

**Estimated Tax Penalty Assessment Processes  
Create Significant Taxpayer Inequity**

**August 2000**

**Reference Number: 2000-30-112**

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.



DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

INSPECTOR GENERAL  
for TAX  
ADMINISTRATION

August 22, 2000

MEMORANDUM FOR COMMISSIONER ROSSOTTI

FROM: Pamela J. Gardiner  
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Estimated Tax Penalty Assessment  
Processes Create Significant Taxpayer Inequity

This report presents the results of our review of the Internal Revenue Service's (IRS) current process for assessing the estimated tax (ES) penalty. We conducted the review to evaluate the IRS' process for assessing the ES penalty and its potential impact on taxpayer rights.

In summary, the IRS' current process for assessing the ES penalty has created significant taxpayer inequity. We determined that approximately 2.9 million taxpayers who computed their ES penalty paid almost \$116 million which they would not have been required to pay if they let the IRS compute the penalty for them.

Management's response was due on July 21, 2000. As of July 31, 2000, management had not responded to this draft report.

Please contact me at (202) 622-6510 if you have questions, or your staff may call Gordon C. Milbourn III, Associate Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.

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## **Executive Summary**

Most taxpayers who take the time to compute their Estimated Tax (ES) penalty on their Individual Income Tax Return (Form 1040) pay a higher penalty than people in the same circumstances who let the Internal Revenue Service (IRS) compute it for them.

ES penalty assessments are the second most imposed penalty by the IRS. For Tax Year 1998, over 5.1 million taxpayers were assessed ES penalties totaling about \$1.05 billion.

The taxpayers themselves computed about 4.3 million (84 percent) of these penalties. The ES penalty is the only individual civil penalty where taxpayers can choose to be directly involved in the assessment process.

The overall objective of this audit was to evaluate the IRS' process for assessing the ES penalty and its potential impact on taxpayer rights.

## **Results**

The IRS needs to change its' process for assessing the ES penalty to ensure equitable treatment of taxpayers and compliance with its' own policy. Individuals who compute the penalty themselves pay the penalty, while many taxpayers that let the IRS compute the penalty are not required to pay it. In fact, approximately 2.9 million (67.2 percent) of the 4.3 million taxpayers who computed their ES penalty paid almost \$116 million which they would not have been required to pay if they let the IRS compute the penalty for them. This happened because, for taxpayers that let the IRS compute the penalty, the IRS applied a tolerance level to the ES penalty assessments.

### **Inconsistent Application of a Tolerance Level Causes Inequitable Treatment**

IRS procedures provide that if the taxpayer calculates an ES penalty on their return, the penalty is assessed regardless of the amount. However, taxpayers who let the IRS compute the penalty are not required to pay amounts below the tolerance level.

For Tax Year 1998, approximately 2.9 million (67.2 percent) of the 4.3 million taxpayers who computed their ES penalty paid an amount that fell below this tolerance level. These penalties totaled almost \$116 million (16.4 percent) of the \$708 million voluntarily computed by taxpayers.

## **Estimated Tax Penalty Assessment Processes Create Significant Taxpayer Inequity**

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An analysis done in a previous audit report<sup>1</sup> found that at least 2.8 million taxpayers had avoided \$100 million in ES penalties by choosing to have the IRS compute it. The IRS did not assess penalties on these taxpayers because the penalty amounts were below the tolerance level.

Current IRS Penalty Policy Statement P-1-18 states that the IRS administers a penalty system that is designed to ensure consistency. The inconsistent use of a tolerance level for assessing taxpayer-computed penalties and IRS-computed penalties causes inequitable treatment.

### **Summary of Recommendation**

To ensure equitable treatment of taxpayers and consistency in assessing ES penalties, the IRS needs to eliminate penalties computed by taxpayers that fall below the established tolerance level.

Management's Response: Management's response was due on July 21, 2000. As of July 31, 2000, management had not responded to this draft report.

