

**Changes to the Regulations for Granting
Extensions of Time to File Corporate Returns
Are Needed to Alleviate Significant Problems
With Administering the Tax Laws**

June 2004

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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

June 17, 2004

MEMORANDUM FOR DEPUTY COMMISSIONER FOR SERVICES AND
ENFORCEMENT

Gordon C. Milbourn III

FROM: Gordon C. Milbourn III
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Changes to the Regulations for Granting
Extensions of Time to File Corporate Returns Are Needed to
Alleviate Significant Problems With Administering the Tax Laws
(Audit # 200330023)

This report presents the results of our review of the granting of extensions of time to file corporate income tax returns. The overall objective of this review was to determine the effect that the existing tax laws, tax regulations,¹ and Internal Revenue Service (IRS) policies and procedures for granting extensions of time for filing corporate income tax returns are having on the timely payment of taxes, fairness for all taxpayers, taxpayer burden, and the Federal Government's costs. We initiated this audit because a previous Treasury Inspector General for Tax Administration (TIGTA) review of extensions of time to file individual income tax returns identified significant problems in these areas.²

In summary, the IRS is not fully meeting its mission because the regulations and related operational practices for granting extensions of time to file corporate income tax returns are preventing the effective, fair, and efficient administration of the tax laws requiring the timely payment of taxes and the assessment of appropriate penalties for late payments.³

¹ Tax regulations are rules, having the force of law, issued by the IRS to interpret and apply laws added to the Internal Revenue Code by the Congress.

² *The Regulations for Granting Extensions of Time to File Are Delaying the Receipt of Billions of Tax Dollars and Creating Substantial Burden for Compliant Taxpayers* (Reference Number 2003-30-162, dated August 2003).

³ 26 U.S.C. § 6072(a) (2002) requires payment by the normal tax return due date regardless of extensions of time to file, while the granting of an extension under 26 C.F.R. § 1.6081-3 (2002) normally prevents the assessment of the Delinquency Penalty in 26 U.S.C. § 6651(a)(1) (2002) against taxpayers who have not paid their taxes by the normal tax return due date.

A corporation that wishes to obtain a 6-month extension must normally submit 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. Although no justification is required, the corporation must provide an estimate of its tax liability on Form 7004 as well as its tax payment information. The IRS will grant the extension of time to file only if the corporation's payment information indicates it has paid as much or more than its estimated tax liability.⁴

Although an extension of time to file is not an extension of time to pay, approximately 168,000 of the 960,000 taxable corporations that obtained extensions of time to file in Calendar Year (CY) 1999 had failed to pay \$1.8 billion in taxes by the normal tax return due date. Corporations with an extension accounted for 86 percent of all delinquent taxes reported on corporate income tax returns filed after the normal CY 1999 tax return due date.

Payment noncompliance by some corporations that obtain extensions of time to file is habitual. Approximately 310,000 of the 960,000 taxable corporations that obtained an extension of time to file in CY 1999 failed to timely pay taxes on returns with extended due dates at least once between CYs 1998 and 2001, delaying the Federal Government's receipt of approximately \$5.8 billion in corporate taxes. Approximately 107,000 of the 310,000 corporations were delinquent in at least 2 of the 4 years. The average delinquent taxes owed by these corporations increased by 21.2 percent between CYs 1999 and 2000 and by an additional 19.2 percent between CYs 2000 and 2001.

The root causes for this noncompliance problem are the IRS tax regulations and practices for granting extensions of time to file. These regulations and practices can result in the granting of 6-month extensions of time to file based on frequently erroneous information provided by corporations on their extension applications showing that all anticipated taxes have been paid. For example, the corporate income tax returns filed by the approximately 960,000 taxable corporations that obtained extensions in CY 1999 reported total tax liabilities that were more than 3 times higher than the total tax estimates shown on their extension applications as being due and paid. When the extension applications are compared to the tax returns, the incidence of underestimated taxes is 5.5 times more prevalent than overestimated taxes. Despite such inaccurate estimates, once the IRS granted extensions to these corporations, the regulations and practices generally prevent the IRS from assessing the Delinquency Penalty⁵ of

⁴ The IRS automatically grants a 3-month extension of time to file to certain corporations with foreign income. While these corporations are not required to submit a request for an extension, they must add a note to their tax returns to indicate that they have availed themselves of the 3-month extension.

⁵ This penalty is also commonly referred to as the Failure to File Penalty. However, the penalty does not apply to taxpayers who have paid all taxes by the normal tax return due date and thus, could be applied to less than one-half of the corporations that failed to timely file tax returns due in CY 1999. Therefore, the more accurate term of Delinquency Penalty will be used throughout this report.

5 percent per month that would otherwise apply to any delinquent taxes that were not paid by the normal tax return due date.⁶

The current IRS extension regulations not only prevent the IRS from assessing Delinquency Penalties in response to payment noncompliance by some corporations, they also enable corporations owing unusually large amounts (i.e., more than \$100,000) to delay tax payments while avoiding increases in interest and Failure to Pay (FTP) Penalties that could otherwise apply to their unpaid taxes. In CY 1999, approximately 2,000 corporations that received an extension of time to file had unpaid taxes of more than \$100,000 each at the normal return due date. These corporations, 16 of which owed more than \$10 million each, accounted for approximately 60 percent (\$1.1 billion) of all delinquent taxes for CY 1999 owed by corporations with an extension.

The payment noncompliance suggests the IRS regulations and related operational practices for granting extensions of time to file may have caused some corporate taxpayers to lose respect for the deadline for paying income taxes. In addition to slowing the collection of significant amounts of corporate income taxes, the IRS regulations and practices for granting extensions have created other adverse effects on tax administration.

For example, the IRS regulations and practices penalize corporations differently for the same payment noncompliance. Corporations that file their returns and pay the same amount of delinquent taxes on the same day can be subject to vastly different interest and penalty amounts because of the protection from assessment of the Delinquency Penalty provided by an extension of time to file.

In addition, the IRS regulations and practices create unnecessary taxpayer burden. While payment-compliant corporations receive no financial benefit from obtaining an extension of time to file, they bear a substantial share of the burden of the extension-filing process. In CY 1999, about 800,000 payment-compliant taxable corporations, 96 percent of which the IRS considers to be small businesses,⁷ expended an estimated \$183 million to prepare and submit extension forms. These 800,000 payment-compliant corporations would not have been subject to interest or penalties if they had not obtained an extension of time to file.

Finally, the IRS regulations and practices increase operating costs for the Federal Government. We estimate the IRS incurred approximately \$900,000 in costs to process extension applications received from taxable corporations in CY 1999. We also estimate the Federal Government's interest expenses could have been reduced by up

⁶ The Delinquency Penalty is 5 percent per month and generally cannot exceed 25 percent of delinquent taxes. The Delinquency Penalty is reduced by the amount of the Failure to Pay (FTP) Penalty if they apply concurrently. The FTP Penalty is assessed on unpaid taxes at a rate of 0.5 percent per month and cannot exceed 25 percent of delinquent taxes. On grounds other than the amount of unpaid taxes, the IRS can declare an extension void during a tax return examination and retroactively assess the Delinquency Penalty against the taxpayer.

⁷ The IRS includes corporate entities with assets of \$10 million or less as part of its small business customer segment.

to \$57.7 million⁸ if the \$1.8 billion in taxes owed by corporate taxpayers with extensions of time to file in CY 1999 had been paid timely and had been used to avoid additional borrowing.

We recommended the IRS Commissioner change the regulations for granting extensions of time for filing corporate returns to eliminate the reliance on taxpayer estimates of anticipated tax liabilities; provide clear and quantifiable guidelines regarding the level of tax payment compliance needed to obtain an extension of time to file; grant extensions only to payment-compliant corporations; and establish 6 months as the sole length of the extension period. We also recommended that the Commissioner establish equitable safeguards, commonly called “safe harbors,” to protect reasonably compliant corporations from unwarranted assessments of the Delinquency Penalty; require assessment of the Delinquency Penalty, starting the day after the normal tax return due date, for any delinquent tax amounts in excess of the safe harbor allowances; and require the assessment of the FTP Penalty, starting the day after the normal tax return due date, for any delinquent tax amount of \$100,000 or more, regardless of the percentage of taxes paid by the normal tax return due date.

We also recommended that, once the above changes to the IRS regulations have been implemented and improved payment compliance has been achieved through the equitable application of the Delinquency Penalty, the IRS Commissioner consider changing the regulations to eliminate the requirement that taxable corporations must apply for an extension from the IRS.

Finally, we recommended the IRS Commissioner develop a legislative proposal for submission to the Department of the Treasury to change the existing rules for the assessment of increased interest and FTP Penalties. The change would require their assessment starting the day after the normal tax return due date on any corporate income tax delinquency of \$100,000 or more related to a return that, for any reason, was not filed by the normal tax return due date.

Management’s Response: The Commissioner, Small Business/Self-Employed (SB/SE) Division, responded that an IRS study team, convened as the result of the prior TIGTA audit on individual extensions, will also analyze several recommendations from this report. These include changing the regulations to eliminate the reliance on taxpayer estimates of anticipated tax liabilities; providing clear and quantifiable guidelines regarding the level of tax payment compliance needed to obtain an extension of time to file and granting extensions only to payment-compliant corporations; establishing equitable safeguards, or “safe harbors,” to protect reasonably compliant corporations from unwarranted assessment of the Delinquency Penalty; requiring assessment of the Delinquency Penalty, starting the day after the normal tax return due date, for any delinquent tax amounts in excess of the safe harbor allowances; and eliminating the requirement that taxable corporations must apply for an extension from the IRS. The Commissioner, SB/SE Division, advised that the study team will also analyze our

⁸ Estimate is based on the rate of interest paid on Federal Government debt in Fiscal Year 1999 per the Bureau of Public Debt.

recommendation to develop a legislative proposal to change the existing rules for the assessment of increased interest and FTP Penalties.

The Commissioner, SB/SE Division, did not agree with our recommendation to change the regulations to establish 6 months as the sole length of the extension period, stating that a paperless 3-month extension is provided for certain taxpayers that may not be able to file or request an extension by the original due date. The Commissioner, SB/SE Division, also did not agree with our recommendation to change the regulations to require the assessment of the FTP Penalty, starting the day after the normal corporate tax return due date, for any delinquent tax amount of \$100,000 or more, regardless of the percentage of taxes paid by the normal tax return due date. If an extension is granted and the taxpayer fails to pay the required tax, the Commissioner stated that the taxpayer must pay interest from the due date of the return until the tax is paid.

Finally, the Commissioner, SB/SE Division, did not agree with our estimates of the potential benefits that could be realized from implementing the recommendations in this report. The Commissioner expressed concerns with using penalties to increase revenue and disagreed with our conclusion that, over a 5-year period, taxpayer expenses of \$1.967 billion and IRS processing costs of \$5.3 million could be avoided by eliminating the requirement for taxable corporations to apply for an extension of time to file. The Commissioner stated there would be no significant reduction in taxpayer expenses since corporations would still need to make an estimate of the total tax they would need to report on their returns and, therefore, would still have to ensure they met all of the requirements for meeting their tax obligations timely. The Commissioner also stated that the up-front costs to make the needed changes to programming, publications, and training would eliminate the cost savings outlined in our report. Management's complete response to the draft report is included as Appendix VI.

Office of Audit Comment: While we are encouraged the IRS plans to study the feasibility of implementing some of our recommendations, we continue to believe taxpayer burden could be reduced and voluntary payment compliance could be improved by implementing those recommendations with which the IRS disagrees. To reduce taxpayer burden, for example, changing the regulations to establish 6 months as the sole length of the extension period would have the effect of eliminating a 2-tier system under which certain corporations receive automatic 3-month extensions of time to file without filing an application, but then must submit a paper form to obtain an additional 3-month extension, if needed.

To improve payment compliance, changing the regulations to assess FTP Penalties on delinquencies of \$100,000 or more (regardless of the percentage of total taxes that the \$100,000 represents) would have the effect of eliminating the IRS assumption that it is reasonable for corporations to underpay by such large amounts as long as the amount is not over 10 percent of the corporation's total tax liability. By its disagreement with this recommendation, the IRS is taking the position that the interest it charges is a sufficient deterrent to such a large tax delinquency; however, as shown on page 17 of this report, the effective interest rate charged by the IRS can be as little as 1.7 percent of a corporation's delinquent taxes.

We completely agree with the premise of the IRS Penalty Policy Statement P-1-18, which states, "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." However, we believe the evidence supports that the existing extension regulations protect corporate taxpayers from just penalties for payment noncompliance and are, in fact, encouraging noncompliance. Our recommendations advise the IRS to use its penalty authority to encourage compliant conduct. If total payment compliance is achieved, the ultimate result of our recommendations would be \$0 in penalty revenue.

