the business operations as well as the investor's share of interest and dividend income, rental profits or losses, and capital gains or losses. To fully comply with individual income tax laws, an investor must report all items of income and loss from the Schedule K-1 on a timely filed individual income tax return.

Following the assumption that a late-filed partnership or S corporation return may also mean the Schedules K-1 were not timely prepared and provided to the individual partners or shareholders, we computer-analyzed the IRS Information Returns Master File[14] and identified 817,425 individuals who received a Schedule K-1 from a partnership or an S corporation that had filed a late return for TY 2001.[15] In analyzing the filing and income reporting compliance of these individuals,[16] we found that only 78 percent had been fully compliant in both timely filing their individual income tax returns for TY 2001 and fully reporting pass-through operating gains from the Schedules K-1.

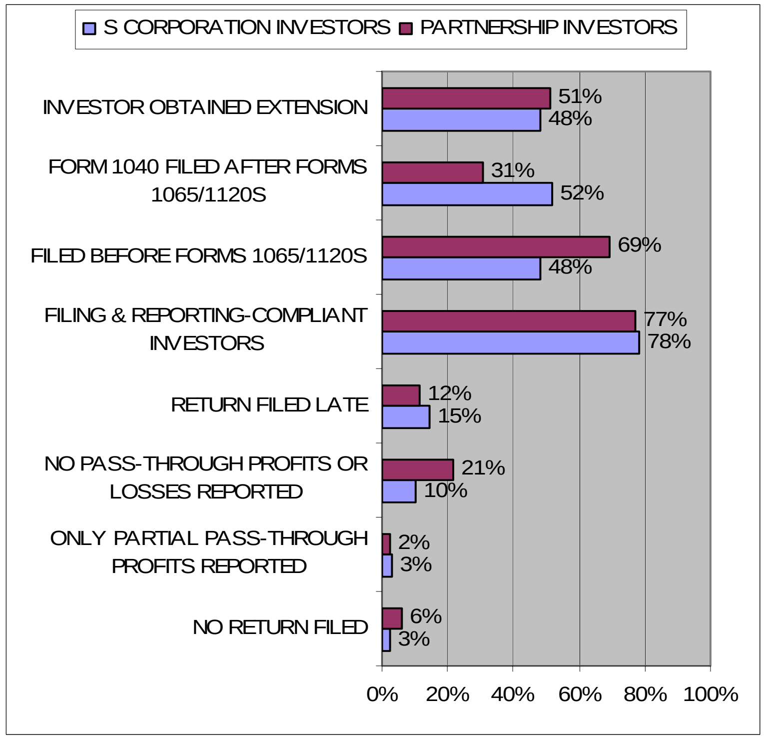
[14] The IRS database of information returns received from employers, financial institutions, and other businesses reporting wages, interest, dividends, nonemployee compensation, and other types of income. The IRS uses these information documents in its computer-matching programs to determine whether the income recipients filed tax returns and/or reported all of their income.

[15] We estimate there were 1.7 million partners and shareholders involved in the 687,521 TY 2001 late-filing pass-through businesses. This reflects the actual number of partners for late-filing partnerships as recorded on the IRS BMF (0.8 million). We were unable to obtain exact counts of the number of shareholders for each late-filing S corporation; therefore, we relied on the average number of 1.8 shareholders per S corporation as reflected in the IRS SOI function publications for TY 2001.

[16] Our compliance checks did not include businesses or trusts that may have been involved in the late-filing pass-through businesses. We were able to identify 1 or more individual owners involved in 421,560 of the 687,521 TY 2001 late-filing pass-through businesses.

Figure 7 provides a summary of the filing and reporting characteristics of the 817,425 individual partners and shareholders.[17]

Figure 7: Impact of Late-Filed Pass-Through Returns on the Individual Partners and Shareholders (TY 2001)



Source: TIGTA analysis of IRS IMF data.

A strong indicator of the correlation between late-filed pass-through returns and the untimely distribution of

[17] Returns were considered timely if received within 7 days of the later of the normal tax return due date or the extended return due date. For purposes of evaluating income reporting compliance, we sought to match the owner's share of partnership profits shown on line 22 of Form 1065 or the owner's share of S corporation profits shown on line 21 of Form 1120S, as reflected on line 1 of Schedules K-1. These profits (ordinary income from trade or business activities) were matched to income reported by the owners on Form 1040 Supplemental Income or Loss (Schedule E), Part II. We did not attempt to match other items of income or loss to Form 1040 tax returns. Taxpayers reporting total pass-through gains on Forms 1040 Schedule E, Part II that equaled or exceeded the pass-through ordinary income of the late-filing businesses shown on Schedules K-1 were considered to be compliant for income reporting purposes. See Appendix IV for further details.

Schedules K-1 is that 403,912 (49 percent) of the 817,425 partners and shareholders obtained extensions of time to file their TY 2001 individual income tax returns. By comparison, only 6 percent of all individual taxpayers obtained extensions of time to file in TY 2001.

Individual taxpayers involved in partnerships and S corporations need the Schedule K-1 information to timely and accurately complete their individual income tax returns. Individual partners and shareholders that have not received a Schedule K-1 by April 15 may need to request an extension of time to file from the IRS to avoid late-filing penalties. Individual partners and shareholders may need to obtain extensions of time to file if the pass-through business was simply late in issuing its Schedules K-1 or if the business obtained an extension of time to file the pass-through return.[18]

There is substantial taxpayer burden associated with requesting an extension. According to IRS estimates, an individual taxpayer expends 67 minutes[19] in obtaining a 4-month extension to August 15. Individual partners and shareholders who have still not received a Schedule K-1 by August 15 may need to request an additional 2-month extension of time to file. According to the IRS, an individual taxpayer expends an additional 46 minutes[20] to request an additional 2-month extension to October 15. Based on these time requirements, we estimate the individual taxpayers involved in partnerships and S corporations that filed a late return for TY 2001 expended a total of 642,615 hours in obtaining extensions of time to

[18] For TY 2001, approximately 98 percent of all partnerships operated on a calendar year basis and, therefore, had an April 15 filing due date; this is the same due date each of the individual partners had for filing their individual income tax returns.
[19] Estimate is provided in the taxpayer instructions for completing the Application for Automatic Extension of Time To File U.S. Individual Income Tax Return (Form 4868) for TY 2001.
[20] Estimate is provided in the taxpayer instructions for completing the Application for Additional Extension of Time To File U.S. Individual Income Tax Return (Form 2688) for TY 2001.

file.[21] The Office of Management and Budget (OMB) values these taxpayer burden hours at $17 million.[22]

Despite the availability of extensions of time to file, 108,587 (13 percent) of the 817,425 individual partners and shareholders delinquently filed their TY 2001 individual income tax returns after their normal or extended due dates, as applicable. This late-filing rate was more than 3 times the TY 2001 late-filing rate of 4 percent for all individual income tax returns. This unusually high late-filing rate may be attributable to the fact that 26 percent of the late-filed partnership and S corporation returns for TY 2001 were filed after October 15, 2002 – the maximum extended due date for TY 2001 individual income tax returns.

Since the Schedule K-1 contains each investor's share of the income and loss information from the business return, the business return logically must be completed prior to the Schedule K-1. In addition, once the business return is completed, there would seem to be little reason for not filing it with the IRS at the same time the Schedules K-1 are furnished to the individual partners and shareholders. Therefore, it seems logical to expect that the pass-through business return would normally be received by the IRS before the related individual income tax returns.

For the 817,425 individual taxpayers involved in partnerships and S corporations that filed late returns for TY 2001, we found 69 percent and 48 percent, respectively, had filed their individual income tax returns before the pass-through returns were filed. This raises questions about the accuracy of the information reported on the individual income tax returns. It is possible that some taxpayers, to avoid filing late themselves, may make educated guesses

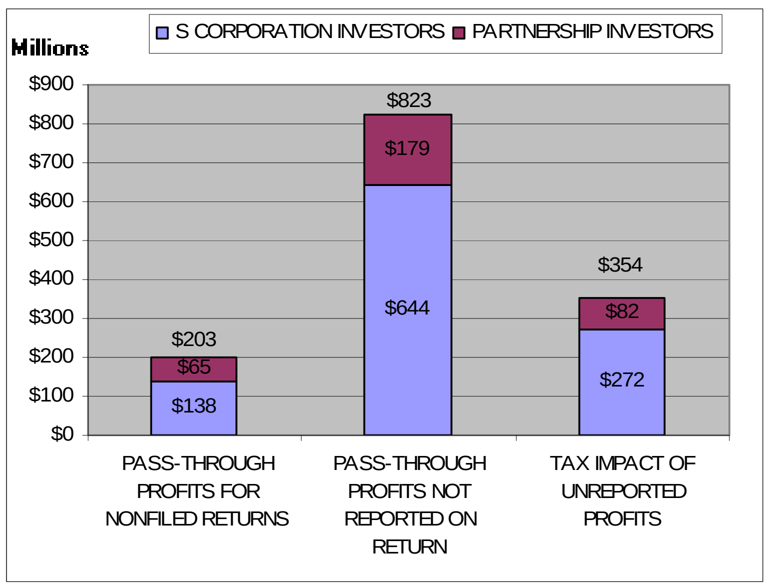
[21] Of the 817,425 individuals identified as having received Schedules K-1 from late-filing pass-through businesses, 403,912 expended 67 minutes each to request extended due dates of August 15, 2002, for filing their TY 2001 individual income tax returns. Of these extended due date taxpayers, 249,887 also expended 46 minutes each to request additional 2-month extensions.