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<sup>1</sup> *Evaluation of the Assessment Tolerance for the Estimated Tax Penalty* (Reference Number 072401, dated April 11, 1997)

### Objective and Scope

*The objective of this audit was to evaluate the IRS' process for assessing the ES penalty and its potential impact on taxpayer rights.*

The objective of this review was to evaluate the Internal Revenue Service's (IRS) process for assessing the estimated tax (ES) penalty and its potential impact on taxpayer rights. To achieve this objective, we:

1. Reviewed current IRS processes for assessing the ES penalty.
2. Determined the total volume and dollar amount of all ES penalties that were assessed nationwide during 1999 on 1998 individual tax returns. From this data, we:
  - Determined the total volume and dollar amount of all ES penalties that taxpayers computed on their 1998 individual tax returns.
  - Determined the total volume and dollar amount of all ES penalties that the IRS assessed.

We conducted fieldwork at the National Office and the Brookhaven IRS Center from December 1999 through April 2000. This audit was performed in accordance with *Government Auditing Standards*.

Details of our audit objective, scope, and methodology are presented in Appendix I. Major contributors to this report are listed in Appendix II.

### Background

Penalties constitute one important IRS tool in pursuing its mission of collecting the proper amount of tax revenue at the least cost. Penalties support the IRS' mission only if the penalties enhance voluntary compliance. The IRS uses penalties to encourage voluntary compliance by:

## **Estimated Tax Penalty Assessment Processes Create Significant Taxpayer Inequity**

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- Helping taxpayers understand that compliant conduct is appropriate and non-compliant conduct is not.
- Deterring noncompliance by imposing costs on it.
- Establishing the fairness of the tax system by justly penalizing the non-compliant taxpayer.

Taxpayers generally are required to pay their income taxes during the year on a “pay-as-you-go” basis as the income is generated. Wages, salaries, and certain other income are subject to withholding when paid. For more than 50 years, the IRS has collected estimated taxes on income not subject to withholding, also known as non-wage income. Non-wage income generally includes income from pensions, interest, self-employment, capital gains, dividends, and partnerships. If taxpayers underpay their tax payments, they may be liable for the ES penalty.

The ES penalty is the second most imposed civil tax penalty. Taxpayers who underpay can choose either to have IRS calculate the penalty they owe or compute it themselves. The ES penalty is the only individual civil penalty where taxpayers can choose to be directly involved in the assessment process.

For Tax Year 1998, over 5.1 million taxpayers were assessed ES penalties totaling about \$1.05 billion. Taxpayers themselves computed about 4.3 million (84 percent) of these penalties.

### **Results**

The IRS’ process for assessing the ES penalty does not ensure equitable treatment of taxpayers and compliance with its’ own policy. Individuals who compute the penalty themselves pay the penalty while many taxpayers, in the same circumstances, that let the IRS compute the penalty are not required to pay it. This inequity occurs because, for taxpayers that let the IRS compute the penalty, the IRS applies a tolerance level to the ES penalty assessments.

### Inconsistent Application of a Tolerance Level Causes Inequitable Treatment

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For Tax Year 1998, about 2.9 million (67.2 percent) of the 4.3 million taxpayers that computed their ES penalty themselves paid an amount that fell below a tolerance level. These penalties totaled almost \$116 million (16.4 percent) of the \$708 million voluntarily computed by taxpayers.

On the other hand, if these taxpayers had not computed the penalty, the IRS would not have assessed it. This happens when the penalty line is left blank and IRS computers calculate the penalty. IRS procedures call for not assessing the penalty when the computed amount falls below the tolerance level.

Appendix V of this report shows hypothetical examples of how taxpayers are treated differently in the assessment of the ES penalty.

Taxpayers that compute the penalty themselves have followed IRS instructions regarding the calculation and reporting of their ES penalty. For example, the 1998 individual tax return instructions stated the following:

*“Figuring the Penalty”*

*“... you choose to figure the penalty yourself, see **Form 2210** (or **2210-F** for farmers and fishermen) to find out if you owe the penalty. If so, you can use the form to figure the amount. In certain situations, you may be able to lower your penalty. ...Enter the penalty on Form 1040 line 69. Add the penalty to any tax due and enter the total on line 68. If you are due a refund, subtract the penalty from the overpayment you show on line 65. **Do not** file Form 2210 with your return unless Form 2210 indicates that you must do so. Instead, keep it for your records.”*

Taxpayers who followed IRS guidelines and computed their ES penalty were not given the advantage of a tolerance level that was given to taxpayers that left the line blank and let the IRS calculate the penalty for them. Taxpayers were not aware that their choice could result



## Estimated Tax Penalty Assessment Processes Create Significant Taxpayer Inequity

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in a penalty amount being assessed that would otherwise not be assessed if they left the line blank.