We disagree with the IRS' determination that there would not be a significant reduction in taxpayer expenses from the recommended elimination of extension applications. As discussed in this report, the IRS' own estimates of the volume of extension applications and related preparation time indicate that taxable corporations will expend approximately 74 million hours in applying for extensions between CYs 2005 and 2009. Estimated Tax for Corporations (Form 1120-W), which is available to corporations to assist them in making the appropriate quarterly estimated tax payments,⁹ states that the average time to complete this Form will vary from 10 hours to 51 hours, depending on individual circumstances. Since our recommendations for requiring payment of sufficient taxes by the tax return due date mirror the requirements for making estimated tax payments, we do not believe corporations desiring extensions of time to file would require additional time to re-estimate their tax liabilities.

We are also unable to evaluate the IRS' conclusion that processing cost savings would not be realized by eliminating the requirement for taxable corporations to apply for an extension of time to file. The IRS provided no specific information to support its conclusion. Without information on the amounts or time periods associated with the costs required to change the programming, publications, and training, we cannot evaluate these change-related costs, including whether they are a one-time or recurring cost.

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 Parker F. Pearson, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs), at (410) 962-9637.

⁹ Corporations generally must make estimated tax payments if they expect their estimated tax (income tax less credits) to exceed \$500 or more. The installments are generally due by the 15th day of the 4th, 6th, 9th, and 12th months of the tax year.

**Changes to the Regulations for Granting Extensions of Time to File Corporate Returns
Are Needed to Alleviate Significant Problems With Administering the Tax Laws**

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Changes to the Regulations for Granting Extensions of Time to File Corporate Returns Are Needed to Alleviate Significant Problems With Administering the Tax Laws

Background

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

The Congress, through the Internal Revenue Code (I.R.C.), established the normal due date for corporate income tax returns at 2.5 months after the end of the corporation's tax year (e.g., March 15 for tax years ending in December).¹ The I.R.C. also establishes this same date as the deadline for paying corporate income taxes.²

The I.R.C. establishes three primary sanctions for not paying corporate income taxes by the normal due date: a Delinquency Penalty,³ a Failure to Pay (FTP) Penalty,⁴ and interest.⁵ Interest assessments, which are tax deductible for corporations, and FTP Penalty assessments both begin on the first day of a delinquency (i.e., the day following the normal tax return due date for newly filed returns) and continue until the delinquent taxes are fully paid. The beginning date of a Delinquency Penalty assessment depends on whether the Internal Revenue Service (IRS) determines that the tax return revealing the delinquent taxes was filed late.

¹ 26 U.S.C. § 6072(b) (2002).

² 26 U.S.C. § 6151(a) (2002).

³ 26 U.S.C. § 6651(a)(1) (2002). This penalty is also commonly referred to as the Failure to File Penalty. However, the penalty does not apply to taxpayers who have paid all taxes by the normal tax return due date and thus, could be applied to less than one-half of the corporations that failed to timely file income tax returns in Calendar Year 1999. Therefore, the more accurate term of Delinquency Penalty will be used throughout this report. The Delinquency Penalty is 5 percent per month and generally cannot exceed 25 percent of delinquent taxes. The Delinquency Penalty is reduced by the amount of the Failure to Pay Penalty if they apply concurrently.

⁴ 26 U.S.C. § 6651(a)(2) (2002). The FTP Penalty is 0.5 percent per month and cannot exceed 25 percent of the taxpayer's delinquent taxes.

⁵ 26 U.S.C. §§ 6621(a)(2) and (b)(2) (2002). Interest is assessed daily on unpaid delinquent taxes at rates that change each calendar quarter.

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The determination that a tax return filed after the normal return due date is late depends on whether the IRS granted the corporation an extension of time to file under authority delegated to it by the Congress.⁶ Income tax regulations⁷ provide guidelines for obtaining extensions of time to file.⁸ By law, an extension of time to file a corporate income tax return does not extend the deadline for paying the taxes that are due.⁹

A corporation that wishes to obtain a 6-month extension must normally submit 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. Although no justification is required, the corporation must provide an estimate of its tax liability on Form 7004 as well as its tax payment information. The IRS will grant the extension of time to file only if the corporation's payment information indicates it has paid as much or more than its estimated tax liability.¹⁰

According to IRS records,¹¹ about 5.4 million corporations filed income tax returns in Calendar Year (CY) 1999. Approximately 2.8 million corporations had requested an extension of time to file.

The audit was performed in accordance with *Government Auditing Standards* during October and November 2003. To perform the audit, we extracted and computer-analyzed 4 years of IRS Business Master File (BMF)¹² data for all

⁶ 26 U.S.C. § 6081 (2002).

⁷ Tax regulations are rules, having the force of law, written by the IRS to interpret and apply laws added to the I.R.C. by the Congress.

⁸ 26 C.F.R. § 1.6081-3 (2002).

⁹ 26 U.S.C. § 6081 and 26 U.S.C. § 6161 (2002).

¹⁰ The IRS automatically grants a 3-month extension of time to file to certain corporations with foreign income. While these corporations are not required to submit a request for an extension, they must add a note to their tax returns to indicate that they have availed themselves of the 3-month extension.

¹¹ IRS Research Division, Document 6186 (Rev. 11-00).

¹² The IRS database that consists of Federal tax-related transactions and accounts for business taxpayers. These include employment taxes, income taxes on businesses, and excise taxes.

Changes to the Regulations for Granting Extensions of Time to File Corporate Returns Are Needed to Alleviate Significant Problems With Administering the Tax Laws

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

taxable and nontaxable¹³ corporations that requested an extension of time to file income tax returns due in CY 1999, and the 600,000 taxable and nontaxable corporations that filed returns after their normal CY 1999 tax return due dates without obtaining extensions. We did not test management controls since they were not significant to our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

The IRS mission is to provide America's taxpayers top-quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all. The IRS is not fully meeting its mission because the regulations and related operational practices for granting extensions of time to file corporate income tax returns are preventing the effective, fair, and efficient administration of the tax laws requiring the timely payment of taxes and the assessment of appropriate penalties for late payments.¹⁴ These regulations and related operational practices are having the following significant adverse effects on tax administration:

- The IRS routinely grants extensions of time to file to corporations that have unpaid taxes totaling billions of dollars. Approximately 168,000 corporations that obtained an extension in CY 1999 had failed to pay \$1.8 billion in taxes by the normal tax return due date. Payment noncompliance by some corporations that obtain an extension of time to file is habitual, involves large amounts of delinquent taxes, and represents significant percentages of taxes due. This strongly suggests the IRS regulations¹⁵ and related

¹³ The IRS received 2.8 million income tax returns from Subchapter S corporations in 1999. Income earned by these corporations is not normally subject to corporate income tax but is, instead, subject to individual income taxes on the shareholder(s) returns.

¹⁴ 26 U.S.C. § 6072(a) (2002) requires payment by the normal tax return due date regardless of extensions of time to file, while the granting of an extension under 26 C.F.R. § 1.6081-3 normally prevents the assessment of the Delinquency Penalty in 26 U.S.C. § 6651(a)(1) against taxpayers who have not paid their taxes by the normal tax return due date.

¹⁵ 26 C.F.R. § 1.6081-3.

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operational practices for granting extensions have caused some corporations to lose respect for the deadline for paying income taxes.

- Fairness to all taxpayers is not being achieved since similarly situated corporations are assessed significantly different penalty amounts for delinquent taxes.
- Substantial and needless taxpayer burden is being created, primarily for small business corporations, since the extension-filing requirements are unnecessary and time-consuming. In CY 1999, approximately 800,000 payment-compliant taxable corporations expended approximately 6.9 million hours, valued at \$183 million, on preparing and submitting extension forms to the IRS. These 800,000 payment-compliant corporations would not have been subject to interest or penalties if they had not obtained an extension of time to file.
- Federal Government costs are being incurred to process unnecessary extension forms, and the Federal Government is losing the benefits normally derived from the prompt collection of tax revenues. We estimate the IRS incurred costs of approximately \$900,000 to process extension applications received from taxable corporations in CY 1999. The Federal Government's interest expenses could have been reduced by up to \$57.7 million¹⁶ in CY 1999 if the collection of \$1.8 billion in taxes owed by corporate taxpayers with extensions of time to file had not been delayed.

The root causes for these problems are the IRS tax regulations and practices for granting extensions of time to file. These regulations and practices can result in the granting of 6-month extensions of time to file based on frequently erroneous information provided on the Form 7004 that all anticipated taxes have been paid. These

¹⁶ Estimate is based on the rate of interest paid on Federal Government debt in Fiscal Year 1999 per the Bureau of Public Debt.

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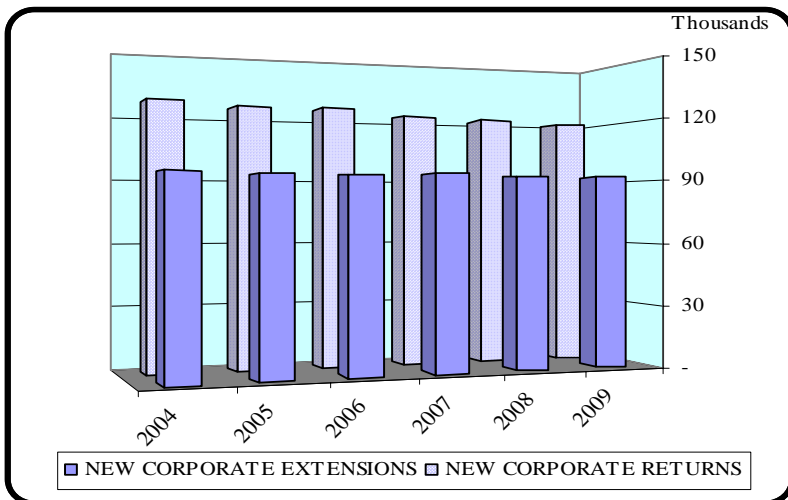
regulations and practices also generally prevent the IRS from assessing the Delinquency Penalty¹⁷ of 5 percent per month during the extension period, regardless of the amount of taxes that were underpaid at the normal tax return due date. The only available sanctions (i.e., interest and the FTP Penalty) against corporations with extensions of time to file may not provide sufficient incentive for making timely tax payments.

The adverse effects on tax administration may grow if, as the IRS expects, increasing numbers of corporations obtain extensions of time to file. As displayed in Figure 1, the IRS' projections of future filing activity for CYs 2004 through 2009 indicate the number of extensions obtained by corporate taxpayers will increase by an average of 92,000 per year, while corporate tax return filings will increase by an average of 123,000 per year. Thus, the IRS projects an extension growth rate equal to 75 percent of corporate tax return growth. In contrast, only 51 percent of corporations obtained an extension of time to file in 1999.

¹⁷ On grounds other than the amount of unpaid taxes, the IRS can declare an extension void during a tax return examination and retroactively assess the Delinquency Penalty against the taxpayer.

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Figure 1: Projected Annual Increases in New Corporate Returns and Extensions (CYs 2004-2009)



Source: *Projections of Returns to be Filed in CYs 2002-2009. Statistics of Income Bulletin, Winter 2002-2003 (April 2003).*

The remainder of this report presents a detailed analysis of the adverse effects the IRS extension regulations and practices are having on tax administration.

Corporations that obtain an extension of time to file are frequently noncompliant in timely paying their taxes

To evaluate the level of tax payment noncompliance among corporate taxpayers that obtain extensions of time to file, we computer-analyzed 4 years of tax account data for the approximately 960,000 *taxable* corporations that obtained an extension of time to file in CY 1999.¹⁸ We also computer-analyzed the accounts of approximately 300,000 taxable corporations that did not obtain an extension but filed tax returns after the normal CY 1999 due date.

More than 653,000 (68 percent) of the 960,000 taxable corporations that filed returns after receiving extensions of time to file in CY 1999 had paid all of their taxes by the normal return due date and filed their tax returns by the

¹⁸ Account analysis was limited to taxpayers filing a United States (U.S.) Corporation Income Tax Return (Form 1120) or a U.S. Corporation Short-Form Income Tax Return (Form 1120-A), representing approximately 93.6 percent of all return filings by taxable corporations.

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extended return due date. However, the remaining 306,000 corporations (32 percent) presented the IRS with payment and/or filing compliance problems:¹⁹

- Approximately 168,000 corporations failed to pay all of their taxes by the normal tax return due date. In addition, approximately 34,000 of these corporations still had balance due accounts after filing their returns.
- Approximately 169,000 corporations filed tax returns after the extension periods had expired.²⁰

The IRS granted an extension of time to file to approximately 960,000 taxable corporations in CY 1999 based on information provided on their Forms 7004 showing that all anticipated taxes had been paid. However, this information proved to be highly unreliable. The income tax returns subsequently filed by these 960,000 taxable corporations reported total tax liabilities that were more than 3 times higher than the total tax estimates shown on their extension applications as being due and paid. When the extension applications are compared to the tax returns, the incidence of underestimated taxes is 5.5 times more prevalent than overestimated taxes.