[22] The OMB measures paperwork burden in terms of the time and financial resources the public devotes to complying with information requests. The OMB's estimate of the cost-per-hour of taxpayer burden is $26.50.

regarding the information they expect to receive on the Schedule K-1, while other taxpayers may simply choose to file without reporting the Schedule K-1 information. This may explain, in part, the discrepancies we identified between the profits reported on the Schedules K-1 and those reported on the individual income tax returns of the partners and shareholders.

As shown in Figure 8, for TY 2001, the 817,425 partners and shareholders failed to report (either partially or entirely) more than $1 billion in business operating profits from partnerships or S corporations that had filed late returns. We estimate that up to $354 million in individual income taxes may not have been paid on this unreported pass-through income.[23]

Figure 8: Reporting Noncompliance by Individual Taxpayers in Partnerships and S Corporations With Late Returns TY 2001



Source: TIGTA analysis of IRS Master File data.

[23] Tax losses were estimated by relying on the marginal tax rates of individuals that underreported Schedule K-1 ordinary operating gains on returns filed. We did not attempt to determine the reasons for the taxpayer omissions, such as whether the income may have been offset by equivalent losses and, therefore, both income and losses were omitted from the tax returns by the taxpayers.

If the filing compliance of pass-through businesses was improved, we estimate that individual income tax revenues could be increased by up to $1.2 billion between CYs 2006 and 2010 due to more accurate reporting of ordinary gains received by individual partners and shareholders. See Appendix IV for details.

The late filing and/or nonfiling of pass-through returns is also problematic for the IRS

The timely receipt of financial information related to the operation of pass-through businesses is not only important to their partners and shareholders, it is also important for the efficient and effective operations of the IRS. For example, the information from a pass-through business return is needed by the IRS to ensure the accuracy of both the return and the Schedules K-1 issued to the partners and shareholders. The information from the Schedules K-1 is also needed by the IRS to ensure the proper reporting of that information on the individual income tax returns of the partners and shareholders.

The untimely receipt of pass-through business returns, Schedules K-1, and/or individual income tax returns of the applicable partners and shareholders can delay and complicate these processes for the IRS. In addition, delays in receiving either the business or individual returns can result in the issuance of delinquency notices or even more expensive Taxpayer Delinquency Investigations (TDI) to secure the nonfiled returns. All of these processes consume the limited resources of the IRS.

Our audit concentrated on late-filed pass-through business returns rather than nonfiled returns. However, categorizing a taxpayer as either a late filer or a nonfiler often depends on the day on which the categorization is made. For instance, a taxpayer not filing by the return due date could be considered a nonfiler on the day after the due date. However, if the taxpayer subsequently files a return, either voluntarily or as a result of IRS enforcement actions, the taxpayer will be categorized as a late filer rather than a nonfiler.

Approximately 11 percent of the late-filed TY 2001 pass-through business returns filed through December 2003 were received by the IRS following IRS inquiries about the missing returns. As indicated by a recent IRS study,[24] there may yet be more returns that are still due but not yet filed. The study, completed in December 2003, identified 6,419 delinquent partnerships that had a total of 8,956 nonfiled returns as of September 2002. Of these, 96 percent were 1 or more years past the due date of the return.

Because the IRS does not have the resources to address every identified case of potential taxpayer noncompliance, only 4 percent of the nonfiled partnership returns that were 1 or more years past due were in TDI status, which made them subject to the full range of compliance treatments[25] by the IRS.[26] For the remaining 96 percent of the partnership returns that were 1 or more years past due, the IRS had taken no enforcement action beyond issuing return delinquency notices that were unsuccessful in resolving the nonfiling situations.

The same study also identified 19,747 corporations that had a total of 26,552 nonfiled returns as of September 2002. Of these, 75 percent were 1 or more years past due. Only 11 percent of the corporate returns that were 1 or more years past due were in TDI status.[27]

The tax laws and regulations do not provide sufficient tools for the IRS to effectively address late filing by pass-through businesses

The I.R.C. authorizes the IRS to assert a variety of civil penalties, as needed, to encourage voluntary compliance

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[24] *Large and Mid-Size Business Non-filer Report, Phase II,* Strategy Research and Program Planning Project 0502, December 2003.
[25] The full range of compliance treatments for cases in TDI status includes assignment to the Automated Collection System inventory for telephone contact with the taxpayer or assignment to the Collection Field function inventory for personal contact with the taxpayer.
[26] The 2003 study cited a December 2002 IRS study that indicated the low percentage of delinquent returns in TDI status situation was attributed in part to a policy decision not to apply compliance resources to certain types of nonfiled returns.
[27] Total included 1,524 S corporations. However, the study report did not separate S corporations from other taxable corporations for the total number of nonfiled returns and the percentage of delinquent returns in TDI status.

with America's tax laws. For most taxpayers, voluntary compliance consists of preparing an accurate return, filing it by the return due date, and timely paying any taxes due.

Penalties constitute one important tool for the IRS in pursuing its mission of collecting the proper amount of tax revenue at the least cost. Historically, the IRS has used 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 fairness of the tax system by justly punishing the noncompliant taxpayer.

However, the existing tax laws and regulations fail to provide the IRS with the necessary penalty sanctions to effectively and fairly encourage the timely filing of pass-through business returns or the timely submission of Schedules K-1 to the partners, shareholders, and IRS.

Penalties are avoided by most late-filing partnerships

I.R.C. § 6698[28] imposes a penalty for the failure to timely file a partnership return. The penalty is $50 per partner for each month, or fraction of a month, that the return is filed late, not to exceed 5 months. For TY 2001, the IRS assessed penalties totaling $36.2 million for late-filed partnership returns.

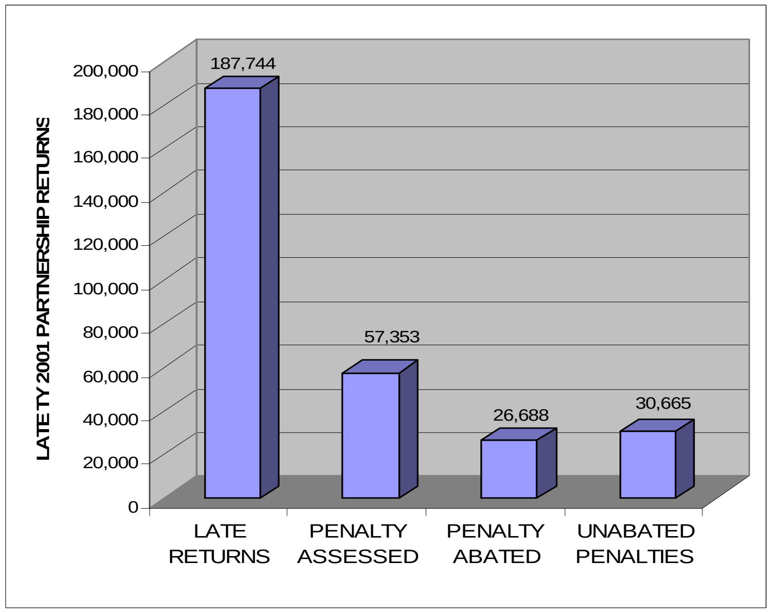
However, the penalty was not effectively promoting voluntary compliance because it was avoided by 84 percent of the partnerships that filed late returns for TY 2001. The IRS initially assessed the penalty on less than one-third of the late-filed partnership returns to which it could apply. In addition, nearly one-half of the partnerships against which the late-filing penalty was assessed subsequently had it abated by the IRS.

Figure 9 shows that penalties were assessed on only 57,353 (31 percent) of the 187,744 partnership returns that were filed late for TY 2001. The IRS subsequently abated 26,688 (47 percent) of these penalties totaling $20.4 million. This means that only 30,665 (16 percent) of the

[28] 26 U.S.C. § 6698 (2003).

187,744 partnerships that filed their returns late actually incurred a cost for their noncompliance.

Figure 9: Penalties Assessed and Abated on Late-Filed Partnership Returns TY 2001



Source: TIGTA analysis of IRS Master File data.