IRS instructions recognize the complexity involved for taxpayers to compute the penalty themselves and allow taxpayers to let the IRS figure the penalty for them. The 1998 Form 1040 instructions state:

*“Because Form 2210 is complicated, if you want to, you can leave line 69 blank and the IRS will figure the penalty and send you a bill. We will not charge you interest on the penalty if you pay by the date specified on the bill.”*

Current IRS procedures provide that if the taxpayer calculates an ES penalty with a return, the ES penalty is assessed even if it is below the tolerance amount. A section of the procedures that deal with ES penalties provides the following directions to IRS employees:

*“Input...to assess any estimated tax (ES) penalty.”*

<i>If</i>	<i>Then</i>
<i>Taxpayer calculates an estimated tax penalty with an acceptable return</i>	<i>Input ES penalty even if below \$... tolerance</i>
<i>Taxpayer’s computation of estimated tax penalty varies by less than \$... from our computation</i>	<i>Accept taxpayer’s figures</i>
<i>Otherwise</i>	<i>ES penalties are subject to \$... tolerance</i>

Based on the guidelines above, taxpayers that chose to calculate their penalty did not receive the benefit of the stated tolerance and were subject to an additional tolerance in regards to possible computational errors. As the guidelines state, if the taxpayer’s computation varies from the IRS calculation by less than \$..., the IRS will accept the taxpayer’s figures.

## **Estimated Tax Penalty Assessment Processes Create Significant Taxpayer Inequity**

An analysis done in a previous audit report<sup>1</sup> found that at least 2.8 million taxpayers had avoided \$100 million in ES penalties by choosing to have the IRS compute the penalty. The penalties were not assessed on these taxpayers because the penalty amounts were below the tolerance level.

### **Processing procedures are not consistent with the IRS' penalty policy**

IRS Penalty Policy Statement P-1-18 states that the IRS administers a penalty system that is designed to ensure consistency. The inconsistent use of a tolerance level for assessing taxpayer computed penalties and IRS computed penalties causes inequitable treatment.

Policy Statement P-1-18 presents the current IRS policy in regards to penalties.

*“Penalties constitute one important tool of the Internal Revenue Service in pursuing its mission of collecting the proper amount of tax revenue at the least cost. Penalties support the Service’s mission only if penalties enhance voluntary compliance.”*

The statement goes on to say:

*“To this end, the IRS administers a penalty system that is designed to:*

- *ensure consistency;*
- *ensure accuracy of results in light of the facts and the law;*
- *provide methods for the taxpayer to have his or her interests heard and considered;*
- *require impartiality and a commitment to achieve the correct decision;*
- *allow for prompt reversal of initial determinations when sufficient information has been presented to indicate that the penalty is not appropriate;*

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<sup>1</sup> *Evaluation of the Assessment Tolerance for the Estimated Tax Penalty* (Reference Number 072401, dated April 11, 1997)

## **Estimated Tax Penalty Assessment Processes Create Significant Taxpayer Inequity**

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- *ensure that penalties are used for their proper purpose and not as bargaining points in the development or processing of cases.”*

The IRS issued a penalty task group study report in September 1998 that stated:

*“The use of penalties is to ensure and promote voluntary compliance. Consistency of application is implicit in achieving the goals of fairness, effectiveness, and administrability.”*

Current IRS processing procedures have divided taxpayers’ returns with the same compliance issue - the ES penalty - into two separate and distinct groups after basic processing. Each group of returns goes through the same set of processing procedures and administrative actions up to the point of assessment. From that point, returns for taxpayers that computed the penalty follow a different set of procedures and administrative actions.

As shown in Attachment V, hypothetical taxpayers in the same circumstances can be assessed different amounts based solely on IRS internal procedures and not on proper application of the applicable tax law. These assessment processes do not provide for consistent treatment of taxpayers and compliance with IRS policy.