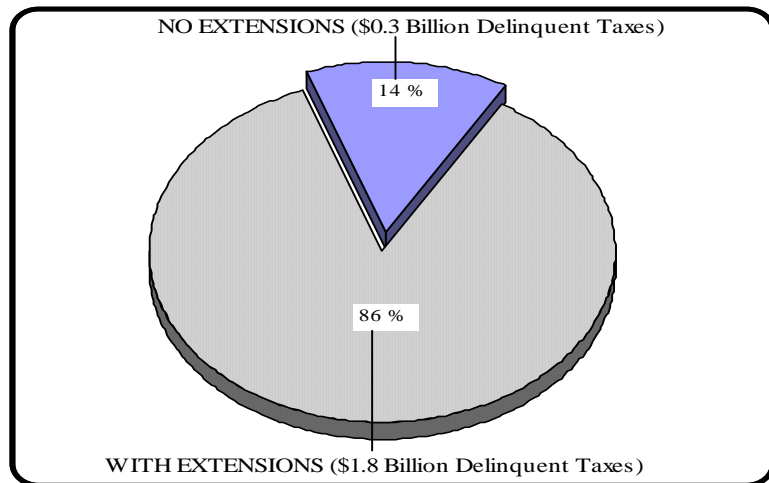
Figure 2 demonstrates the economic impact of payment noncompliance among corporations with an extension of time to file. Corporations with an extension accounted for 86 percent of all delinquent taxes reported on corporate income tax returns filed after the normal CY 1999 tax return due date.

¹⁹ The 653,000 compliant corporations and 306,000 noncompliant corporations do not equal the total of 960,000 due to rounding.

²⁰ The totals of these 2 categories exceed 306,000 because some corporate taxpayers presented both payment and filing compliance problems.

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Figure 2: CY 1999 Delinquent Taxes on Corporate Income Tax Returns Filed After Their Normal Due Dates



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

This noncompliance suggests that obtaining extensions of time to file may be the strategy of choice for corporations that are unable or unwilling to pay their taxes by the normal tax return due date. It also suggests the interest and penalty charges on tax underpayments by corporations with extensions are ineffective for achieving compliance and are hampering the IRS' ability to carry out its commitment to America's taxpayers. If the use of extensions of time to file by corporations continues to grow, as the IRS believes it will, it is likely that this apparent indifference to making timely tax payments will also grow.

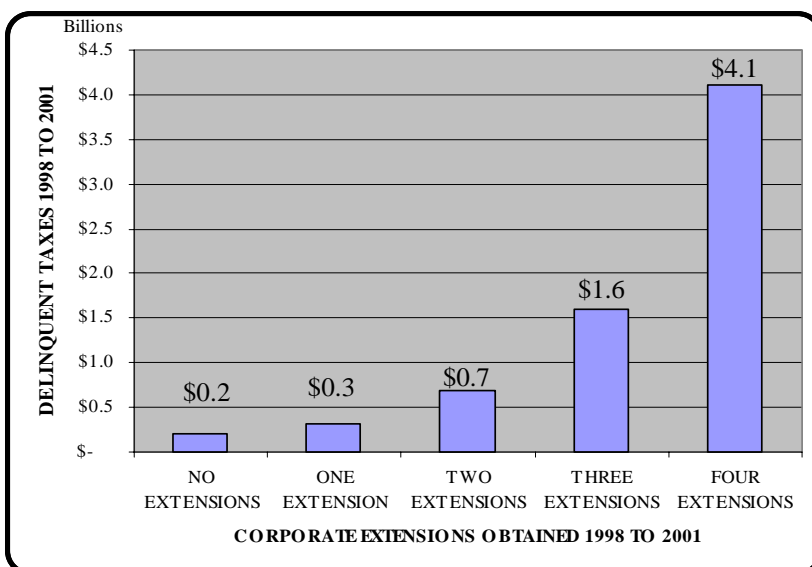
Payment noncompliance by some corporations that obtain extensions of time to file is habitual

Approximately 310,000 of the 960,000 corporations that obtained an extension in CY 1999 failed to timely pay taxes on extension-related returns at least once between CYs 1998 and 2001. Approximately 107,000 of the 310,000 corporations were delinquent in at least 2 of the 4 years. The total delinquent taxes of these corporations exceeded \$5.8 billion over the 4-year period. The average delinquent tax amounts owed by these corporations increased by 21.2 percent between CYs 1999 and 2000 and by an additional 19.2 percent between CYs 2000 and 2001.

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Figure 3 presents a 4-year history of the corporations that filed tax returns after their normal due dates, with or without obtaining extensions of time to file. It shows the corporations that obtained an extension in 3 or more years accounted for almost 83 percent of the delinquent taxes. This strong relationship between delinquent taxes and the frequency of extension use suggests some corporations that regularly obtain extensions are indifferent to both the importance of timely tax payments and the impact of current penalties for late payments.

Figure 3: Relationship Between Extension Use and the Amount of Delinquent Taxes Owed

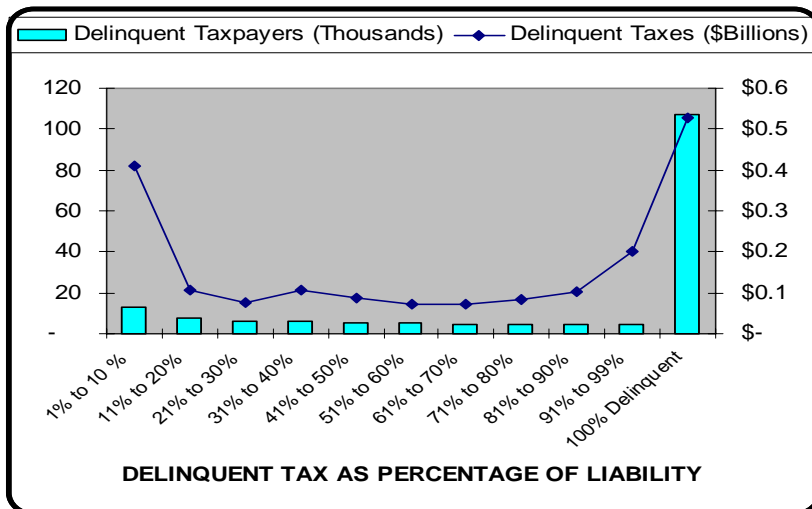


Source: TIGTA analysis of IRS BMF data.

Figure 4 demonstrates that many corporations with an extension of time to file had apparently made little or no effort to pay their taxes by the normal tax return due date for CY 1999. For example, the far right column of Figure 4 shows that 107,000 corporations made no tax payments at all by the return due date and owed more than \$0.5 billion in delinquent taxes. In all, 130,000 corporations with an extension of time to file paid less than one-half of their tax liabilities by their return due dates.

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Figure 4: CY 1999 Delinquent Taxes as a Percentage of Tax Liability



Source: TIGTA analysis of IRS BMF data.

While it is understandable that some corporations obtaining extensions of time to file may not know their exact tax liabilities before their returns are completed, the above data suggest a lack of concern or due care by some corporations regarding the timeliness of their tax payments.

To explore the levels of filing and payment noncompliance among chronically delinquent corporate taxpayers, we analyzed the accounts of approximately 74,000 corporations that obtained an extension of time to file. This group was comprised of all corporations that obtained an extension of time to file in at least 3 of the 4 years (including CY 1999) between CYs 1998 and 2001 and failed to pay their taxes by the normal tax return due date at least twice (including CY 1999) during the 4-year period.

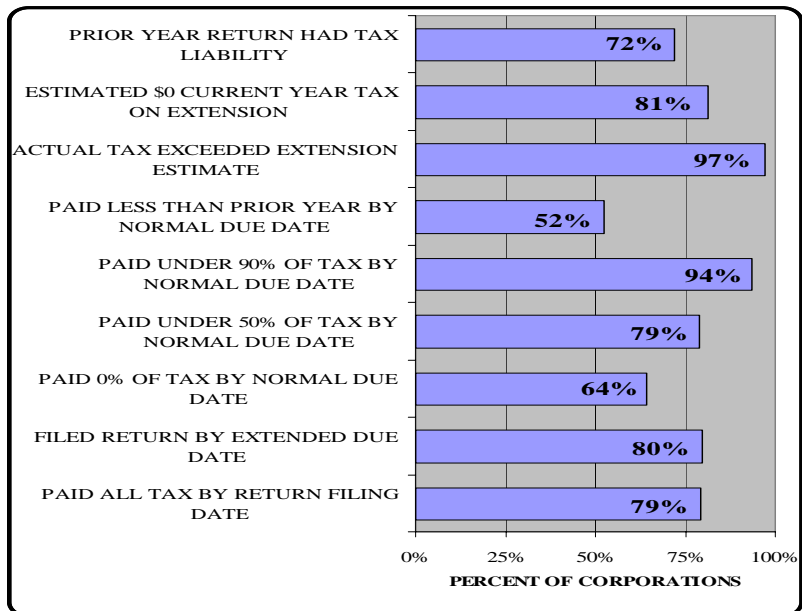
In obtaining an extension of time to file in CY 1999, these 74,000 corporations estimated tax liabilities that averaged approximately \$10,800. However, the tax returns that were eventually filed by these corporations reported tax liabilities that averaged approximately \$48,200. In reality, at the time the extensions were obtained, these corporations had underpaid their taxes by a total of \$730 million. Of these 74,000 corporations, 920 had underpaid by more than \$100,000 each, including 45 that had underpaid by more

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than \$1 million each and another 6 that had underpaid by more than \$10 million each.

Figure 5 shows other common filing and payment characteristics of the 74,000 chronically noncompliant corporations.

Figure 5: Characteristics of Chronically Noncompliant Corporations That Obtained an Extension of Time to File (Returns With Normal Due Dates in CY 1999)



Source: TIGTA analysis of IRS BMF data.

Those corporations considered by the IRS to be large or mid-size businesses had underpaid their 1999 taxes by an average of approximately \$194,100 each.²¹ Those corporations considered by the IRS to be small businesses had underpaid their taxes by an average of approximately \$6,100 each.²²

Fairness to all taxpayers is not being achieved

The IRS mission statement conveys the IRS' commitment to helping taxpayers "understand and meet their tax

²¹ The IRS includes corporate entities with assets greater than \$10 million in its large and mid-size business customer segment.

²² The IRS includes corporate entities with assets of \$10 million or less as part of its small business customer segment.

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responsibilities...by applying the tax law with...fairness to all.” To help taxpayers understand the importance of compliance, the I.R.C. authorizes the IRS to penalize taxpayers who fail to timely file their tax returns and/or timely pay their tax liabilities.

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

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

The IRS regulations and practices for granting extensions of time to file are not ensuring fairness to all corporate taxpayers because:

- Corporations can neutralize the penalties and interest charged for delaying large tax payments by obtaining an extension of time to file.
- Similarly situated corporations are assessed significantly different penalty amounts.

The cumulative effect of these problems is the potential erosion of public confidence in the fairness of the tax system. This effect may grow if increasing numbers of corporations use extensions of time to file and benefit from their protection against assessment of the Delinquency Penalty.

A study by the Joint Committee on Taxation (JCT)²³ pointed out that tax laws sometimes reduce taxpayer perceptions of fairness in the Federal tax system in the following ways:

²³ JCT, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS-3-01, dated April 2001).

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- Taxpayers may believe certain tax laws confer an opportunity for manipulation of the tax laws by other taxpayers.
- Taxpayers who inadvertently fail to comply may become disillusioned with apparently inconsistent tax policy, grow cynical, and ultimately engage in intentional noncompliance.
- The disparate treatment of similarly situated taxpayers can lead some taxpayers to believe they bear a disproportionate tax burden.

Corporations can obtain an extension of time to file to neutralize the penalties and interest charged for delaying large tax payments

In a 1999 report to the Congress, the Department of the Treasury, Office of Tax Policy, emphasized that interest and penalties for tax delinquencies should “discourage use of the government as a low-cost source of funds.” The report further stated that if the sanctions were not set sufficiently high, taxpayers “would have an incentive to defer payment of their tax debt and to utilize the funds for other investment purposes.”²⁴

Without the Delinquency Penalty of 5 percent per month, the only sanctions against corporations with extensions of time to file are interest charges and the FTP Penalty. These sanctions may not provide sufficient incentive for timely tax payments, depending on the economic conditions and the level of investment risk a corporation is willing to assume.