One reason for the frequently avoided or abated penalties is that the Revenue Procedures allow "small" partnerships (defined by I.R.C. § 6231(a)(1)(b)[29] as those made up of 10 or fewer partners)[30] that file late returns to qualify for reasonable cause exceptions and have the late-filing penalties abated. To qualify, a partnership must establish that all partners have fully reported their share of the income, deductions, and credits of the partnership on their timely filed individual income tax returns.[31]

Figure 10 shows that 182,235 (97 percent) of the 187,744 partnerships that filed a late return for TY 2001 met the criteria of 10 or fewer partners. By excusing small partnerships for their delinquency, the IRS is allowing

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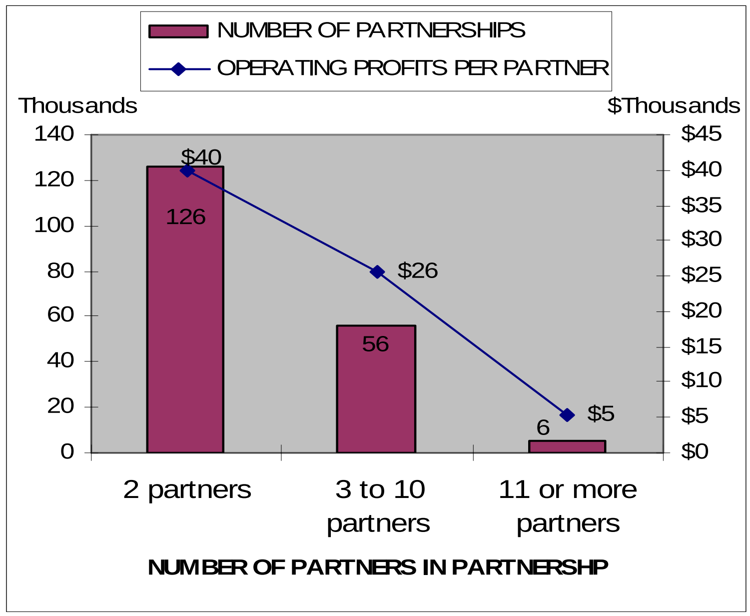
[29] 26 U.S.C. § 6231(a)(1)(b) (2003).
[30] The instructions for completing a partnership return advise the preparer to answer "no" to Question 4 on Schedule B of Form 1065 if the partnership had 10 or fewer partners.
[31] Rev. Proc. 84-35, 1984-1 C.B. 509.

almost all partnerships to avoid paying penalties for late-filed returns.

Figure 10: Net Pass-Through Income per Partner From Late-Filed Partnership Returns TY 2001



Source: TIGTA analysis of IRS Master File data.

Figure 10 also shows that, by excusing small partnerships, the IRS is allowing the partnerships that pass through the highest amount of operating profits per partner to avoid penalties for late filing. Of the late-filed partnership returns for TY 2001 that involved only 2 partners, the ordinary income that was passed through averaged $39,874 per partner. On the other hand, the late-filed partnership returns with 11 or more partners averaged only $5,337 in ordinary income per partner. Yet, the IRS subjects only these “large” partnerships to late-filing penalties.

If the Revenue Procedures were changed to remove the automatic reasonable cause exception for late filing by partnerships with 10 or fewer partners and all late-filing partnerships were assessed penalties when applicable, we estimate that additional penalty assessments of approximately $253.5 million would result between

CYs 2006 and 2010 while filing compliance would improve.[32] See Appendix IV for details.

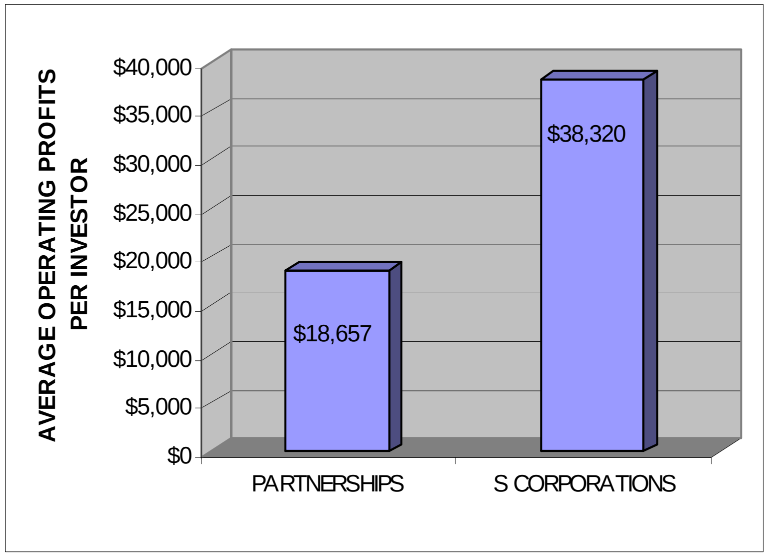
Penalties are not imposed on late-filed S corporation returns

The absence of penalties for late-filed S corporation returns is an unfair aspect of the tax system. Although individuals, taxable corporations, and partnerships face penalties for late-filed returns, S corporations do not. This exception for S corporations, which operate their businesses and are subject to the same pass-through tax status as partnerships, implies that accountability for pass-through income from S corporation returns is less significant than that from partnership returns.

As shown in Figure 11, however, the individual shareholders in S corporations earned pass-through income for TY 2001 that was, on average, twice the amount of the pass-through income earned by the individual partners of partnerships.

[32] Estimate assumes the level of filing noncompliance found for TY 2001 is typical.

Figure 11: Comparison of Pass-Through Ordinary Gains Reported on TY 2001 Partnership and S Corporation Returns[33]



Source: IRS SOI function reports data for TY 2001.

Figure 12 shows that both the volume of late-filed S corporation returns and the level of pass-through income from these late-filed returns create more serious compliance problems for the IRS than filing noncompliance by partnerships. For TY 2001, almost 500,000 (17 percent) of the 3 million returns filed by S corporations were received after the tax return due date (as extended). The absence of even a nominal penalty to deter late filing may contribute to the rate of late-filed S corporation returns being almost twice the rate of late-filed partnership returns (9 percent).

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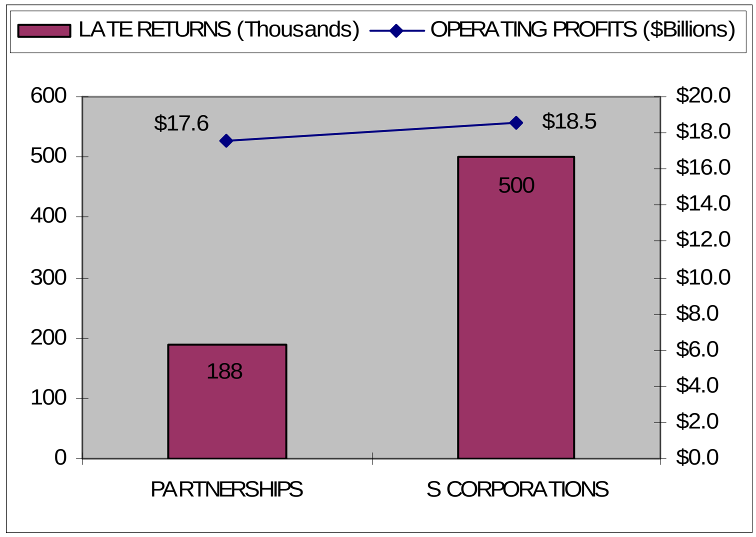
[33] Reflects total operating profits of all businesses divided by the total number of shareholders or partners participating in all businesses and includes all returns, regardless of whether they were timely filed.

Figure 12: Filing Noncompliance by Pass-Through Businesses and Its Implications for Partners and Shareholders TY 2001



Source: TIGTA analysis of IRS Master File data.

We estimate that changing the law to establish a penalty for late-filed S corporation returns would result in additional penalty assessments of $444.2 million between CYs 2006 and 2010 while improving filing compliance. See Appendix IV for details.

The 5-month limit on the penalty for late-filed partnership returns does not address the full extent of the noncompliance problem

The penalty for the late filing of a partnership return is limited by I.R.C. § 6698 to a maximum of 5 months. As previously shown in Figure 5, however, 27 percent of the late-filed partnership returns for TY 2001 were filed more than 5 months after their due dates (as extended).

If the automatic reasonable cause exception for late filing by partnerships with 10 or fewer partners was eliminated, the 5-month cap on assessing late-filing penalties would still prevent the IRS from assessing higher penalties on the partnerships that were the most egregious in their filing noncompliance. For example, a partnership with 2 partners that filed its return more than 1 year late would be subject to the same maximum late filing penalty of $500 as a partnership with 2 partners that filed its return only 5 months late.

Assuming the filing delays found in TY 2001 were typical, we estimate that changing the tax law to eliminate the 5-month penalty cap on all late-filed pass-through returns would result in additional penalty assessments of $316.2 million between CYs 2006 and 2010 while improving filing compliance. See Appendix IV for details.

The tax law does not provide penalties for the late submission of Schedules K-1 to the IRS

Copies of Schedules K-1 that report the distribution of profits to investors are required to be attached to the partnership or S corporation return filed with the IRS. In TY 2001, late-filed pass-through returns distributed $36 billion in operating profits to approximately 1.7 million partners and shareholders.[34]

The law does not impose a penalty specifically for the late-filing of Schedules K-1 by partnerships or S corporations.[35] In contrast, I.R.C. § 6721 provides a $50 penalty for the late filing of each information return, such as Interest Income (Form 1099-INT), reporting various types of income payments to individual taxpayers.