If taxpayers were to become aware of this inequity, voluntary compliance may be impacted and public confidence in the IRS could suffer. The IRS is not achieving fairness by inappropriately burdening taxpayers that take the time and effort to compute the penalty themselves, or pay a tax preparer to do it.

### **Recommendation**

The Deputy Commissioner (Operations) should establish procedures to eliminate those estimated tax penalties computed by taxpayers that fall below the tolerance level.

Management’s Response: Management’s response was due on July 21, 2000. As of July 31, 2000, management had not responded to the draft report.

## **Conclusion**

The IRS' processes for assessing the ES penalty have created significant taxpayer inequity when they are applied to taxpayers whose penalties fall below the tolerance level. Procedures need to ensure that all taxpayers are treated equally and are assessed the same penalty regardless of whether the penalty was computed by the taxpayer or the IRS.

#### Detailed Objective, Scope, and Methodology

The objective of this audit was to evaluate the Internal Revenue Service's (IRS) process for assessing the estimated tax (ES) penalty and its potential impact on taxpayer rights. During the review, we identified IRS processes for assessing the ES penalty but did not verify whether the processes were working effectively. Specifically, we:

- Determined the total volume and dollar amount of ES penalties that were assessed during 1999 on individual tax returns filed for Tax Year 1998.
- Determined how many taxpayers chose to have the IRS perform the calculations.
- Determined how many taxpayers computed the penalty themselves and how many of these were adversely affected by the tolerance level.
- Determined how much revenue the IRS collected on computed ES penalties under the tolerance level.

We performed the following audit tests to accomplish our objective:

- I. Performed a nationwide Masterfile<sup>1</sup> analysis of all 1998 individual income tax returns processed during 1999 and identified all tax modules which met the basic requirements for calculation of the ES penalty: (a) tax liability which was at least \$1,000, and (b) total prepaid credits which were less than 90 percent of the current year tax or 100 percent of the prior year tax.
- II. Counted the number of modules and calculated the total dollar amount of all ES penalties that were IRS-computed, and all of the IRS-computed that were subsequently abated (in whole or in part).
- III. Counted the number of modules and calculated the total dollar amount of all ES penalties that were taxpayer-computed, and all of the taxpayer-computed that were subsequently abated (in whole or in part).
- IV. Analyzed all tax modules with a taxpayer-computed ES penalty less than or equal to the tolerance amount. We counted the number of taxpayer accounts and calculated the total dollar amount of the ES penalties paid by these taxpayers.

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<sup>1</sup> The Masterfile is the IRS' database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

## **Estimated Tax Penalty Assessment Processes Create Significant Taxpayer Inequity**

- V. Contacted the Office of Penalty Administration to determine if there were any plans to modify the IRS' administration of the ES penalty.

**Major Contributors to This Report**

Gordon C. Milbourn III, Associate Inspector General for Audit (Small Business and Corporate Programs)

Richard J. Dagliolo, Director

Bernard Kelly, Senior Auditor

Paul R. Baker, Auditor

James Wellman, Auditor

Richard Ellsberry, Computer Specialist

Kevin O’Gallagher, Computer Specialist

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### **Outcome Measures**

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

Finding and recommendation:

Approximately 2.9 million (67.2 percent) of the 4.3 million taxpayers who computed their estimated tax (ES) penalty paid an amount that fell below the Internal Revenue Service's (IRS) tolerance level. These payments amounted to almost \$116 million for Tax Year 1998 returns filed in 1999. Other taxpayers, in the same circumstances, that did not compute the penalty on their tax return were not assessed penalties for amounts that fell below the tolerance level. We recommend that the Deputy Commissioner (Operations) establish procedures to eliminate penalties computed by taxpayers that fall below the tolerance level.

Type of Outcome Measure:

Taxpayer rights and entitlements (potential).

Value of the Benefit:

Approximately 2.9 million taxpayers did not receive equitable treatment when assessed ES penalties. These 2.9 million taxpayers paid almost \$116 million in estimated tax penalties that would not have been assessed if the taxpayers left the penalty line blank and let the IRS compute the penalty amount due.