For example, if a corporation had paid less than 90 percent of its taxes by March 15, 2003, the interest and FTP Penalty charges totaled only 5.6 percent of the taxes that were due by March 15 but not paid until the September 15 extended return due date. A corporation paying at least 90 percent of its taxes by March 15 faced interest and penalty charges of

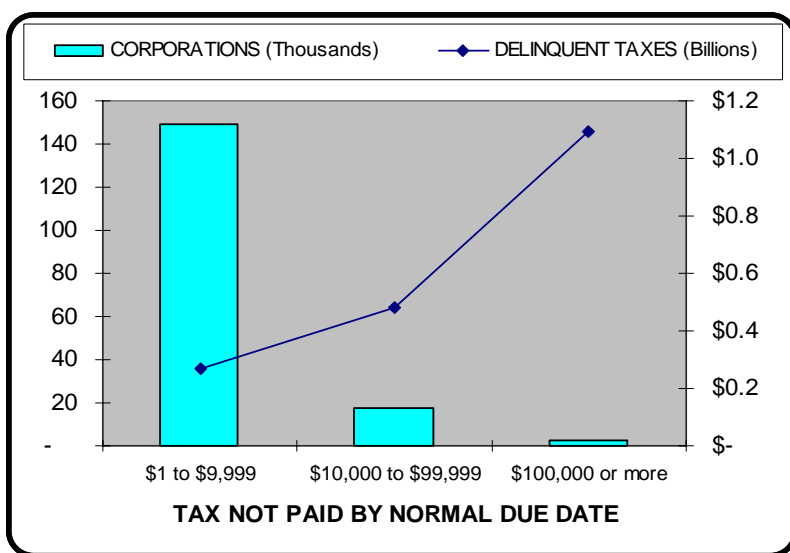
²⁴ Department of the Treasury, Office of Tax Policy, *Report to The Congress on Penalty and Interest Provisions of the Internal Revenue Code* (dated October 1999).

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only 2.6 percent for the same offense.²⁵ The ability of corporations to deduct interest paid to the IRS from their taxable income effectively reduces their actual penalty and interest costs to as little as 1.7 percent.²⁶

As Figure 6 shows, approximately 2,000 corporations that received an extension of time to file in CY 1999 had unpaid taxes of more than \$100,000 each at the normal return due date. These 2,000 corporations, 16 of which owed more than \$10 million each, accounted for approximately 60 percent (\$1.1 billion) of all delinquent taxes for CY 1999 owed by corporations with an extension.

Figure 6: Delinquent Taxes Owed by Corporations With an Extension of Time to File (CY 1999)



Source: TIGTA analysis of IRS BMF data.

The Congress has expressed its displeasure with taxpayers delaying the payment of substantial amounts of taxes by requiring the earlier doubling of the FTP Penalty rates²⁷ and

²⁵ Delinquent taxes less than 10 percent of the tax liability are generally exempt from the FTP Penalty during the extension period per IRS regulations in 26 C.F.R. § 301.6651(c)(4)(ii) (2002).

²⁶ Depending on the corporation's marginal tax rate (the rate at which each additional dollar of income is taxed). The actual cost savings would not be realized until the corporation files its subsequent year return deducting the interest paid.

²⁷ 26 U.S.C. §§ 6651(a)(3) and (d)(1) (2002).

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raising interest rates by 2 percent²⁸ for corporate tax delinquencies in excess of \$100,000. However, these provisions do not take effect until the corporations have filed their returns, received bills from the IRS, and failed to timely pay in response to the bills. Since extensions of time to file allow corporations to delay the filing of returns, the extensions also delay the IRS billing process.

Table 1 demonstrates the economic advantage that a corporation with a significant tax debt receives by obtaining an extension of time to file from the IRS.

²⁸ 26 U.S.C. § 6621(c) (2002).

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**Table 1: Identical Delinquent Taxes and Payment Dates;
Corporation 2 Files on Normal Tax Return Due Date²⁹**

	Corporation 1	Corporation 2
Return Due Date	3/15/2003	3/15/2003
Actual Tax Liability	\$100,000,000	\$100,000,000
Taxes Unpaid on 3/15	\$ 10,000,000	\$ 10,000,000
Extended Due Date	9/15/2003	None
Date Return Filed	9/15/2003	3/15/2003
Date Tax Balance Paid	9/15/2003	9/15/2003
Interest	\$255,241	\$331,373
FTP Penalty ³⁰	\$0	\$400,000
Delinquency Penalty	\$0	\$0
Total Interest and Penalties	\$255,241	\$731,373³¹
Interest and Penalties As a Percentage of Delinquent Taxes	2.6%	7.3%

Source: TIGTA analysis. Interest and penalty amounts are rounded to the nearest dollar.

In the above hypothetical example, both taxpayers owed the same amount of delinquent taxes for the same period of time. However, Corporation 2 hastened the IRS' demands for payment by filing on its normal tax return due date and disclosing its tax underpayment.

Since Corporation 2 did not pay its taxes until 6 months after it started receiving bills from the IRS, it was assessed an FTP Penalty at twice the normal rate and was assessed

²⁹ The hypothetical situation presented in Table 1 is designed to illustrate an egregious, rather than typical, example of the impact that obtaining an extension of time to file can have on penalty and interest charges on the late payment of taxes.

³⁰ Corporation 1 is exempt from the FTP penalty for the period of the extension per IRS regulations in 26 C.F.R. § 301.6651(c)(4)(ii) which assume that corporations have reasonable cause to underpay by 10 percent of their tax liability during the extension period.

³¹ Assumes the increase in interest began on May 1, 2003, and the increased FTP Penalty began on June 15, 2003.

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interest at a rate that was 2 percent higher than normal. In contrast, Corporation 1 delayed the disclosure of its \$10 million tax delinquency for 6 months with the help of an extension of time to file granted by the IRS. Although Corporation 1 took just as long as Corporation 2 to fully pay its taxes, it faced only the normal interest rate and no penalties.

Thus, the current IRS extension regulations create an environment in which corporations that are comfortable with weighing the risks and rewards of alternative financial strategies may not always choose to promptly pay their taxes. In the example presented in Table 1, the 6-month delay in paying taxes by Corporation 1 would have been a profit-maximizing decision in 2003. Although the IRS would have billed the corporation for \$255,241 in interest on its untimely paid taxes, the interest would have been deductible from the corporation's current year income, thereby reducing the actual interest cost to \$165,907, or just 1.7 percent of the delinquent taxes.

During the same March 15 to September 15, 2003, time period, the Standard and Poor's (S&P) stock market index increased by 18.1 percent.³² In light of such economic conditions, it is possible that, by delaying payment of its taxes by 6 months, Corporation 1 could have made an initial "profit" of \$1.8 million by choosing investments with risks and profit potential similar to the S&P 500 stocks. After paying the IRS interest on its untimely paid taxes and then deducting the interest from its current year taxes, Corporation 1's net "profit" for delaying payment of its taxes could be over \$1.6 million.

In lieu of investing money that should have been paid in taxes, Corporation 1 could also have benefited by paying any creditors that charged higher interest rates than the IRS. Thus, corporations that may have been unable or unwilling to pay substantial tax amounts on the normal due date in

³² The S&P index represents the 500 largest publicly traded companies and is considered to be a benchmark of the overall conditions of the stock market.

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CY 2003 may have profited by seeking an extension of time to file and exploring investment alternatives.

In summary, the current extension regulations and related penalty regulations enable corporations that owe large tax amounts to escape both Delinquency and FTP Penalties, and to delay or eliminate increases in interest and FTP Penalties intended by the Congress to ensure rapid payment of large tax delinquencies. As a consequence, depending on the investment environment, investing tax dollars rather than paying them promptly when due can become a profitable financial strategy.

If the interest and penalty increases were tied to the tax payment deadline (i.e., the normal tax return due date) rather than the timing of the payment in relation to IRS billing dates, corporations with at least \$100,000 in unpaid taxes that file returns after the normal due date would be assessed approximately \$120.6 million in additional interest and FTP Penalties between CYs 2005 and 2009. To ensure the effectiveness of such a measure, the IRS would need to change its regulations that currently eliminate an FTP Penalty assessment if the delinquent tax amount is less than 10 percent of the corporation's total tax liability, even if the amount of the delinquency is unusually large.³³

Similarly situated corporations are assessed significantly different penalty amounts

Fairness in the tax system suggests similarly situated corporations should be treated in a like manner. Further, fairness to all taxpayers suggests all corporations should be confident that other corporations are compliant and that, when noncompliance occurs, appropriate penalties will be assessed.

The current regulations and practices for granting extensions of time for filing corporate income tax returns do not promote fairness. Similarly situated corporations are treated differently based only on the Delinquency Penalty

³³ Delinquent taxes less than 10 percent of the tax liability are generally exempt from the FTP Penalty during the extension period, per IRS regulations in 26 C.F.R. § 301.6651(c)(4)(ii).

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protection provided by the extension of time to file. As shown by the hypothetical examples in Tables 2 and 3, corporations that file their returns and pay the same amount of delinquent taxes on the same day can be subject to vastly different interest and penalty amounts.

In the hypothetical example presented in Table 2, both corporations owed the same amount of taxes on their normal March 15 tax return due dates and both filed their returns on September 15 with full payment of the taxes owed. The only difference between these similarly situated taxpayers is that Corporation A requested and obtained an extension of time to file until September 15 and Corporation B did not.

As a result, Corporation B was charged \$2,308 more in interest and penalties than Corporation A by not requesting and obtaining an extension of time to file. In actual practice, this penalty imbalance primarily affects small businesses since, based on the corporate tax returns due in CY 1999, approximately 99 percent of the taxpayers fitting the general description of Corporation B were considered by the IRS to be small businesses.

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**Table 2: Identical Delinquent Taxes, Payment Dates, Filing Dates;
Extension of Time to File Protects Corporation A**

	Corporation A	Corporation B
Return Due Date	3/15/2003	3/15/2003
Actual Tax Liability	\$10,000	\$10,000
Tax Paid by Normal Due Date	\$0	\$0
Tax Estimate on Extension Form	\$0	N/A
Extended Due Date	9/15/2003	None
Date Return Filed	9/15/2003	9/15/2003
Tax Paid With Return	\$10,000	\$10,000
Interest (5 percent) ³⁴	\$255	\$313
FTP Penalty	\$300	\$300
Delinquency Penalty	\$0	\$2,250
Total Interest and Penalties	\$555	\$2,863

Source: TIGTA analysis. Interest and penalty amounts are rounded to the nearest dollar.

Table 3 demonstrates how the identical timing of payments by two corporations with different extended due dates results in unequal treatment. In this hypothetical example, both corporations received an extension of time to file, filed their returns by September 15, and paid their delinquent taxes on September 15. Corporation C is a domestic corporation doing business principally within offshore United States (U.S.) possessions and, therefore, received an automatic 3-month extension without requesting it from the IRS. However, Corporation C did not file its return by its June 15 extended due date and was charged \$1,367 more in interest and penalties than Corporation A for not filing until September 15. Corporation C could have avoided this situation by submitting a request for an additional 3-month extension to September 15.

³⁴ Interest is computed daily over a 365-day year.

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**Table 3: Identical Delinquent Taxes, Payment Dates, Filing Dates;
Corporation C Penalized for Obtaining Only a 3-Month Extension**

	Corporation A	Corporation C
Return Due Date	3/15/2003	3/15/2003
Actual Tax Liability	\$10,000	\$10,000
Tax Paid by Normal Due Date	\$0	\$0
Tax Estimate on Extension Form	\$0	N/A
Extended Due Date	9/15/2003	6/15/2003
Date Return Filed	9/15/2003	9/15/2003
Tax Paid With Return	\$10,000	\$10,000
Interest (5 percent) ³⁵	\$255	\$272
FTP Penalty	\$300	\$300
Delinquency Penalty	\$0	\$1,350
Total Interest and Penalties	\$555	\$1,922

Source: TIGTA analysis. Interest and penalty amounts are rounded to the nearest dollar.

While Corporations B (see Table 2) and C (see Table 3) both filed tax returns after their respective due dates, Corporation C was charged \$941 less than Corporation B for paying late. This is because a corporation that has been granted an extension of time to file is exempt from the Delinquency Penalty for the period of the extension, regardless of whether the return is eventually filed by the extended due date.

Extension requirements create unnecessary taxpayer burden, particularly for small businesses

The Paperwork Reduction Act³⁶ seeks to ensure that Federal Government agencies balance their need to collect information with the paperwork burden imposed on the public in complying with the collection. The Office of Management and Budget (OMB) measures paperwork

³⁵ Interest is computed daily over a 365-day year.

³⁶ 44 U.S.C. Chapter 35 (2003).

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burden in terms of the time and financial resources the public devotes to complying with information requests.