As previously discussed in this report, information from the Schedules K-1 is needed for the IRS to ensure the proper reporting of pass-through income on individual income tax returns. Delays in the IRS' receipt of Schedules K-1 can needlessly delay or complicate this process and consume the limited resources of the IRS that could be more effectively used for other activities.

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[34] Reflects the actual number of partners for late-filing partnerships as recorded on the IRS BMF (0.8 million). We were unable to obtain exact counts of the number of shareholders for each late-filing S corporation; therefore, we relied on the average number of 1.8 shareholders per S corporation as reflected in the IRS SOI function publications for TY 2001.

[35] Although the late filing of Schedules K-1 does not result in a penalty, a $50 penalty is assessed under I.R.C. § 6721 (2003) if Schedules K-1 (whether timely or late) are not filed with the IRS electronically by a partnership with more than 100 partners. For the electronic filing penalty, each Schedule K-1 is treated as a separate information return.

In 1982, the Congress increased the penalty for the late filing of information returns with the IRS from $10 to $50 each. In discussing this, the Senate Finance Committee explained its reasons for the change as follows:[36]

> *The Committee believes that inadequate information reporting of non-wage income is a substantial factor in the underreporting of such income by taxpayers. In many cases, persons who are required to make information reports do not do so because they consider the informational forms unimportant or the cost of their processing is more than the cost of the penalty that might be incurred for failure to comply with the filing requirements. The committee believes that the current penalty and the way it historically has been applied does not reflect the importance of timely filed information returns to the administration of the tax laws.*

To place further emphasis on the importance of ensuring timely submission of information documents, the Senate Finance Committee concluded by saying:

> *Although the committee is aware that the penalty for failure to file information returns has been little used in the past, it intends that the Internal Revenue Service will use this increased penalty more fully to protect the information reporting and withholding systems.*

If the tax law was amended to provide that, whenever a partnership or an S corporation return is filed late, a $50 penalty is assessed for each Schedule K-1 not timely submitted to the IRS, we estimate that $302.7 million in additional penalty assessments would result between CYs 2006 and 2010, while filing compliance would improve. See Appendix IV for details.

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[36] S. Rep. No. 97-494, 97th Cong., 2nd Session, 254 (1982).

The burden of proof that Schedules K-1 were timely provided to partners and shareholders should rest on the pass-through businesses

I.R.C. § 6722[37] provides for a penalty of $50 for each Schedule K-1 that is not timely provided to an investor in a partnership or an S corporation.[38] However, the IRS could provide no evidence that this penalty is being routinely assessed.

In TY 2001 alone, there were approximately 1.7 million partners and shareholders in 688,000 pass-through businesses that filed a late return. Therefore, it seems highly unlikely that all related Schedules K-1 were timely distributed to the partners and shareholders. Since the Schedules K-1 detail each individual's portion of the gains and losses shown on the business return and there is little reason to delay the filing of the business returns once they are prepared, it is reasonable to assume that the filing dates of the business returns should very closely approximate the distribution dates of the Schedules K-1.

Since, under current law, to assess this penalty the IRS must know that an individual has not timely received a Schedule K-1, it would seem this penalty could be assessed only if the IRS contacted taxpayers to determine the dates they received their Schedules K-1 or if the IRS found evidence of untimely Schedule K-1 distribution during an examination of a pass-through business return. Both methods would place an enormous administrative burden on the IRS.

If the tax law was amended to provide that the Schedule K-1 distribution date to the partners and shareholders is assumed to be 7 days before the filing of a partnership or S corporation return, and that the I.R.C § 6722 penalty is automatically assessed on partnership and S corporation returns filed more than 7 days after the return due date, we estimate that penalty assessments of $299 million would result between CYs 2006 and 2010, while filing compliance would improve. See Appendix IV for details.

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[37] 26 U.S.C. § 6722 (2003).
[38] 26 U.S.C § 6724(d)(2) defines payee statements to include Schedule K-1.

The deterrent effect of the fixed-dollar penalties for late-filed pass-through businesses has eroded over time

The penalty for the late filing of a partnership return can be rather modest. I.R.C. § 6698 sets the penalty at $50 per partner[39] for each month, or fraction of a month, the return is filed late. Therefore, a partnership that files its return 1 month late would be potentially subject to a maximum late filing penalty of $50 per partner. The same $50 maximum penalty per partner would apply to the partnership regardless of whether its pass-through income produced $1,000 or $10,000 in individual income tax liabilities per partner.

In contrast, the penalty for the late filing of an individual income tax return equals 5 percent of any unpaid tax amount per each month of delinquency.[40] Therefore, an individual who files a return 1 month late will be penalized $50 on a $1,000 unpaid tax liability, the same amount as the per partner late-filing penalty for partnerships. However, unlike the partnership penalty, the individual's penalty would increase to $500 if the individual's unpaid tax liability rose to $10,000.

In this way, it is possible for a late-filing partnership to distribute income that causes a taxpayer to owe $10,000 in tax and pay $500 per month in penalties while subjecting the partnership to only a $50 penalty per month. This imbalance seems to indicate a need for more substantial deterrents to the late filing of pass-through business returns.

The amount of the penalty for a late-filed partnership return has not been increased since its enactment by the Congress in 1978. As a result, the current penalty carries the equivalent value of only a $17.22 penalty in 2004 dollars. Put another way, to impose the same economic impact on a late-filing partnership in 2004 would require the penalty to

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[39] If the number of partners in a partnership is not known, the IRS procedures for computing the penalty assume there are two partners.
[40] 26 U.S.C. § 6651 (2003). The penalty for a late-filed individual income tax return is 5 percent per month of the net tax due and generally cannot exceed 25 percent of the delinquent taxes. The late-filing penalty is reduced by the amount of the Failure to Pay (FTP) Penalty if they apply concurrently. The FTP Penalty is assessed on the unpaid tax due at a rate of 0.5 percent per month.

be $145.17 per partner per month. However, even at that level, inflation would again degrade the penalty's economic impact.

Inflation has been growing at an annual compound rate of 4.185 percent per year since 1978. At this rate of growth, tripling a penalty in CY 2004 that was $50 in 1978 would maintain the same or more impact than in 1978 only until CY 2005. After that point, the penalty's impact would again fall below the 1978 level. However, increasing the penalty to $200 would preserve the impact of the penalty at or above the 1978 level until CY 2012.

Changing the tax law to increase the various fixed-dollar late-filing penalties for partnerships and S corporations to $200 per occurrence would help reduce filing noncompliance by imposing more appropriate financial costs on it. It would also compensate for past inflation and would continue to be a viable deterrent until CY 2012. We estimate this change would result in an increase in penalty assessments of $5.1 billion between CYs 2006 and 2010 while improving filing compliance. See Appendix IV for details.

Recommendations

To improve the filing compliance of pass-through businesses and to ensure fairness in the tax system for all similarly situated pass-through businesses, the Commissioner, Small Business/Self-Employed (SB/SE) Division, and the Commissioner, Large and Mid-Size Business (LMSB) Division, should coordinate with the Office of Chief Counsel to develop a legislative proposal for the IRS Commissioner to submit to the Department of the Treasury that would amend I.R.C. § 6698 to:

1. Require the assessment of late-filing penalties regardless of the number of partners in a partnership.

<u>Management's Response</u>: The Commissioner, SB/SE Division, disagreed with our recommendation to eliminate reasonable cause exceptions that are based solely on the number of partners in a partnership. The Commissioner stated the existing statutory provision does not permit a partnership composed of a certain number of partners to

automatically avoid the I.R.C. § 6698 penalty; Revenue Procedure 84-35 was issued to provide the reasonable cause exceptions consistent with Congressional intent. The Commissioner believes our recommendation essentially called for the reversal of Revenue Procedure 84-35. The Commissioner stated this Revenue Procedure provides for a reasonable cause standard to apply when a partnership has 10 or fewer partners, all of whom have included their share of the partnership income in their income tax returns. If any partner fails to correctly or timely file his or her individual income tax return, the partnership would not be entitled to the reasonable cause exception. The Commissioner believes this Revenue Procedure actually encourages partners to correctly and timely file individual returns so their partnership may qualify for the reasonable cause exception.

<u>Office of Audit Comment</u>: Regarding our recommendation to eliminate reasonable cause exceptions that are based solely on the number of partners in a partnership, we agree it is IRS Revenue Procedure 84-35, not I.R.C. § 6698, that permits 97 percent of late-filing partnerships to potentially qualify for reasonable cause exceptions to the I.R.C. § 6698 late-filing penalty based solely upon the number of partners. However, we disagree that the Revenue Procedure reflects the intent of the Congress when it established the late-filing penalty present in I.R.C. § 6698.

While the IRS contends reasonable cause exceptions are available only when all partners have timely and accurately reported their pass-through income, if a partnership claims that its partners have met this requirement, the burden of proof for establishing the veracity of such a statement is effectively shifted to the IRS. As this is an unreasonable and costly administrative burden for the IRS to undertake on a universal basis, it is unlikely the IRS will challenge the assertion of compliance by a pass-through business except under extraordinary circumstances. Furthermore, we do not believe the number of partners participating in a partnership accurately reflects the economic ramifications of late filing by the partnership. As demonstrated on page 18, the highest economic ramifications are reflected in partnerships with the fewest number of partners. For these reasons, we continue to believe the IRS should seek Congressional assistance in codifying in the I.R.C. the proper basis for exceptions to the I.R.C. § 6698 penalty.