Methodology Used to Measure the Reported Benefit:

Using a computer program developed by the Treasury Inspector General for Tax Administration, we analyzed IRS Masterfile<sup>1</sup> data for Tax Year 1998 individual income tax returns. These returns were the most recent available for analysis. We identified 4,312,834 taxpayers nationwide that had entered an amount on their 1998 tax return for an estimated tax penalty. Further computer analysis indicated that for 2,898,359 of these taxpayers (67.2 percent) the amount assessed was below the tolerance level. The total dollar amount of these 2,898,359 penalties was \$115,594,354.

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<sup>1</sup> The Masterfile is the IRS' database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

**Hypothetical Examples of Estimated Tax Penalty Assessments**

The following hypothetical examples show how taxpayers are treated differently in the assessment of the estimated tax (ES) penalty. For the examples below, we will assume that all figures are identical on both returns and only the taxpayer's decision is different.

**Taxpayer Enters the Estimated Tax Penalty Amount on the Return**

We will assume that while preparing a 1998 individual tax return, the hypothetical taxpayer or a paid preparer finds that the amount of unpaid tax owed is greater than: (1) \$1,000, and (2) at least 10 percent of the total tax due shown on the return. The taxpayer or preparer would use Underpayment of Estimated Tax by Individuals, Estates, and Trusts (Form 2210) or commercially available tax preparation software to calculate the penalty, and would enter this amount on the designated line of the Individual Income Tax Return (Form 1040). The return would then go through Internal Revenue Service (IRS) processing procedures. IRS procedures instruct employees to assess the ES penalty as entered by the taxpayer. These same IRS procedures are silent in regards to application of the tolerance level to the amount entered by the taxpayer. The IRS would then accept the taxpayer's payment.

**Taxpayer Does Not Enter the Estimated Tax Penalty Amount on the Return**

We will assume that the facts are exactly the same as above, except the hypothetical taxpayer or paid preparer does not use a Form 2210 or commercially available tax preparation software to calculate the penalty. Instead, the same taxpayer or preparer chooses to leave the ES penalty line blank, and allows the IRS to calculate the penalty and send a bill. Individual tax return instructions indicate that the taxpayer will not be charged interest on the penalty amount if it is paid by the date specified on the bill. This return also would go through the same IRS processing procedures and the IRS would compute the penalty amount due. In this scenario, IRS procedures instruct employees to apply the tolerance amount because the penalty was not calculated by the taxpayer. Since the IRS-computed penalty amount is less than the tolerance amount, no ES penalty is assessed and no bill is sent.

**Penalty Policy Statement (P-1-18)**

Penalties constitute one important tool of the Internal Revenue Service in pursuing its mission of collecting the proper amount of tax revenue at the least cost. Penalties support the Service's mission only if penalties enhance voluntary compliance. Even though other results, such as raising of revenue, punishment, or reimbursement of the costs of enforcement, may also arise when penalties are asserted, the Service will design, administer, and evaluate penalty programs solely on the basis of whether they do the best possible job of encouraging compliant conduct.

In the interest of an effective tax system, the Service uses penalties to encourage voluntary compliance by:

- (1) helping taxpayers understand that compliant conduct is appropriate and that non-compliant conduct is not;
- (2) deterring noncompliance by imposing costs on it; and
- (3) establishing the fairness of the tax system by justly penalizing the non-compliant taxpayer.

To this end, the Service administers a penalty system that is designed to:

- ensure consistency;
- ensure accuracy of results in light of the facts and the law;
- provide methods for the taxpayer to have his or her interests heard and considered;
- require impartiality and a commitment to achieve the correct decision;
- allow for prompt reversal of initial determinations when sufficient information has been presented to indicate that the penalty is not appropriate;
- ensure that penalties are used for their proper purpose and not as bargaining points in the development or processing of cases.

The Service maintains an ongoing effort to develop, monitor, and revise programs designed to assist taxpayers in complying with legal requirements and, thus, avoid penalties.

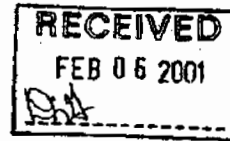
To ensure consistency, the Service prescribes and uses a single set of guidelines in a Penalty Handbook which will be followed by all operational and processing functions. Prior to implementation, changes to the Penalty Handbook must be reviewed for consistency with Service Policy and approved by the Office of Penalty Administration.