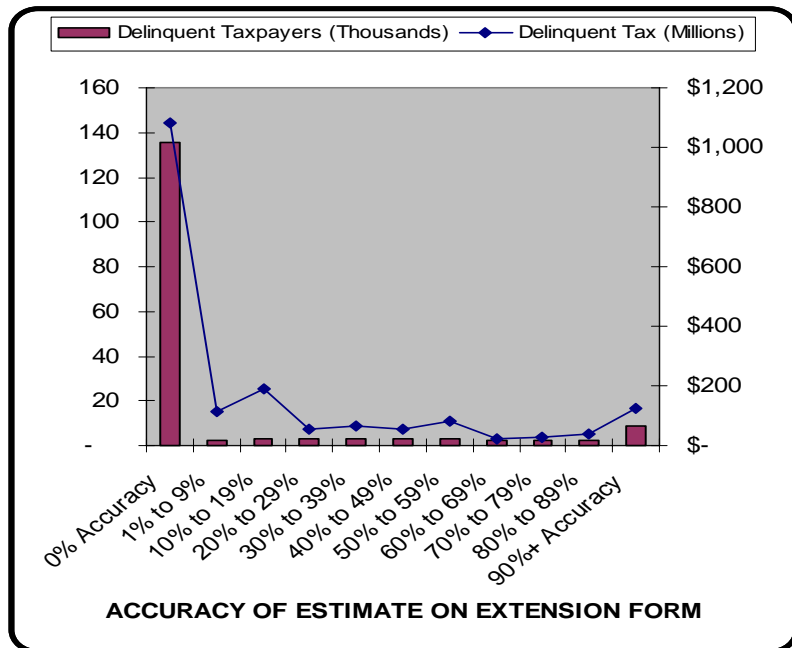
The primary reason for requiring corporations to provide estimated tax liabilities and payment information on the extension application is to ensure they have paid all taxes timely and, thereby, qualify for an extension of time to file. For those corporations applying for extensions of time to file returns due in CY 1999, this goal was generally not met. Given the magnitude of the discrepancies between the tax estimates on the extension forms and the actual tax liabilities, it is unclear whether the information being collected on the extension forms holds any value for the taxpayers or the IRS.

For the approximately 960,000 taxable corporations that were granted an extension of time to file in CY 1999, the estimated tax liabilities shown on the extension applications represented only 32 percent of the actual tax liabilities that the corporations subsequently reported on their returns. Underestimated taxes were 5.5 times more prevalent than overestimated taxes on the extension applications.

Figure 7 explores the tax estimates of the 168,000 taxable corporations with an extension of time to file that did not pay all of their taxes by their normal CY 1999 return due dates. The data demonstrate that 84 percent of the taxpayers were granted an extension based on tentative tax estimates that represented only 20 percent or less of their actual tax liabilities. These taxpayers accounted for \$1.4 billion of the \$1.8 billion in CY 1999 delinquent taxes that were related to corporations with extended return due dates.

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Figure 7: Accuracy of Tax Estimates by Delinquent Taxpayers



Source: TIGTA analysis of IRS BMF data.

Not only does obtaining an extension of time to file from the IRS not ensure the timely payment of taxes required by law, it enables payment-noncompliant corporations to avoid the full consequences of their noncompliance by preventing the routine assessment of the Delinquency Penalty. In addition, while payment-compliant corporations receive no financial benefit from obtaining extensions of time to file, they bear a substantial share of the burden of the extension-filing process.

For example, in CY 1999, about 800,000 of the approximately 960,000 taxable corporations that filed returns after obtaining an extension of time to file were payment-compliant (i.e., all taxes paid by the normal return due date). These 800,000 payment-compliant corporations would not have been subject to interest or penalties if they had not obtained an extension of time to file.

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The IRS and OMB estimate that, in CY 1999, corporations spent 8.75 hours,³⁷ at a cost of \$26.50 per hour, to prepare and submit extension applications. Thus, the payment-compliant corporations expended approximately 6.9 million hours, valued at \$183 million, on extension preparation and submission in CY 1999. During the 5-year period of CYs 2005 through 2009, payment-compliant corporations will be subjected to 47.3 million hours of unnecessary burden, valued at \$1.3 billion, from the IRS extension regulations. Approximately 96 percent of this burden will be borne by corporations considered by the IRS to be small businesses.

If a new regulatory action that placed such a sizable burden on small businesses was proposed today, it would be subject to extensive review, analysis, and comment to determine its compliance with:

- The Regulatory Flexibility Act of 1980.³⁸
- Executive Order 12866 (1993).
- The Paperwork Reduction Act of 1995.³⁹
- The Small Business Regulatory Enforcement Fairness Act of 1996.⁴⁰
- The Small Business Paperwork Relief Act of 2002.⁴¹
- Executive Order 13272 (2002).

These numerous attempts by the Congress and the President to curb unnecessary paperwork burden would require studies of the impact of such a costly regulation on small businesses, a comparison of the regulation's costs versus its benefits, and a consideration of less burdensome means of

³⁷ Per the Form 7004 used for Tax Years 1998 and 1999, the time estimate includes 5 hours and 30 minutes for record keeping, 58 minutes to learn about the law or the Form, 2 hours and 1 minute to prepare the Form, and 16 minutes to copy, assemble, and mail the Form to the IRS. Per the Form 7004 used for Tax Years 2000 and 2001, the total time for these activities was 9.817 hours.

³⁸ Pub. L. No. 96-354.

³⁹ 44 U.S.C. Chapter 35.

⁴⁰ Pub. L. No. 104-121.

⁴¹ Pub. L. No. 107-198.

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achieving the desired results. However, the reviews and studies required by these public laws and Presidential orders apply only to new regulations. The IRS regulations for granting extensions of time to file to corporate taxpayers have not changed since 1983.

Currently, only certain corporations with offshore or foreign income are exempted from the burden of filing extension applications with the IRS.⁴² If the IRS changed its regulations to establish 6 months as the sole extension period for all taxable corporations and eliminate the requirement for taxable corporations to apply for extensions, we estimate that, between CYs 2005 and 2009, approximately 2.1 million corporations would be relieved of the burden of preparing and filing extension applications, saving them an estimated \$2.0 billion. Of these corporations, approximately 2.0 million (96 percent) are considered small businesses by the IRS.

The Federal Government's costs are increased

The IRS incurs a significant and costly burden to process extension applications each year. We estimate the IRS costs to process the extension applications received from taxable corporations in CY 1999 were approximately \$900,000. Between CYs 2005 and 2009, the IRS could save \$5.3 million by eliminating the processing of the 7.6 million extension applications that are expected to be filed by taxable corporations.

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

In CY 1999, approximately 168,000 corporations with an extension of time to file failed to pay \$1.8 billion in taxes by

⁴² Per 26 C.F.R. § 1.6081-5 (2002), certain corporations need not submit extension forms to be automatically granted 3-month extensions but must submit Form 7004 to receive an extension of 6 months from the normal tax return due date.

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the normal tax return due date. Of this amount, \$700 million had remained unpaid by September 30, 1999 (the end of the Federal Government's fiscal year). Increasing tax receipts or decreasing Federal Government expenditures during a fiscal year makes additional funds available for the Government's use. These additional funds can be used to reduce existing or planned Federal Government debt or to procure additional vital goods and services without incurring debt. The Federal Government would have been presented with such opportunities if more of the \$700 million in corporate income taxes that were not paid by September 30, 1999, had been collected in the fiscal year in which they were actually due to be received.

Collecting taxes earlier can also help the Federal Government avoid additional borrowing. In CY 1999, for example, the Federal Government's interest expenses could have been reduced by up to \$57.7 million⁴³ if the \$1.8 billion in taxes owed by corporate taxpayers with an extension of time to file had been paid timely and had been used to avoid additional borrowing.

The earlier collection of corporate income taxes could be brought about by revising IRS extension regulations to 1) provide clear, quantifiable guidelines regarding the level of payment compliance needed to obtain an extension of time to file; 2) require the assessment of the Delinquency Penalty on delinquent tax amounts starting on the day after the normal tax return due date; 3) provide equitable safeguards, commonly called "safe harbors," to ensure the Delinquency Penalty is not assessed for inadvertent or minor underpayments; and 4) establish 6 months as the sole extension of time to file corporate returns.

With such changes, we estimate that between CYs 2005 and 2009:

⁴³ Estimate is based on the rate of interest paid on Federal Government debt in Fiscal Year 1999 per the Bureau of Public Debt.

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- Corporations seeking to meet the new safe harbor allowances⁴⁴ would increase the amount of taxes they pay by their normal tax return due dates, thus incrementally increasing current year Federal Government receipts in each of the fiscal years. This would increase tax receipts by the normal return due date by an estimated \$2.9 billion over a 5-year period. Approximately \$267.1 million of these accelerated tax receipts would be collected in the same fiscal years in which they are actually due, rather than in subsequent fiscal years. (See Appendix V for our calculation of these amounts.)
- Corporations with an extension of time to file that increase their tax payments by the normal tax return due date would save \$421.5 million in interest and FTP Penalties in comparison to the interest and penalties they would be assessed on their current tax underpayments under the existing IRS regulations.
- Corporations that are currently assessed Delinquency Penalties because they file after the normal return due date without obtaining an extension of time to file would have the penalties decreased by \$60.7 million because the timely tax payments would satisfy the conditions of the new safe harbors.
- Noncompliant corporations would be assessed Delinquency Penalties of \$392.3 million. These penalties would decrease incrementally over the 5-year period as payment compliance improves.

⁴⁴ The Delinquency Penalty would not be assessed if a corporation with underpaid taxes less than \$100,000 filed within 6 months of the normal tax return due date and paid, by the normal tax return due date, an amount at least equal to the prior year's tax liability or an amount at least equal to 90 percent of the current year's tax liability. For a corporation not meeting one of these "safe harbor" percentages but filing within 6 months of the normal due date, no Delinquency Penalty would be assessed on the first 10 percent of the current year's tax liability.

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Recommendations

To improve payment compliance, ensure fairness to all taxpayers, relieve taxpayer burden, and reduce the Federal Government's costs:

1. The IRS Commissioner should revise the tax regulations applicable to corporations to:
 - a. Eliminate the requirement that corporations make tentative estimates of their tax liabilities to obtain an extension of time to file. The revised regulations should specify that corporations will qualify for an extension of time to file only if the prescribed percentage (see Recommendation 1.b.) of the prior year tax liability or the current year tax liability (as determined by the tax return, when filed) was paid by the normal due date for filing the return and any current year unpaid taxes, as of the day after the normal tax return due date, are less than \$100,000.
 - b. Grant extensions of time to file only to payment-compliant corporations. Under the authority given in I.R.C. § 6081(a) for granting reasonable extensions of time to file of up to 6 months, extensions should be granted only to corporations whose underpayments are less than \$100,000 and whose payments by their normal tax return due dates either:
 - 1) Equal or exceed the corporation's prior year tax return liability, or
 - 2) Equal or exceed 90 percent of the corporation's current year tax liability.
 - c. Establish 6 months as the sole length of an extension of time to file a corporate tax return, replacing the current paperless 3-month and optional 6-month extended due dates. This action should be taken under authority given in I.R.C. § 6081(a) for granting reasonable extensions of time to file of up to 6 months.

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- d. Establish safeguards, commonly called “safe harbors,” to protect reasonably compliant corporations from unwarranted assessments of the Delinquency Penalty. Under authority granted in I.R.C. § 6651(a)(1) for determining reasonable cause in relation to the Delinquency Penalty, reasonable cause should be assumed for all corporate income tax returns filed within 6 months of the normal due date and having unpaid taxes of less than \$100,000, regardless of whether an extension of time to file was granted, if:
 - 1) By the normal tax return due date, a corporation has paid taxes that equal or exceed its prior year tax liability or paid at least 90 percent of its current year taxes. These safe harbors ensure all like-situated corporations will be subject to the same penalties for the same payment noncompliance.
 - 2) Within 6 months after the normal tax return due date, a corporation has filed a tax return but has not met either of the payment requirements, the Delinquency Penalty should be assessed only on the underpaid tax amount that exceeds 10 percent of the corporation’s current year tax liability. This would supplement the first safeguard by preventing a corporation from being harshly penalized for missing the 90 percent payment requirement by an insignificant amount.
- e. Provide for the assessment of the Delinquency Penalty on all taxes not paid by the normal tax return due date by corporations filing more than 6 months after the normal tax return due date or having unpaid taxes of \$100,000 or more the day after the normal tax return due date. Those corporations with large underpayments or lengthy delays in filing indicate they were not prudent in meeting either their tax payment or tax filing obligations and, therefore, would not earn the recommended safeguards that are

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provided to corporations that are making a reasonable effort to comply.

- f. Require the assessment of the FTP Penalty, starting the day after the normal corporate tax return due date, for any delinquent tax amount of \$100,000 or more, regardless of the percentage of taxes paid by the normal tax return due date, by eliminating the assumption of reasonable cause, as described in 26 C.F.R. § 301.6651-1(c)(4)(ii), for underpayments of \$100,000 or more.