2. Prohibit the granting of reasonable cause exceptions regarding late-filing penalties applicable to partnerships that file returns late despite having been granted the privilege of extensions of time to file.

Management's Response: The Commissioner, SB/SE Division, disagreed with our recommendation to eliminate reasonable cause exceptions for late-filing penalties when a partnership files its return after the extension date has passed. The Commissioner believes the reasoning in the report is that an entity that receives an extension of time to file, then fails to file by the extended due date, has committed "repetitive noncompliance." However, under current law, a partnership that is granted an extension of time to file is in compliance with the law. A partnership that received an extension of time to file a return and nevertheless filed an inaccurate or untimely return may still meet the reasonable cause exception of the I.R.C. The fact that the partnership files its return after the extension of time to file has passed has no bearing on whether the partnership is entitled to the reasonable cause exception. The failure to file a timely or correct return after receiving an extension to file does not represent a repetitive act of noncompliance. The Commissioner further stated there was a lack of information or statistics to demonstrate that adopting this recommendation would result in increased compliance.

Office of Audit Comment: Regarding our recommendation to eliminate reasonable cause exceptions for partnerships that file after their extended due dates, we agree that obtaining an extension of time to file does not represent a violation of tax law. While our discussion on pages 6 through 8 provided examples of flagrant noncompliance as well as examples of repetitive noncompliance, it was Figure 6 that demonstrated the repetitive noncompliance of pass-through businesses over several years. The data presented in Figure 4 regarding taxpayers with extended due dates covered only 1 year and demonstrated that 45 percent of late-filed partnership returns and 38 percent of late-filed S corporations returns had failed to file by their extended due dates. While these are not repetitive acts of noncompliance, they are multifaceted acts of noncompliance. We believe failure by a pass-through business to file a timely return after being granted the privilege of an extension of time to file simultaneously demonstrates a failure to honor the terms of the extension privilege, a lack of respect for the statutes that require the timely filing of returns, and a lack of concern for the ability of its partners or shareholders to be able to file timely and accurate returns. Although the IRS stated such failures meet the reasonable cause exception of the I.R.C., as the IRS pointed out in its response, it is Revenue Procedure 84-35, not the I.R.C., that provides for the reasonable cause exceptions. For these reasons, we believe the IRS should seek Congressional assistance in codifying in the I.R.C. the proper basis for exceptions to the I.R.C. § 6698 penalty.

3. Increase the penalty for late-filed partnership returns from $50 per partner per month to $200 per partner per month (at a minimum).

Management's Response: See response to Recommendation 8.

Office of Audit Comment: See response to Recommendation 8.

4. Remove the 5-month limitation on the number of months of delinquency the late-filing penalty is assessed on partnership returns.

Management's Response: See response to Recommendation 8.

Office of Audit Comment: See response to Recommendation 8.

5. Make all requirements of I.R.C. § 6698 applicable to S corporations as well as partnerships.

Management's Response: The Commissioner, SB/SE Division, agreed with the concept of including S Corporations in the same code section. See response to Recommendation 8.

Office of Audit Comment: See response to Recommendation 8.

To improve the ability of the IRS to timely, efficiently, and accurately match Schedule K-1 data to individual income tax returns, the Commissioner, SB/SE Division, and Commissioner, LMSB Division, should coordinate with the Office of Chief Counsel to develop a legislative proposal that would amend I.R.C. § 6721 to:

6. Require the assessment of a $200 penalty (at a minimum) per Schedule K-1 for the failure to timely provide Schedules K-1 to the IRS when a partnership or an S corporation return is filed late.

Management's Response: See response to Recommendation 8.

Office of Audit Comment: See response to Recommendation 8.

To improve the filing and reporting compliance of the individual partners and shareholders that depend on the timely receipt of payee statements from partnerships and S corporations, the Commissioner, SB/SE Division, and Commissioner, LMSB Division, should coordinate with the Office of Chief Counsel to develop a legislative proposal that would amend I.R.C. § 6722 to:

7. Require the assessment of a $200 penalty (at a minimum) per Schedule K-1 for the failure to timely provide Schedules K-1 to payees when a partnership or an S corporation return is filed more than 7 days beyond the return due date (as extended).

Management's Response: See response to Recommendation 8.

Office of Audit Comment: See response to Recommendation 8.

To determine whether more significant penalties are needed to improve filing compliance of pass-through businesses, the Commissioner, SB/SE Division, should:

8. Conduct a study to determine whether fixed-dollar penalties set at a $200 level in I.R.C. §§ 6698, 6721, and 6722 will be effective in ensuring future compliance or whether other penalty types and/or higher amounts would be more effective.

Management's Response: The Commissioner, SB/SE Division, stated the decision to implement Recommendations 3 through 7 requires not only further study but also input and concurrence from the Department of the Treasury Office of Tax Policy. The Commissioner, SB/SE Division, stated the IRS will consult with the Department of the Treasury Office of Tax Policy regarding the value and merit of conducting a study of the current penalty structure, related to the filing of pass-through returns, to determine if changes to the levels and types of penalties would be effective in increasing filing compliance. The decision as to whether to take further action will be made jointly with the Department of the Treasury.

Office of Audit Comment: We are encouraged the IRS plans to discuss with the Department of the Treasury whether to study the remaining recommendations that would increase various fixed-dollar penalties from the current $50 level to $200 to counteract inflation that has occurred since the establishment of the current penalty levels; remove the 5-month limit on the assessment of the I.R.C. § 6698 penalty; subject S corporations to the I.R.C. § 6698 penalty; subject partnerships and S corporations to penalties for not filing timely Schedules K-1 with the IRS; and simplify the assessment criteria for failure to timely provide Schedules K-1 to partners or S corporation shareholders. However, from preliminary discussions it was our understanding that these recommendations would receive prompt attention and that further study would involve only determinations of whether fixed-dollar penalties set at a $200 level, in accordance with our recommendations, would be sufficiently stringent to achieve and maintain filing compliance among pass-through businesses. The IRS written response indicates that no changes in the treatment of late-filing pass-through businesses will be acted upon unless it is decided that a future study is warranted. We believe the need for at least some immediate action is highlighted on page 25, where we point out that the $50 late-filing penalty for partnerships established by the Congress in 1978 had the economic equivalent of only $17.22 in 2004. Given the serious levels of noncompliance discussed in the report, we believe immediate action, not potential future study, is warranted.

Finally, regarding IRS concerns about the revenue that would be generated by our recommendations, we agree with the IRS that penalties should be viewed as a means to encourage compliance. As was discussed in the IRS Penalty Policy Statement P-1-18, additional revenue is a by-product of the effort to achieve voluntary compliance, not a goal in itself. We also agree that such additional revenue will decrease over time as compliance improves. It is for that reason that increasing compliance and decreasing penalty revenues were reflected in the computations supporting our outcome measures in Table 4 of Appendix IV.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether the existing laws, tax regulations, and Internal Revenue Service (IRS) policies and practices are adequate, effective, and fair for promoting filing compliance among pass-through businesses. To accomplish this objective, we:

I. Researched tax laws and regulations regarding timely filing by pass-through businesses.

  A. Researched historical changes to the Internal Revenue Code and regulations regarding late-filing penalties for pass-through businesses and the reasons for changes, where possible.

  B. Identified differences in filing requirements and related penalties for noncompliance among like-situated organizations.

II. Reviewed available IRS records, studies, reports, and general statistics regarding filing noncompliance and related penalties.

  A. Obtained and computer-analyzed a computer extract of IRS Business Master File[1] information consisting of all partnerships and S corporations filing late returns during Calendar Years 2000 through 2003 for Tax Years (TY) 1999 through 2002 (the most current years for which complete data were available).

    1. Determined whether statutory penalties were being assessed, additional penalties were needed to improve compliance and fairness, and penalty amounts were adequate to effect compliance.

    2. Quantified the differences in penalties applied to each type of organization.

    3. Identified trends in filing noncompliance and quantified incidences of repeated noncompliance.

  B. Quantified the TY 2001 impact of late filing by pass-through businesses on their individual partners and shareholders.

    1. Obtained a computer extract of the IRS Information Returns Master File[2] to identify individual partners or shareholders and the amount of operating profits they received from the late-filing pass-through businesses.

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[1] The IRS database of Federal tax-related transactions and accounts for business taxpayers.

[2] The IRS database of information returns received from employers, financial institutions, and other businesses reporting wages, interest, dividends, nonemployee compensation, and other types of income. The IRS uses these information documents in its computer-matching programs to determine whether the income recipients filed tax returns and/or reported all of their income.

2. Obtained IRS Individual Master File[3] computer extracts of the accounts of the individual partners and shareholders to determine their filing timeliness.
3. Obtained an IRS Return Transaction File[4] extract to determine whether operating profits from late-filed pass-through business returns were reflected on the individual income tax returns filed by the partners and shareholders.