## **Estimated Tax Penalty Assessment Processes Create Significant Taxpayer Inequity**

The Service collects statistical and demographic information to evaluate penalties and penalty administration and how they relate to the goal of voluntary compliance. The Service continually evaluates the impact of the penalty program on compliance and recommends changes when the statutes or administration of penalties are not effectively promoting voluntary compliance.



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



JAN 30 2001

MEMORANDUM FOR TREASURY INSPECTOR GENERAL FOR TAX  
ADMINISTRATION

FROM: Joseph G. Kehoe *Joe G. Kehoe*  
Commissioner, Small Business/Self-Employed Division

SUBJECT: Treasury Inspector General for Tax Administration  
  
(TIGTA) Final Report - Estimated Tax Penalty  
Assessment Processes Create Significant Taxpayer  
Inequity (Reference #2000-30-112)

I am responding to your August 22, 2000, final report on the IRS estimated tax penalty process and its impact on some taxpayers. The estimated tax (ES) payment and penalty process have been a subject of many studies and audits. Although the findings have been similar, the recommendations to improve the process have varied. I welcome the opportunity to discuss the issues, and find innovative ways to simplify this complex area of the law.

While I appreciate the Treasury Inspector General for Tax Administration's recommendation to "eliminate penalties computed by taxpayers that fall below the established tolerance level," I do not agree that this alone will solve the issues raised by this report. In fact, I believe a better solution is to see if the self-assessment option can be eliminated or modified. Also, I believe that enactment of legislation would help eliminate the inequitable treatment of taxpayers.

**IDENTITY OF RECOMMENDATION/FINDING #1**

Individuals who compute the ES penalty themselves pay the penalty, while a portion of taxpayers that elect to have IRS compute the penalty are not required to pay it as their penalty balance due would fall below the IRS tolerance policy. To ensure equitable treatment of taxpayers and consistency in assessing ES penalties, the IRS needs to eliminate penalties computed by taxpayers that fall below the established tolerance level. The application of the tolerance policy causes inequitable treatment of taxpayers.

**ASSESSMENT OF CAUSE**

Taxpayers who are wage earners have income taxes and social security taxes withheld from their paychecks on a regular basis. The ES tax system supports the "pay-as-you-go" concept by requiring quarterly deposits from taxpayers who are self-employed and/or have earnings from such sources as interest, dividends, rent, alimony, and unemployment.

The IRS imposes an ES penalty on taxpayers who do not have enough withholding or pay enough estimated taxes throughout the year or did not make the payments on time. The ES penalty is the principal civil sanction supporting the standard of behavior taxpayers are expected to follow.

Taxpayers have the option of letting the IRS compute their ES penalty or computing their own penalty and Form 2210 provides such instructions. We apply an administrative tolerance to the penalties we compute, due to the cost/burden of computing, billing, and collecting the penalties under a certain amount. But, we do not apply the tolerance to the penalties taxpayers compute since the payment is what the taxpayers legally owe. Our tolerance amount is not public information.

**CORRECTIVE ACTION #1**

The Taxpayer Bill of Rights 2000, H.R. 4163, contained provisions on Failure to Pay Estimated Tax. Among the items proposed was an increase and revision to the estimated tax minimum threshold from \$1000 to \$2000 for taxable years beginning on or after December 31, 2000.

(b)(7)(E)

Unfortunately, for reasons unrelated to this issue, the Congress did not enact the bill into law. The IRS, however, is committed to seeking similar legislation in the future.

**IMPLEMENTATION DATE:**

Corrective Action #1 – Ongoing

**RESPONSIBLE OFFICIALS:**

Corrective Action #1 – Commissioner of Small Business/Self-Employed Division of the IRS

**CORRECTIVE ACTIONS MONITORING PLAN:**

The Commissioner of the Small Business/Self-Employed Division will work with Treasury to seek legislation similar to Bill H.R. 4163.

If you have any questions about our response, please contact me at (202) 622-0600 or Glenn Henderson, Director, Compliance at (202) 622-5100.