Management's Response: The Commissioner, Small Business/Self-Employed (SB/SE) Division, responded that an IRS study team, convened as the result of the prior TIGTA audit report on individual extensions, will analyze the feasibility of implementing Recommendations 1.a., 1.b., 1.d., and 1.e. and their impact on filing and payment compliance.

The Commissioner did not agree with Recommendation 1.c., stating that the paperless 3-month extension is based on C.F.R. § 1.6081-5, which provides for an extension of time for filing and paying by the 15th day of the 6th month following the close of the taxable year for certain taxpayers such as foreign corporations that maintain offices in the U.S. and domestic corporations whose principal business income is derived from sources within U.S. possessions. The Commissioner stated this regulation effectively extends the filing date for taxpayers who fall into this category, allows sufficient time to those taxpayers whose records may be outside the U.S. to file a U.S. income tax return, and is not intended for all taxpayers. The Commissioner stated this is a benefit to those corporations that may not be able to file or request an extension by the original due date and none of these corporations are prohibited from requesting a full 6-month automatic extension by filing a Form 7004 by the original due date. The Commissioner stated that, if a corporation that qualifies does take advantage of the paperless 3-month extension, but still needs additional time to file (not pay), then the corporation may file Form 7004 by the 15th day of the 6th month following the close of the taxable year to automatically obtain an additional 3 months

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to file. The Commissioner stated that, as the paperless 3-month extension of time to file and pay is a benefit to taxpayers and does not prevent a corporate taxpayer from obtaining an automatic 6-month extension, the IRS believes the regulations already provide for a 6-month automatic extension of time to file a corporate tax return.

The Commissioner, SB/SE Division, also did not agree with Recommendation 1.f., stating that to obtain an extension, a corporation must file a Form 7004 and pay the estimated taxes due at the time of filing. The Commissioner advised that filing this Form is an indication of the taxpayer's intent to take advantage of the 6-month extension for filing the tax return and that the extension of time to file does not extend the time to pay required taxes shown on the tax return. The Commissioner stated that, if the extension is granted and the taxpayer fails to pay the required tax, the taxpayer must pay interest from the due date of the return until the tax is paid. The Commissioner stated the Tax Court has ruled that the "date prescribed for payment" is determined without regard to any extension of time for filing the tax returns. The Commissioner stated the Congress placed a greater penalty on failure to file a tax return as a means of encouraging tax compliance, while interest serves as a payment for the use of the money due and owed. The Commissioner advised that reasonable cause is assumed for any underpayment of tax, if the corporate taxpayer meets specific criteria under C.F.R. § 301.6651-1(c)(4), where 90 percent of current taxes has been paid by the return due date and any remaining amount is paid by the extended due date. The Commissioner stated that, if these requirements are met, the FTP Penalty is administratively waived.

In addition, the Commissioner, SB/SE Division, stated the IRS will not be able to track the potential benefits we identified until an analysis of our findings is completed. The Commissioner expressed concerns with the use of penalties as a method of increasing revenue due to Penalty Policy Statement 1-1-18, which states penalties support the IRS mission only if they enhance voluntary compliance. The Commissioner stated that penalties may increase revenue, but they should only be used to encourage compliant conduct.

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The Commissioner's response also included an example to illustrate the IRS' concerns with denying any extension based on an unpaid tax balance of \$100,000 or more. The example showed that, if a corporate taxpayer received an extension, paid \$12,000,000 in estimated income taxes as of the due date of the return, but had unpaid taxes of \$110,000 at the time of filing the corporate tax return, this taxpayer would be denied an extension based on the safe harbor we recommended even though the taxpayer met the requirement of paying at least 90 percent of the current year's taxes. The Commissioner stated this taxpayer would not be treated as a similarly situated taxpayer who may owe \$90,000 of \$200,000 required taxes at the time a tax return is filed with an automatic 6-month extension. The Commissioner advised that the amount paid (\$110,000) on the normal due date of the return represents less than 90 percent of the taxes required to be shown on the return but, due to the safe harbor in our recommendation for revised regulations, this taxpayer will escape any penalties since the \$90,000 balance due is less than \$100,000.

Office of Audit Comment: While we are encouraged the IRS plans to study the feasibility of implementing some of our recommendations, we continue to believe taxpayer burden could be reduced and voluntary payment compliance could be improved by implementing those recommendations with which the IRS disagrees. To reduce taxpayer burden, for example, the implementation of Recommendation 1.c. would have the effect of eliminating a 2-tier system under which certain corporations receive automatic 3-month extensions of time to file without filing an application, but then must submit a paper form to obtain an additional 3-month extension, if needed. With the recommended elimination of the 2-tier system and the recommended eventual elimination of extension forms, all payment-compliant taxable corporations would qualify for a 6-month extension of time to file without filing an extension form.

To improve payment compliance, the implementation of Recommendation 1.f., which proposed assessing the FTP Penalty on delinquencies of \$100,000 or more regardless of the percentage of total taxes the \$100,000

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represents, would have the effect of eliminating the IRS' assumption that it is reasonable for corporations to underpay by such large amounts as long as the amount is not over 10 percent of the corporation's total tax liability. By disagreeing with this recommendation, the IRS is taking the position that the interest it charges is a sufficient deterrent to such a large tax delinquency. We disagree since, as shown on page 17 of this report, the effective interest rate charged by the IRS can be as little as 1.7 percent of the corporation's delinquent taxes.

We completely agree with the premise of Penalty Policy Statement P-1-18, which states, "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." However, we believe the evidence supports that the existing extension regulations protect corporate taxpayers from just penalties for payment noncompliance and are, in fact, encouraging the noncompliance. Appendix IV of this report quantifies the anticipated changes in taxpayer behavior from the implementation of our recommendations for the IRS to use its penalty authority to encourage compliant conduct. As shown in the detailed calculations in Appendix IV, the anticipated penalties for payment noncompliance would decrease significantly over a 5-year implementation period. If total payment compliance is achieved, the ultimate result of our recommendations would be \$0 in penalty revenue.

The example provided in the IRS' response to illustrate its concerns with denying an extension if the taxpayer's unpaid taxes are \$100,000 or more (Recommendation 1.a.) mistakenly concludes that the hypothetical corporation owing \$90,000 (45 percent) of a \$200,000 liability would receive an extension and not be penalized. Actually, under our recommendations, this corporation would be denied an extension per Recommendation 1.b. and would be assessed a Delinquency Penalty per Recommendation 1.d.2. (assuming the \$110,000 paid by the due date was less than the taxpayer's prior year tax liability, a fact not provided in the IRS' example). Per Recommendation 1.d.2., the

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Delinquency Penalty would be assessed on all delinquent amounts in excess of 10 percent of the tax liability. In this example, the Delinquency Penalty would be assessed on \$70,000 ($\$90,000 - (0.1 \times \$200,000)$) of the delinquent tax amount.

2. Once the above changes to the IRS regulations have been implemented to ensure the objective and equitable treatment of payment noncompliance by corporate taxpayers, the IRS Commissioner should consider further changing the regulations to eliminate the requirement that taxable corporations must apply, either on paper or electronically, to the IRS to receive extensions of time to file tax returns. This action should be taken under authority granted in I.R.C. § 6081(a) for granting reasonable extensions of time to file of up to 6 months.

Management's Response: The Commissioner, SB/SE Division, stated that further study must be done regarding this recommendation, particularly since an IRS study completed on June 18, 1999, raised serious concerns about similar proposals. The Commissioner stated the IRS will use the study team that was put in place to address the recommendations from the prior TIGTA audit on individual extensions of time to file.

The Commissioner, SB/SE Division, did not agree with our conclusion that, over a 5-year period, taxpayer expenses of \$1.967 billion and IRS processing costs of \$5.3 million could be reduced by eliminating the requirement for taxable corporations to apply for an extension of time to file. The Commissioner stated there would be no significant reduction in taxpayer expenses since they would still need to make an estimate of the total tax they would report on their returns and, therefore, they would still have to ensure they met all of the requirements for meeting their tax obligations timely. The Commissioner also stated that the up-front costs to make the needed changes to programming, publications, and training would eliminate the cost savings outlined in our report.

Office of Audit Comment: Although management's response states that our recommendation to eventually

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eliminate extension forms needs further study, our communications with the Office of Taxpayer Burden Reduction indicated the requirement for taxpayers to request extensions of time to file from the IRS will likely remain and other approaches for simplifying the extension process are under consideration. While the IRS' efforts to reduce the burden on corporations seeking extensions of time to file are commendable, substantial and unnecessary taxpayer burden will remain as long as the IRS continues to require taxable corporations to apply for an extension.

We disagree with the IRS' determination that there would not be a significant reduction in taxpayer expenses from the recommended elimination of extension applications. As discussed in this report, the IRS' own estimates of the volume of extension applications and related preparation time indicate that taxable corporations will expend approximately 74 million hours in applying for extensions between CYs 2005 and 2009. Estimated Tax for Corporations (Form 1120-W), which is available to corporations to assist them in making the appropriate quarterly estimated tax payments,⁴⁵ states that the average time to complete this Form will vary from 10 hours to 51 hours, depending on individual circumstances.⁴⁶ Since our recommendations for requiring payment of sufficient taxes by the tax return due date mirror the requirements for making estimated tax payments, we do not believe corporations desiring extensions of time to file would require additional time to re-estimate their tax liabilities. Rather, the time the IRS estimates is needed to prepare and submit extension forms would be eliminated by the implementation of our recommendations.

We are also unable to evaluate the IRS' conclusion that processing cost savings would not be realized by eliminating the requirement for taxable corporations to

⁴⁵ Corporations generally must make estimated tax payments if they expect their estimated tax (income tax less credits) to exceed \$500 or more. The installments are generally due by the 15th day of the 4th, 6th, 9th, and 12th months of the tax year.

⁴⁶ Includes time spent for record keeping, learning about the law or the Form, and preparing the Form.

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apply for an extension of time to file. The IRS provided no specific information to support its conclusion. Without information on the amounts or time periods associated with the costs required to change the programming, publications, and training, we cannot evaluate these change-related costs, including whether they are a one-time or recurring cost.

3. The IRS Commissioner should develop a legislative proposal for submission to the Department of the Treasury to change I.R.C. §§ 6651(d) and 6621(c) to require assessments of the higher interest and FTP Penalties, starting the day after the normal tax return due date, on any corporate income tax delinquency of \$100,000 or more related to a return that, for any reason, was not filed by the normal tax return due date.

Management's Response: The Commissioner, SB/SE Division, advised the IRS will incorporate this issue into the study team that was put in place to address the recommendations from the prior TIGTA audit on individual extensions of time to file. The Commissioner stated the team will determine if it is appropriate to develop a legislative proposal for submission to the Department of the Treasury, Office of Tax Policy.

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Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to determine the effect that the existing tax laws, tax regulations, and Internal Revenue Service (IRS) policies and procedures for granting extensions of time for filing corporate income tax returns are having on the timely payment of taxes, fairness for all taxpayers, taxpayer burden, and the Federal Government's costs. We initiated this audit because a previous Treasury Inspector General for Tax Administration review of extensions of time to file individual income tax returns identified significant problems in these areas.¹

To accomplish our objective, we:

- I. Determined, through study of legislative and regulatory histories, the intended tax administration role of extensions of time for filing corporate income tax returns and related IRS penalty enforcement in ensuring successful tax administration.
- II. Determined the level of corporate taxpayer burden created by extension-filing requirements by analyzing IRS statistics on the volume of extensions filed, both historical and projected, and by quantifying the time and dollar value of taxpayer burden hours estimated by the IRS to be associated with extension filing.
- III. Determined the effect of extension filing and related IRS penalty enforcement on corporate taxpayer behavior by securing and analyzing a Business Master File (BMF)² extract of corporate taxpayer account data. The extract consisted of those corporations with a normal tax return due date in Calendar Year 1999 that filed their returns after the normal due date, regardless of whether they obtained an extension of time to file. The extract contained a 4-year account history on each taxpayer.
- IV. Explored the demographics of payment-noncompliant corporations with extensions of time to file by analyzing tax return and account information on the corporate taxpayers included in our BMF extract.
- V. Evaluated the burden on the Department of the Treasury, including IRS processing costs and cash-flow impairments, related to the corporate return extension process.

¹ *The Regulations for Granting Extensions of Time to File Are Delaying the Receipt of Billions of Tax Dollars and Creating Substantial Burden for Compliant Taxpayers* (Reference Number 2003-30-162, dated August 2003).

² The IRS database that consists of Federal tax-related transactions and accounts for business taxpayers. These include employment taxes, income taxes on businesses, and excise taxes.