[3] The IRS database of Federal tax-related transactions and accounts for individual taxpayers.
[4] 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.

Appendix II

Major Contributors to This Report

Philip Shropshire, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs)
William E. Stewart, Audit Manager
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Appendix III

Report Distribution List

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Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration for Calendar Years (CY) 2006 through 2010. These benefits will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

- Increased Revenue – Potential; $253.5 million from limiting exceptions to the delinquency penalty for late-filed partnership returns (see page 18, and page 40 item R).
- Increased Revenue – Potential; $444.2 million from establishing a delinquency penalty for late-filed S corporation returns (see page 21, and page 40 item S).
- Increased Revenue – Potential; $316.2 million from removing the limit on the number of months to which the delinquency penalty applies to late-filed pass-through business returns (see page 22, and page 40 item T).
- Increased Revenue – Potential; $302.7 million from establishing a penalty for delaying the submission of Partner's Share of Income, Credits, Deductions, etc. (Schedule K-1) or Shareholder's Share of Income, Credits, Deductions, etc. (Schedule K-1) to the Internal Revenue Service (IRS) (see page 23, and page 40 item U).
- Increased Revenue – Potential; $299 million from the automatic assessment of penalties for delaying the issuance of Schedules K-1 to the individual partners and shareholders (see page 24, and page 40 item V).
- Increased Revenue – Potential; $5.1 billion from adjusting for inflation the amount of the fixed-dollar delinquency penalties related to pass-through businesses (see page 26, and page 41 item AH).
- Increased Revenue – Potential; $1.2 billion in individual income taxes realized from the more accurate reporting of ordinary gains received by individual partners and shareholders from pass-through businesses (see page 14, and page 43 item O).

Methodology Used to Measure the Reported Benefit:

To determine the amounts of increased revenues from various penalty increases to encourage compliance, we used computer programs to calculate the penalties using the actual number of months each late-filed pass-through return was filed beyond the return due date (as extended) and the number of partners and shareholders in the pass-through business. In determining the number of partners in partnerships, we used the actual number of partners as reflected on the

IRS Business Master File (BMF).[1] We were unable to obtain exact counts of the number of shareholders for each late-filing S corporation; therefore, we relied on the average number of 1.8 shareholders per S corporation as reflected in the IRS Statistics of Income function publications for Tax Year (TY) 2001.

To determine the annual increases in noncompliance levels, we obtained an extract of IRS BMF data and identified the actual volumes of late-filed returns received each calendar year from CYs 2000 through 2003. We then determined the average annual increase in late-filed returns (8.3 percent). We applied this rate of increase to TYs 2002 through 2005 noncompliance statistics to determine the degree of noncompliance that would likely exist in the earliest year in which new penalties were likely to be applied (TY 2005/CY 2006). No further noncompliance increases were assumed for later years since we assumed that more stringent penalty enforcement would arrest the growth of noncompliance.

Table 1: Recommended Penalties Based on TY 2001 Noncompliance (Returns Due in CY 2002) and Average Annual Noncompliance Growth Rate From CYs 2000 Through 2003 (8.3 percent)

	TY 2001 ACTUAL DUE IN CY 2002	TY 2002 DUE IN CY 2003	TY 2003 DUE IN CY 2004	TY 2004 DUE IN CY 2005	TY 2005 DUE IN CY 2006
A) Partnership penalties for late-filed returns - $50 per partner per month, limit 5 months	$ 98,223,500	$ 106,376,051	$ 115,205,263	$ 124,767,299	$ 135,122,985
B) S corporation penalties for late-filed returns - $50 per shareholder per month, limit 5 months	$ 120,491,910	$ 130,492,739	$ 141,323,636	$ 153,053,498	$ 165,756,938
C) Late filing penalties for months late in excess of 5	$ 85,773,140	$ 92,892,311	$ 100,602,372	$ 108,952,369	$ 117,995,416
D) Penalties for late filing of Schedules K-1 with the IRS	$ 82,113,430	$ 88,928,845	$ 96,309,939	$ 104,303,664	$ 112,960,868
E) Penalties for late issuance of Schedules K-1 to investors	$ 81,096,030	$ 87,827,000	$ 95,116,642	$ 103,011,323	$ 111,561,263
F) Total penalties for late filing (total of item A through item E)	$ 467,698,010	$ 506,516,945	$ 548,557,851	$ 594,088,153	$ 643,397,470
G) Total pass-through businesses penalized (recommended)	687,571	744,639	806,444	873,379	945,870
H) Average recommended penalties for late filing prior to inflation adjustment (item F / item G)	$ 680.22	$ 680.22	$ 680.22	$ 680.22	$ 680.22

Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of IRS Master File data.

To determine the volume and dollar value of penalties that would likely be assessed by the IRS in future years, given current laws, regulations, and IRS operating procedures, we analyzed IRS BMF data to determine the actual volume and dollar amounts of penalties assessed for TY 2001 related to late-filed partnership returns. We applied the average annual noncompliance increase of 8.3 percent to these figures to determine future values.

[1] The IRS database of Federal tax-related transactions and accounts for business taxpayers.

Table 2: Actual TY 2001 and Estimated Future IRS Penalty Assessments Related to Late-Filed Partnership Returns

	TY 2001 ACTUAL DUE IN CY 2002	TY 2002 DUE IN CY 2003	TY 2003 DUE IN CY 2004	TY 2004 DUE IN CY 2005	TY 2005 DUE IN CY 2006
I) Late-filing partnerships	187,744	203,327	220,203	238,480	258,274
J) Partnerships penalized under current conditions (actual TY 2001 increased by 8.3% annually)	30,889	33,453	36,229	39,236	42,493
K) Penalty per partnership actually penalized (actual TY 2001)	$ 511.47	$ 511.47	$ 511.47	$ 511.47	$ 511.47
L) Partnership late-filing penalties (item K * item J)	$ 15,798,797	$ 17,110,097	$ 18,530,235	$ 20,068,245	$ 21,733,909

Source: TIGTA analysis of IRS Master File data. Minor differences may result from the rounding of multiplicands.

We assumed that pass-through businesses could achieve the same level of filing compliance as individual taxpayers (95.6 percent) after 5 years of increased penalty enforcement. Using the remaining noncompliance level (4.4 percent), we determined the number of returns that would still be filed late based upon the volume of returns filed for TY 2001 (due in CY 2002). We then used this volume to compute the percentage of TY 2001 late-filed returns that would still be late if the overall pass-through return population contained 4.4 percent of noncompliance. This number was expressed as a percentage of late pass-through returns, representing the ultimate rate of noncompliance expected among existing late filers (33 percent of existing late filers).

Table 3: Impact of Assumption That Pass-Through Businesses Will Become As Compliant As Individual Filers

Filing noncompliance rate for individuals	4.4%
Pass-through returns filed for TY 2001	5,118,603
Noncompliant pass-through businesses expected at individual noncompliance rate (4.4% of returns)	225,219
Actual noncompliant pass-through businesses TY 2001	687,571
Percent of noncompliant taxpayers that will continue noncompliance (225,219 of 687,571)	33%

Source: TIGTA analysis of IRS Master File data.

Using the CY 2006 penalty assessments from Tables 1 and 2 as well as the assumptions regarding future noncompliance levels shown in Table 3, we computed the penalties that would be assessed for the late filing of pass-through returns as filing compliance improved.

Table 4: Annual Penalty Assessments Expected As Future Filing Compliance Improves

	CY 2006	CY 2007	CY 2008	CY 2009	CY 2010	TOTAL
M) New compliance level for current late filers	20%	35%	50%	60%	67%	N/A
N) Remaining noncompliance for current late filers	80%	65%	50%	40%	33%	N/A
O) Recommended partnership penalties for late-filed returns - $50 per partner per month, limit 5 months (item A for CY 2006 * item N)	$ 108,098,388	$ 87,829,940	$ 67,561,493	$ 54,049,194	$ 44,590,585	$ 362,129,601
P) Partnership late-filing penalties normally assessed (see item L for CY 2006)	$ 21,733,909	$ 21,733,909	$ 21,733,909	$ 21,733,909	$ 21,733,909	$ 108,669,544
Q) Net increase in partnership late-filing penalties (item O minus item P)	$ 86,364,479	$ 66,096,032	$ 45,827,584	$ 32,315,285	$ 22,856,676	$ 253,460,057
R) Net increase in partnership late-filing penalties (see item Q)	$ 86,364,479	$ 66,096,032	$ 45,827,584	$ 32,315,285	$ 22,856,676	$ 253,460,057
S) S corporation penalties for late-filed returns - $50 per shareholder per month, limit 5 months (item B for CY 2006 * item N)	$ 132,605,550	$ 107,742,010	$ 82,878,469	$ 66,302,775	$ 54,699,790	$ 444,228,594
T) Late-filing penalties for months late in excess of 5 (item C for CY 2006 * item N)	$ 94,396,333	$ 76,697,020	$ 58,997,708	$ 47,198,166	$ 38,938,487	$ 316,227,715
U) Penalties for late filing of Schedules K-1 with the IRS @$50 (item D for CY 2006 * item N)	$ 90,368,694	$ 73,424,564	$ 56,480,434	$ 45,184,347	$ 37,277,086	$ 302,735,126
V) Penalties for late issuance of Schedules K-1 to investors @$50 (item E for CY 2006 * item N)	$ 89,249,010	$ 72,514,821	$ 55,780,631	$ 44,624,505	$ 36,815,217	$ 298,984,184
W) Total increases in late-filing penalties @$50 each (total of items R through item V)	$ 492,984,067	$ 396,474,446	$ 299,964,826	$ 235,625,079	$ 190,587,256	$1,615,635,674

Source: TIGTA analysis of IRS Master File data. Minor differences may result from the rounding of multiplicands.

We then determined the impact of increasing penalties for inflation to $200 per occurrence from the current $50 per occurrence. The increase is intended to adjust the current penalties for inflation, particularly the $50 penalty level for late-filed partnership returns that was set in 1978. Adjusted for inflation, this amount would need to be $145.17 in CY 2004 to have the same economic impact as $50 did in 1978. By CY 2006, the amount needed to compensate for inflation will likely require that the penalty exceed $150 to achieve the same level of economic impact. We therefore recommend the $200 level to compensate for past and several years of future inflation.

By analyzing IRS BMF data, we determined whether the penalties at this level would exceed the legal maximum amount of each penalty that applies to each type of penalty. We compared the total amount of anticipated penalties at the $50 level to those at the $200 level to isolate and quantify the net impact of raising penalties to the $200 level.

Table 5: Impact of Adjusting Recommended Penalties for Inflation[2]

	CY 2006	CY 2007	CY 2008	CY 2009	CY 2010	TOTAL
AA) Partnership late-filing penalties normally assessed (see item P)	$ 21,733,909	$ 21,733,909	$ 21,733,909	$ 21,733,909	$ 21,733,909	$ 108,669,544
AB) Total increases in late-filing penalties @$50 each (see item W)	$ 492,984,067	$ 396,474,446	$ 299,964,826	$ 235,625,079	$ 190,587,256	$1,615,635,674
AC) Total penalties recommended or currently assessed @$50 (item AA + item AB)	$ 514,717,976	$ 418,208,355	$ 321,698,735	$ 257,358,988	$ 212,321,165	$1,724,305,219
AD) Total gross pass-through late-filing penalties @ $200 each (item AC * 4)	$ 2,058,871,903	$1,672,833,421	$ 1,286,794,939	$1,029,435,951	$ 849,284,660	$6,897,220,874
AE) Percentage of penalties below current maximums per late return if penalties @ $200 each* (actual TY 2001)	97.4%	97.4%	97.4%	97.4%	97.4%	97.4%
AF) Net assessable pass-through penalties @$200 each (item AE * item AD)	$ 2,005,604,474	$1,629,553,635	$ 1,253,502,796	$1,002,802,237	$ 827,311,845	$6,718,774,986
AG) Total increases in late-filing penalties @$50 each (see item W or item AB)	$ 492,984,067	$ 396,474,446	$ 299,964,826	$ 235,625,079	$ 190,587,256	$1,615,635,674
AH) Net increase attributable to adjusting new penalties for inflation (item AF minus item AG)	$ 1,512,620,407	$1,233,079,188	$ 953,537,970	$ 767,177,158	$ 636,724,589	$5,103,139,312

Source: TIGTA analysis of IRS Master File data. Minor differences may result from the rounding of multiplicands.

To determine the initial noncompliance level among the individual partners and shareholders in late-filing pass-through businesses, we obtained a computer extract of TY 2001 Schedule K-1 information for all individual partners and shareholders in TY 2001 late-filing partnerships and S corporations. We also obtained computer extracts of all TY 2001 tax returns filed, with and without extensions of time to file, as well as information for all U.S. Individual Income Tax Return (Form 1040) Supplemental Income or Loss (Schedule E) filers for TY 2001. With this information, we determined through computer programming how many of the partners and shareholders filed timely returns (as extended) and/or reported all of the ordinary income from the late-filing pass-through businesses.

If the amount of total gains reported in Part II of Schedule E equaled or exceeded the amount reported on the investor's Schedule K-1, we considered that the taxpayer had reported all income from the late-filing pass-through business. If the total gains reported in Part II of Schedule E were less than the ordinary gain amount on the Schedule K-1, we considered the difference to be underreported income. For partners and shareholders not filing tax returns or filing tax returns without a Schedule E, we considered the entire ordinary income amount from the Schedules K-1 to be underreported. We did not track other items of income or loss from the Schedules K-1.

To determine the tax impact of the underreporting, we added the taxpayer's underreported income to the taxpayer's taxable income as reflected on IRS records. We then used the IRS tax tables in conjunction with the taxpayer's filing status as reflected on IRS records to determine

[2] Amounts of penalties in excess of current legal maximums were determined by computer programs that computed penalty amounts for each taxpayer at $200 each and compared the total penalties of each type to the legal maximum for that penalty type. We are not recommending increases to legal maximums.

the taxpayer's marginal income tax rate. This rate was multiplied by the underreported income to arrive at the tax loss amount.

When our computer analysis was complete, we computed the level of underreporting as a percentage of the total ordinary gains reported by late-filing pass-through businesses (partnerships and S corporations). We also expressed the overall tax loss as a percentage of the overall amount of underreported ordinary income from late-filing pass-through businesses. These percentages were applied to future tax periods to determine the level of expected underreporting and the tax impact of that underreporting. We assumed that the noncompliance among partners and shareholders in the pass-through businesses would grow at the same pace as the noncompliance among the pass-through businesses (8.3 percent average annual growth).

Table 6: Estimate of Income Underreporting by Individual Partners and Shareholders Based Upon TY 2001 Pass-Through Business Noncompliance (Returns Due in CY 2002) and Average Annual Noncompliance Growth Rate From CYs 2000 Through 2003 (8.3 percent)

	TY 2001 ACTUAL DUE IN CY 2002	TY 2002 DUE IN CY 2003	TY 2003 DUE IN CY 2004	TY 2004 DUE IN CY 2005	TY 2005 DUE IN CY 2006
A) Average annual growth in noncompliance (actual CYs 2000 through 2003)	8.3%	8.3%	8.3%	8.3%	8.3%
B) Ordinary gains on late-filed pass-through returns (actual TY 2001, remaining years at 8.3% annual growth)	$ 36,085,450,229	$39,086,956,776	$42,338,121,884	$45,859,711,589	$49,674,219,202
C) Amount of ordinary gains underreported (actual TY 2001)	$ 1,025,117,902	N/A	N/A	N/A	N/A
D) Percentage underreported with actual TY 2001 rate (item C / item B)	2.8%	2.8%	2.8%	2.8%	2.8%
E) Amount of ordinary gains underreported (item D * item B)	$ 1,025,117,902	$ 1,110,384,902	$ 1,202,744,220	$ 1,302,785,777	$ 1,411,148,567
F) Tax loss as a percentage of underreported income (actual TY 2001)	34.54215%	N/A	N/A	N/A	N/A
G) Maximum tax rate for tax year (actual)	39.1%	38.6%	35.0%	35.0%	35.0%
H) Tax loss as a percentage of maximum tax rate (item F / item G)	88.3%	88.3%	88.3%	88.3%	88.3%
I) Tax loss as a percentage of underreported income (adjusted for post-TY 2001 tax rate reductions)	34.5%	34.1%	30.9%	30.9%	30.9%
J) Tax loss as a result of underreporting adjusted for post-TY 2001 tax rate reductions (item I * item E)	$ 354,097,784	$ 378,646,099	$ 371,889,534	$ 402,822,469	$ 436,328,336

Source: TIGTA analysis of IRS BMF and Individual Master File[3] data. Minor differences may result from the rounding of multiplicands.

We assumed that improved filing compliance by pass-through businesses would lead to improved filing compliance by partners and shareholders in those businesses. We assumed that investor compliance would improve at the same rate as compliance by pass-through businesses.

[3] The IRS database of Federal tax-related transactions and accounts for individual taxpayers.

We therefore assumed the same remaining noncompliance level (33 percent of current noncompliant taxpayers) as we assumed for noncompliant pass-through businesses.

Table 7: Estimate of Increased Tax Revenue As Filing Compliance Improves

	TY 2005 DUE IN CY 2006	TY 2006 DUE IN CY 2007	TY 2007 DUE IN CY 2008	TY 2008 DUE IN CY 2009	TY 2009 DUE IN CY 2010	TOTAL
K) Underreporting without changes assuming 8.3% growth in noncompliance	$ 1,411,148,567	$1,528,524,729	$1,655,663,976	$1,793,378,380	$1,942,547,558	$ 8,331,263,211
L) Tax loss as a percentage of underreported income	30.9%	30.9%	30.9%	30.9%	30.9%	N/A
M) Tax loss from under-reporting without changes	$ 436,328,336	$ 472,621,145	$ 511,932,708	$ 554,514,119	$ 600,637,355	$ 2,576,033,662
N) Cumulative percentage of current underreporters brought into compliance due to more timely pass-through business reporting	20%	35%	50%	60%	67%	N/A
O) Reduction in tax loss from underreporting at new compliance level (item N * item M)	$ 87,265,667	$ 165,417,401	$ 255,966,354	$ 332,708,471	$ 402,427,028	$ 1,243,784,921

Source: TIGTA analysis of Master File data. Minor differences may result from the rounding of multiplicands.