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Appendix II

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Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Commissioner, Large and Mid-Size Business Division SE:LM
Commissioner, Small Business/Self-Employed Division SE:S
Commissioner, Wage and Investment Division SE:W
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 Commissioner, Small Business/Self-Employed Division SE:S
 GAO/TIGTA Liaison, Wage and Investment Division SE:W:S:PA

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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. These benefits will accrue from 2005 through 2009 and will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

- Taxpayer Burden – Potential; \$1.967 billion and 2.1 million corporations affected; reduced expenses by eliminating the requirement for taxable corporations to apply for extensions of time to file (see page 3).
- Increased Revenue – Potential; \$392.3 million; increased Delinquency Penalty assessments for payment-noncompliant corporate taxpayers (see page 3).
- Increased Revenue – Potential; \$120.6 million; increased interest and Failure to Pay (FTP) Penalty assessments for those taxpayers that, by the normal return due date, do not file a corporate income tax return and have unpaid taxes of \$100,000 or more (see page 3).
- Taxpayer Rights and Entitlements – Potential; \$421.5 million; reduced interest and FTP Penalties assessed against those corporations that increase the amount of taxes paid by the normal tax return due date in order to meet the recommended new safe harbor requirements (see page 3).
- Taxpayer Rights and Entitlements – Potential; \$60.7 million; reduced Delinquency Penalties for those corporations that are currently assessed the Delinquency Penalty but would be exempted from the Penalty by meeting the recommended new safe harbors (see page 3).
- Inefficient Use of Resources – Potential; \$5.3 million; reduced processing costs for the Internal Revenue Service (IRS) by eliminating the requirement for taxable corporations to apply for extensions of time to file (see page 3).

Methodology Used to Measure the Reported Benefit:

The following is a general summary of the methodologies used to measure the reported benefits. All references to “taxpayers” and “returns” are to *corporate taxpayers* and *corporate income tax returns*, respectively. All references to 1999 refer to extensions granted, payments made, or returns filed for which the normal tax return due date was sometime during Calendar Year (CY) 1999. This includes all corporations with tax years ending on October 31, 1998, through September 30, 1999. For all tax, penalty, and interest estimates, we assumed the future

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levels and types of noncompliance would be the same as those among taxpayers with normal (i.e., nonextended) 1999 tax return due dates.

To determine the IRS processing cost savings from the elimination of extension applications received from taxable corporations, we relied on IRS projections of future extension volumes as reflected in *Projections of Returns to be Filed in Calendar Years 2002-2009*, Statistics of Income Bulletin, Winter 2002-2003 (April 2003) and the costs contained in the IRS' Cost Estimate Reference 3.30.10-38. The costs for processing Application for Automatic Extension of Time to File Corporation Income Tax Return (Form 7004) were \$703.32 per 1,000.

To determine the cost savings to corporations from the elimination of extension applications, we assumed the corporations would be relieved of the 9.817 hours of burden that the IRS states on Form 7004 as being required to complete the extension process. We used computer programs to determine the percentage of extensions obtained in CY 1999 by taxable corporations. We applied this percentage to IRS projections of future extension volumes to determine the total number of extensions that could be eliminated. To determine the total burden hours that could be eliminated, we multiplied the extension volume by 9.817 hours. To place a monetary value on this taxpayer burden, we multiplied the total burden hours by the Office of Management and Budget's estimate of the cost-per-hour (\$26.50) of taxpayer burden.

**Table 1: Value of Taxpayer Time Saved by Eliminating Extension Forms for Taxable Corporations
CYs 2005 – 2009 (in millions)**

	2005	2006	2007	2008	2009	Totals
Projected Number of Forms 7004 (Per the IRS, April 2003)	3.185	3.277	3.370	3.462	3.554	16.848
Percentage of Forms 7004 Filed by Taxable Corporations in CY 1999	44.89%	44.89%	44.89%	44.89%	44.89%	N/A
Extension Forms to be Eliminated	1.430	1.471	1.513	1.554	1.595	7.563
IRS Processing Cost Savings From Eliminating Extension Forms (\$703.32 per 1,000 Forms 7004)	\$1.0	\$1.0	\$1.1	\$1.1	\$1.1	\$5.3
Extension Preparation Hours (9.817 Hours per Form 7004)	14.03	14.44	14.85	15.26	15.66	74.24
Value of Corporation's Time Saved by Extension Elimination (\$26.50 per Hour)	\$371.9	\$382.7	\$393.5	\$404.3	\$415.0	\$1,967.4

Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of IRS filing projections and related processing costs.

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To determine the number of corporations affected by eliminating extension applications, it was necessary to compensate for those corporations that applied for extensions in multiple years. Therefore, we relied on our computer extract of IRS records that contained 4 years of account data for each corporation that filed its return after the normal CY 1999 tax return due date, regardless of whether an extension of time to file was obtained. We determined the frequency of extensions filed by each corporation that had obtained an extension at least once for tax returns with normal due dates during the 4 years from CYs 1998 through 2001. As shown in Table 2, this analysis, in conjunction with IRS projections of future extension filings, was used to estimate the number of taxable corporations that would benefit from the elimination of extension applications.

**Table 2: Estimated Number of Taxable Corporations Affected by Eliminating Extension Forms
(in thousands, except for averages)**

Number of Extensions Obtained by Corporations During 4-Year Period:	One	Two	Three	Four	Totals¹
Number of Taxable Corporations Obtaining at Least One Extension From 1998 Through 2001 (including an extension in 1999)	172.1	240.8	301.8	401.7	1,116.3
Total Number of Extensions Obtained (1998 through 2001)	172.1	481.6	905.4	1,606.7	3,165.7
Percentage of All Extensions	5.43%	15.21%	28.60%	50.75%	100.00%
Percentage of Years in Which an Extension Was Obtained From 1998 Through 2001	25%	50%	75%	100%	N/A
Average Number of Extensions per Taxable Corporation in 5 Years	1.25	2.50	3.75	5.00	N/A
Total Number of Extensions to Be Filed in 2005 Through 2009 by Taxable Corporations (See Table 1 for total. Details obtained by applying “Percentage of All Extensions” to total.)	410.9	1,150.5	2,162.9	3,838.4	7,562.6
Total Number of Taxable Corporations Filing Extensions From 2005 Through 2009 (total number of extensions divided by average number of extensions per corporation)	328.7	460.2	576.8	767.7	2,133.4

Source: TIGTA analysis of IRS Business Master File (BMF)² data and IRS filing projections.

Table 3 presents an analysis of the impact of implementing the new safe harbors recommended in this report. To comply with the recommended new safe harbors, we assumed taxpayers would

¹ Details may not add to totals due to rounding.

² The IRS database that consists of Federal tax-related transactions and accounts for business taxpayers. These include employment taxes, income taxes on businesses, and excise taxes.

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be required to file by the extended due date and pay, by the normal tax return due date, the lesser of 90 percent of the current year's tax or an amount equal to the prior year's tax. We further assumed no safe harbors would be available for those corporate taxpayers that do not file by the extended due date or underpay their taxes by \$100,000 or more on the normal due date.

We used computer programs to recompute the Delinquency Penalties on all postnormal due date Fiscal Year 1999 delinquencies based on these recommended new safe harbors. These recomputations produced an increase in total Delinquency Penalties for corporations not meeting the new safe harbor criteria and a decrease in total Delinquency Penalties for corporations that did not obtain extensions of time to file but nevertheless met the recommended safe harbor criteria.

We also used computer programs to identify those corporations that would likely change their tax payment behavior (both the timing and amount of payments) in reaction to the recommended new safe harbors. We assumed those corporations with extensions of time to file that filed returns by the extended due date, thus avoiding the Delinquency Penalty, would also take the steps necessary to meet the new safe harbors and continue avoiding the Delinquency Penalty. We determined the actual amounts of interest and FTP Penalties assessed against these taxpayers, determined the amounts of their delinquent taxes, computed the new safe harbor amount for each taxpayer, and computed the increases in their Delinquency Penalties under the new safe harbors.

In recognition that all corporations would not immediately adapt to the recommended new safe harbors, we assumed a 5-year phase-in period. To determine the amount of the annual accelerated tax payments, we multiplied the total amounts in excess of the safe harbor allowances by the percentage of corporations expected to be in compliance with the new safe harbors each year. We also used these percentages to determine the decreases that would occur in their current interest and FTP penalties (under the current regulations) due to their increased payment compliance. Finally, we used these percentages to determine how much of the computer-determined Delinquency Penalty, under the new safe harbors, these taxpayers would avoid by improving their payment compliance. We assumed that, at the end of 5 years, the payment compliance level among these corporations would reach 91 percent, the 1999 level of payment compliance present in the general population of taxable corporations.

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**Table 3: Increased Delinquency Penalties Due to Recommended Regulatory Changes
CYs 2005 – 2009 (in millions)**

	2005	2006	2007	2008	2009	Totals ³
Delinquency Penalties, Under Current Regulations, for Taxable Corporations With No Extension	\$40.2	\$40.2	\$40.2	\$40.2	\$40.2	\$200.9
Reduction in Delinquency Penalties From New Safe Harbors for Taxable Corporations With No Extension	\$12.1	\$12.1	\$12.1	\$12.1	\$12.1	\$60.7
Potential Delinquency Penalty Increases for All Taxable Corporations Under Proposed Safe Harbors	\$165.1	\$165.1	\$165.1	\$165.1	\$165.1	\$825.6
Corporations Likely to Change Tax Payment Behavior:						
Delinquent Taxes in Excess of Safe Harbors	\$903.2	\$903.2	\$903.2	\$903.2	\$903.2	\$4,516.2
Delinquency Penalty Increases	\$135.0	\$135.0	\$135.0	\$135.0	\$135.0	\$675.0
Interest and FTP Penalties, Current Regulations	\$131.3	\$131.3	\$131.3	\$131.3	\$131.3	\$656.6
Assumed Level of Compliance With Recommended Safe Harbors	25%	50%	70%	85%	91%	N/A
New Tax Payments by the Normal Due Date	\$225.8	\$451.6	\$632.3	\$767.8	\$821.9	\$2,899.4
Delinquency Penalty Increases Avoided	\$33.7	\$67.5	\$94.5	\$114.7	\$122.8	\$433.3
Net Delinquency Penalty Increases (potential minus avoided)	\$131.4	\$97.6	\$70.6	\$50.4	\$42.3	\$392.3
Interest and FTP Penalty Reductions From Improved Payment Compliance	\$32.8	\$65.7	\$91.9	\$111.6	\$119.5	\$421.5

Source: TIGTA analysis of IRS BMF data.

Table 4 presents the calculations used to estimate the increases in FTP Penalties and interest following the implementation of the recommended tax law changes relative to delinquent taxes of \$100,000 or more. The computations assume the IRS regulations are changed to no longer assume reasonable cause for FTP Penalty purposes for underpayments that are less than 10 percent of the corporation's tax liability if the underpayment is \$100,000 or more. The computations also assume tax law changes that require an additional 2 percent of interest on large corporate tax underpayments and the doubling of the FTP Penalty to begin on the day after

³ Details may not add to totals due to rounding.

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the normal tax return due date in the case of delinquencies in excess of \$100,000 on returns that are not filed by the normal tax return due date.

To assess the impact of these changes, we used computer programs to determine the total of such CY 1999 delinquencies, as well as the portion of those delinquencies attributable to corporations that had paid 90 percent or more of their liabilities by the normal tax return due date and, thus, would have benefited from current reasonable cause assumptions. We also used computer programs to determine the average number of days between the normal return due dates for these corporations and their actual return filing dates. For computing FTP Penalties related to reasonable cause elimination, we converted the days to the number of months to which the FTP Penalties would apply if not for current reasonable cause regulations (a part of a month was considered an additional month). For computing the increased interest and increased penalties from the doubling of the FTP Penalty, we used computer programs to determine the average number of days between the normal return due dates and actual return filing dates for all corporate taxpayers with delinquencies of \$100,000 or more, regardless of whether they would have met reasonable cause criteria. For this period of time, we computed the interest at 2 percent compounded daily on the total amount of delinquencies of \$100,000 or more. We computed the increased penalties from the doubling of the FTP Penalty by multiplying the same total delinquent tax amount by the average number of months delinquent (a part of a month was considered an additional month) and by 0.5 percent, the additional amount of the FTP Penalty to be assessed.