Appendix V

Management's Response to the Draft Report

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

RECEIVED
MAR 22 2005

March 22, 2005

MEMORANDUM FOR PAMELA J. GARDINER
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Kevin M. Brown
Commissioner, Small Business/Self Employed Division

SUBJECT: Draft Audit Title: Stronger Sanctions Are Needed to Encourage Timely Filing of Pass-Through Returns and Ensure Fairness in the Tax System (Audit #: 200430010)

We have reviewed your draft report and would like to provide feedback regarding several issues outlined in the report. Detailed feedback regarding Recommendations 1 and 2 and your analysis of potential benefits, are described below. In addition, the decision to implement any of Recommendations 3 through 7 requires not only additional analysis but also input and concurrence from Treasury's Office of Tax Policy. Accordingly, we will consult with them to determine if a study is warranted to determine if changes to the levels and types of penalties would be effective for increasing filing compliance.

Recommendation 1 essentially calls for the reversal of Revenue Procedure 84-35. This Revenue Procedure provides for a reasonable cause standard to apply where a partnership has 10 or less partners, all of whom have included their share of the partnership income in their income tax returns. We believe that Revenue Procedure 84-35 actually encourages partners to correctly and timely file their individual returns. We are currently conducting a study of this area to specifically determine the overall compliance level of the partners' filings. Although the study is in its preliminary stages, early data indicate the error rate may be as low as three percent.

Recommendation 2 calls for the elimination of reasonable cause exceptions for late filing penalties when a partnership files its return after the extension date has passed. The reasoning in the report is that an entity that receives an extension of time to file, and then fails to file by the extended due date, has committed "repetitive noncompliance." However, under current law, a partnership that is granted an extension of time to file is in compliance with the law. The fact that a partnership files its return late, in spite of receiving an extension of time to file, has no bearing on whether the partnership is entitled to the reasonable cause exception under section 6698.

After reviewing the potential benefits described in Appendix IV of your report, we believe two important points have not been fully considered. First, of the almost $8 billion in claimed outcome measures that would potentially result from the implementation of the audit recommendations, 84% are the result of proposed increases in penalties. If the IRS were to adopt the audit recommendations, the objective should be to improve the timeliness of pass-through return filings. The more effective IRS is in doing this, the fewer penalties we would expect to assess. Since the decrease in penalties would be only partially offset by additional tax revenue, we would anticipate decreases in the dollar values associated with the outcome measures over time. Second, and even more fundamental, we believe that penalties should be viewed as a means to encourage compliance, not as a means to raise revenue.

Our comments on your recommendations follow. Please note that we have consolidated our responses to Recommendations 3 through 7 under Recommendation 8, since any future action on these will be dependent on the decision to conduct a study.

RECOMMENDATION 1

To improve the filing compliance of pass-through businesses and to ensure fairness in the tax system for all similarly situated pass-through businesses, the Commissioner, Small Business/Self-Employed (SB/SE) Division, and the Commissioner, Large and Mid-Size Business (LMSB) Division, should coordinate with the Office of Chief Counsel to develop a legislative proposal for the IRS Commissioner to submit to the Department of the Treasury that would amend I.R.C. § 6698 to require the assessment of late-filing penalties regardless of the number of partners in a partnership.

CORRECTIVE ACTION(S):

We disagree with this recommendation. The existing statutory provision does not permit a partnership composed of a certain number of partners to automatically avoid the section 6698 penalty. The IRS issued Revenue Procedure 84-35 to be consistent with Congressional intent with respect to section 6698. The Revenue Procedure provides guidance that permits certain partnerships of 10 partners or less, that file late returns, to qualify for the reasonable cause exception. However, in order for the partnership to qualify for the reasonable cause exception, all the partners must have correctly and timely filed their income tax returns. If any partner fails to correctly or timely file his/her individual income tax return, the partnership would not be entitled to the reasonable cause exception. We believe that this Revenue Procedure actually encourages partners to correctly and timely file individual returns so that their partnership may qualify for the reasonable cause exception.

IMPLEMENTATION DATE:
N/A

RESPONSIBLE OFFICIAL(S):
N/A

CORRECTIVE ACTION(S) MONITORING PLAN:
N/A

RECOMMENDATION 2
Coordinate with the Office of Chief Counsel to develop a legislative proposal for the IRS Commissioner to submit to the Department of the Treasury that would amend I.R.C. § 6698 to prohibit the granting of reasonable cause exceptions regarding late filing penalties applicable to partnerships filing returns late, despite having been granted the privilege of extensions of time to file.

CORRECTIVE ACTION(S):
We disagree with this recommendation. The Internal Revenue Code (IRC) permits the IRS to grant an extension of time to file a return; therefore, a partnership that receives an extension to file is in compliance with the tax laws. The failure to file a timely or correct return after receiving an extension to file does not represent a repetitive act of noncompliance. Furthermore, a partnership that has received an extension of time to file a return and nevertheless filed an incorrect or untimely return may still meet the reasonable cause exception in the IRC. The fact that the partnership files its return after the extension of time to file has passed has no bearing on whether the partnership is entitled to the reasonable cause exception. We also could find no information or statistics to demonstrate that adopting this recommendation would result in increased compliance.

IMPLEMENTATION DATE:
N/A

RESPONSIBLE OFFICIAL(S):
N/A

CORRECTIVE ACTION(S) MONITORING PLAN:
N/A

RECOMMENDATION 3
Coordinate with the Office of Chief Counsel to develop a legislative proposal for the IRS Commissioner to submit to the Department of the Treasury that would amend I.R.C. § 6698 to increase the penalty for late-filed partnership returns from $50 per partner per month to $200 per partner per month (at a minimum).

CORRECTIVE ACTION(S):
See response to Recommendation 8.

RECOMMENDATION 4
Coordinate with the Office of Chief Counsel to develop a legislative proposal for the IRS Commissioner to submit to the Department of the Treasury that would amend I.R.C. § 6698 to remove the 5-month limitation on the number of months of delinquency that the late-filing penalty is assessed on partnership returns.

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CORRECTIVE ACTION(S):
See response to Recommendation 8.

RECOMMENDATION 5

Coordinate with the Office of Chief Counsel to develop a legislative proposal for the IRS Commissioner to submit to the Department of the Treasury that would amend I.R.C. § 6698 to make all requirements of I.R.C. § 6698 applicable to S corporations as well as partnerships.

CORRECTIVE ACTION(S).
We agree with the concept of including S Corporations in the same code. See response to Recommendation 8.

RECOMMENDATION 6
To improve the ability of the IRS to timely, efficiently, and accurately match Schedule K-1 data to individual income tax returns, the Commissioner, SB/SE Division, and Commissioner, LMSB Division, should coordinate with the Office of Chief Counsel to develop a legislative proposal that would amend I.R.C. § 6721 to require the assessment of a $200 penalty (at a minimum) per Schedule K-1 for the failure to timely provide Schedules K-1 to the IRS when a partnership or S corporation return is filed late.

CORRECTIVE ACTION(S):
See response to Recommendation 8.

RECOMMENDATION 7
To improve the filing and reporting compliance of the individual partners and shareholders that depend on the timely receipt of payee statements from partnerships and S corporations, the Commissioner, SB/SE Division, and Commissioner, LMSB Division, should coordinate with the Office of Chief Counsel to develop a legislative proposal that would amend I.R.C. § 6722 to require the assessment of a $200 penalty (at a minimum) per Schedule K-1 for the failure to timely provide Schedules K-1 to payees when a partnership or S corporation return is filed more than 7 days beyond the return due date (as extended).

CORRECTIVE ACTION(S):
See response to Recommendation 8.

RECOMMENDATION 8
To determine whether more significant penalties are needed to improve filing compliance of pass-through businesses, the Commissioner, SB/SE Division should conduct a study to determine whether fixed-dollar penalties set at a $200 level in I.R.C. Sections 6698, 6721, and 6722 will be effective in ensuring future compliance or whether other penalty types and/or higher amounts would be more effective.

CORRECTIVE ACTION(S):
The Commissioner, SB/SE Division will consult with Treasury's Office of Tax Policy regarding the value and merit of conducting a study of the current penalty structure, related to the filing of pass through returns, to determine if changes to the levels and types of penalties would be effective for increasing filing compliance. The decision as to whether to take further action will be made jointly with Treasury.

IMPLEMENTATION DATE:
July 1, 2005

RESPONSIBLE OFFICIAL(S):
Director, Examination Policy

CORRECTIVE ACTION(S) MONITORING PLAN:
N/A

If you have any questions, please contact me at (202) 622-0600 or Marsha Ramirez, Director, Examination Policy, Small Business/Self Employed at (202) 283-2518.