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**Table 4: Increased Interest and Penalties on Delinquencies of \$100,000 or More
CYs 2005 – 2009 (in millions)**

	2005	2006	2007	2008	2009	Totals ⁴
CY 1999 Delinquent Taxes Over \$100,000, Return Filed After Normal Due Date, Reasonable Cause Assumed by the IRS	\$370.1	\$370.1	\$370.1	\$370.1	\$370.1	\$1,850.3
Average Number of Months Late by Taxpayers With Reasonable Cause Assumed by the IRS	6	6	6	6	6	N/A
FTP Penalty After Eliminating Reasonable Cause	\$11.1	\$11.1	\$11.1	\$11.1	\$11.1	\$55.5
All Delinquent Taxes Over \$100,000	\$1,238.2	\$1,238.2	\$1,238.2	\$1,238.2	\$1,238.2	\$6,190.8
Average Number of Days From Normal Due Date to Return Filing Date	190	190	190	190	190	N/A
Additional Interest if Rate Increased by 2 Percentage Points After the Normal Return Due Date	\$12.9	\$12.9	\$12.9	\$12.9	\$12.9	\$64.7
Average Number of Months to Which FTP Penalty Applies	7	7	7	7	7	N/A
Additional FTP Penalties if Rate Doubles After the Normal Return Due Date	\$43.3	\$43.3	\$43.3	\$43.3	\$43.3	\$216.7
Noncompliance Levels After Implementing Recommendations	75%	50%	30%	15%	9%	N/A
Adjusted Interest Increases	\$9.7	\$6.5	\$3.9	\$1.9	\$1.2	\$23.2
Adjusted FTP Penalty Increases From Eliminating Reasonable Cause	\$8.3	\$5.6	\$3.3	\$1.6	\$1.0	\$19.9
Adjusted FTP Penalty Increases From Doubling the Rate	\$32.5	\$21.7	\$13.0	\$6.5	\$3.9	\$77.6
Total Increases in Interest and FTP Penalty	\$50.5	\$33.7	\$20.2	\$10.1	\$6.1	\$120.6

Source: TIGTA analysis of IRS BMF data.

⁴ Details may not add to totals due to rounding.

**Changes to the Regulations for Granting Extensions of Time to File Corporate Returns
Are Needed to Alleviate Significant Problems With Administering the Tax Laws**

Appendix V

**Calculation of the Implications of Recommendations
on the Federal Government’s Budget Process**

This appendix presents detailed information on the measurable impact that our recommended actions will have on additional funds available for the Federal Government’s use in Fiscal Years (FY) 2005 through 2009. Accelerating the payment of taxes can help the Federal Government to avoid unnecessary borrowing costs. Increasing tax revenues in a fiscal year makes additional funds available for the Federal Government’s use. Since such benefits are not expressly addressed in the Inspector General Act of 1978,¹ the following measurable benefits of our recommendations will not be listed in our Semiannual Report to the Congress:

- ❑ Tax Revenues Accelerated by 6 Months – Potential; \$2.9 billion. Increased tax payments received by normal return due date resulting from new safe harbors (see page 3).
- ❑ Increased Current Fiscal Year Tax Revenues – Potential; \$267.1 million. Increased tax payments received in the fiscal year in which they are due resulting from new safe harbors (see page 3).

We used computer programs to estimate the increased amount of taxes that would be paid by the normal tax return due date by corporations seeking to comply with the recommended safe harbor requirements. We computed both annual gross and incremental increases in current fiscal year revenues, in recognition that increases in current year receipts cause a corresponding decrease in the subsequent fiscal year.

**Table 1: Changes in Taxpayer Payments due to Proposed New Safe Harbors
FYs 2005 – 2009 (in millions)**

	2005	2006	2007	2008	2009	Totals
Increased Tax Payments by the Normal Tax Return Due Date	\$225.8	\$451.6	\$632.3	\$767.8	\$821.9	\$2,899.4
Additional Current Fiscal Year Tax Revenue	\$73.4	\$146.7	\$205.4	\$249.5	\$267.1	\$942.1
Annual Incremental Increases in Current Fiscal Year Tax Revenue	\$73.4	\$73.4	\$58.7	\$44.0	\$17.6	\$267.1

Source: Treasury Inspector General for Tax Administration analysis of Internal Revenue Service (IRS) Business Master File² data.

¹ 5 U.S.C.A. app 3 (West Supp. 2003).

² The IRS database that consists of Federal tax-related transactions and accounts for businesses. These include employment taxes, income taxes on businesses, and excise taxes.

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Appendix VI

Management's Response to the Draft Report



COMMISSIONER
SMALL BUSINESS / SELF-EMPLOYED DIVISION

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

RECEIVED

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MEMORANDUM FOR TREASURY INSPECTOR GENERAL FOR TAX
ADMINISTRATION

FROM: Dale F. Hart *Dale Hart by M. Sullivan*
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – The Regulations for Granting Extensions of
Time to File Corporate Returns Are Needed to Alleviate
Significant Problems With Administering the Tax Laws
(Audit # 200330023)

I have reviewed your report and am pleased it reflects the IRS is properly following the Internal Revenue Code and Regulation sections pertaining to extensions to file corporate tax returns. Your report and recommendations are very similar to a recent Treasury Inspector General for Tax Administration (TIGTA) report regarding extensions to file individual returns, *The Regulations for Granting Extensions of Time to File Are Delaying The Receipt of Billions of Tax Dollars and Creating Substantial Burden for Compliant Taxpayers* (Audit Number 2001-30-032). As a result of the previous audit on individual extensions to file, the Small Business/Self-Employed (SB/SE) Division convened a team, comprised of representatives from Chief Counsel and other operating divisions, including Large and Mid-Size Business (LMSB) Division, to further study both individual and corporate extensions of time to file. This study will help us determine the feasibility of implementing the audit recommendations from both audit reports and their impact on filing and payment compliance.

In addition, the Office of Taxpayer Burden Reduction is working with the team to simplify the extension process. The team has completed a proposal to simplify the extension process. The proposal is currently under review.

The focus throughout the audit report was on the substantial amount of unpaid taxes where the taxpayer filed an extension. Although we appreciate the statistical information TIGTA gathered, we have concerns with a few of the audit recommendations. We have detailed our concerns with the recommendations below.

We have also reviewed the Outcome Measures in your report. We will not be able to track the potential benefits you identified until we can complete an analysis of your findings. We also have concerns with the use of penalties as a method of increasing

Changes to the Regulations for Granting Extensions of Time to File Corporate Returns Are Needed to Alleviate Significant Problems With Administering the Tax Laws

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revenue. This concern is based on Penalty Policy Statement P-1-18, which states penalties support the Service's mission only if they enhance voluntary compliance. Penalties may increase revenue, but they should only be used to encourage compliant conduct.

We do not agree with your conclusion that there would be a potential reduction of taxpayer expenses of \$1.967 billion by eliminating the requirement for taxable corporations to apply for extensions of time to file. There would be no significant reduction in taxpayer expenses since they would still need to make an estimate of the total tax that they would report on their return. Therefore, they would still have to ensure that they met all the requirements for meeting their tax obligations timely, which would not reduce their time or expense.

Under inefficient use of resources the report states there is a potential to reduce processing costs of \$5.3 million. The up-front costs to make the changes needed to programming, publications, and training would eliminate the benefits as outlined in your report.

Due to these factors and others, we do not agree that there are any positive outcome measures.

Our comments to your recommendations are as follows:

RECOMMENDATION 1

1. The IRS Commissioner should revise the tax regulations applicable to corporations to:
 - a) Eliminate the requirement that corporations make tentative estimates of their tax liabilities to obtain an extension of time to file. The revised regulations should specify that corporations will qualify for an extension of time to file only if the prescribed percentage (see Recommendation 1.b.) of the prior year's tax liability or the current year's tax liability (as determined by the tax return, when filed) was paid by the normal due date for filing the return and any current year's unpaid taxes, as of the day after the normal tax return due date, are less than \$100,000.
 - b) Grant extensions of time to file only to payment-compliant corporations Under the authority given in Internal Revenue Code (I.R.C.) Section 6081(a) for granting reasonable extensions of time to file of up to six months, extensions should be granted only to corporations whose underpayments are less than \$100,000 and whose payments by their normal tax return due dates either:
 1. Equal or exceed the corporation's prior year's tax return liability, or

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2. Equal or exceed 90 percent of the corporation's tax liability.
- c) Establish six months as the sole length of an extension of time to file a corporate tax return, replacing the current paperless three month and optional six month extended due dates. This action should be taken under authority given in I.R.C. Section 6081(a) for granting reasonable extensions of time to file of up to six months.
 - d) Establish safeguard, commonly called "safe harbors," to protect reasonably compliant corporations from unwarranted assessments of the Delinquency Penalty. Under authority granted in I.R.C. Section 6651(a)(1) for determining reasonable cause in relation to the Delinquency Penalty, reasonable cause should be assumed for all corporate income tax returns filed within six months of the normal due date and having unpaid taxes of less than \$100,000, regardless of whether an extension of time to file was granted, if:
 1. By the normal tax return due date, a corporation has paid taxes that equal or exceed its prior year's tax liability, or paid at least 90 percent of its current year's taxes. These safe harbors ensure all like-situated corporations will be subject to the same penalties for the same payment noncompliance.
 2. Within six months after the normal tax return due date, a corporation has filed a tax return but has not met either of the payment requirements, the Delinquency Penalty should be assessed only on the underpaid tax amount that exceeds ten percent of the corporation's current year's tax liability. This would supplement the first safeguard by preventing a corporation from being harshly penalized for missing the 90 percent payment requirement by an insignificant amount.
 - e) Provide for the assessment of the Delinquency Penalty on all taxes not paid by the normal tax return due date by corporations filing more than six months after the normal tax return due date or having unpaid taxes of \$100,000 or more the day after the normal tax return due date. Those corporations with large underpayments or lengthy delays in filing indicate they were not prudent in meeting either their tax payment or tax filing obligations and, therefore, would not earn the recommended safeguards that are provided to corporations that are making a reasonable effort to comply.
 - f) Require the assessment of the Failure to Pay (FTP) Penalty, starting the

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Day after the normal corporate tax return due date, for any delinquent tax amount of \$100,000 or more, regardless of the percentage of taxes paid by the normal tax return due date, by eliminating the assumption of reasonable cause, as described in 26 Code of Federal Regulations (C.F.R.) Section 301.6651-1(c)(4)(ii), for underpayments of \$100,000 or more.

CORRECTIVE ACTION

With respect to Recommendation 1a, 1b, 1d and 1e, the study team looking at the recommendations from the prior TIGTA audit on individual extensions to file will also analyze your recommendations on corporate extensions and the impact upon filing and payment compliance.

Recommendation 1c – We do not agree with this recommendation. The reference to a paperless three month extension is based on C.F.R. Section 1.6081-5, which provides for an extension of time for filing and paying by the 15th day of the sixth month following the close of the taxable year (June 15th for a calendar year corporation) extension for certain taxpayers such as foreign corporations who maintain offices in the United States (U.S.) and domestic corporations whose principal business income is derived from sources within U.S. possessions. This provision effectively extends the filing date for taxpayers who fall into this category. This regulation allows sufficient time to those taxpayers whose records may be outside of the U.S. to file a U.S. income tax return and is not intended for all taxpayers. This is a benefit to those corporations that may not be able to file or request an extension by the original due date. Further, none of these corporations are prohibited from requesting a full six-month automatic extension by filing Form 7004 by the original due date.

If a corporation that qualifies does take advantage of the paperless three month extension, but still needs additional time to file (not pay), then the corporation may file Form 7004 by the 15th day of the sixth month following the close of the taxable year and obtain an additional three months to file. This additional three-month extension is automatic. Thus, as the paperless three-month extension of time to file and pay is a benefit to taxpayers and does not prevent a corporate taxpayer from obtaining an automatic six-month extension of time to file, we believe that the regulations already provide for a six-month automatic extension of time to file a corporate tax return.

Recommendation 1f – We do not agree with this recommendation. To obtain an extension, a corporation must file a Form 7004 and pay the estimated taxes due at the time of filing. Filing the form is an indication of the taxpayer's intent to take advantage of the six-month extension for filing the tax return. The extension to file does not extend the time to pay required taxes shown on the tax return. If the extension is granted and the taxpayer fails to pay the required tax, the taxpayer must pay interest from the due date of the return until the tax is paid. The Tax Court has ruled that the "date prescribed

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for payment” is determined without regard to any extension of time for filing the tax return. Congress placed a greater penalty on failure to file a tax return as a means of encouraging tax compliance, while interest serves as a payment for the use of money due and owed. Reasonable cause is assumed for any underpayment of tax, if the corporate taxpayer meets specific criteria under C.F.R. Section 301.6651-1(c)(4), where 90 percent of current taxes has been paid by the return due date and any remaining amount is paid by the extended due date. If these requirements are met, the FTP Penalty is administratively waived.

The following example demonstrates our concerns with the recommendation to deny any extension based on an unpaid tax balance of \$100,000 or more, regardless of the percentage of taxes paid by a corporate taxpayer. If a corporate taxpayer received an extension and paid \$12,000,000 in estimated income taxes as of the due date of the return, but had unpaid taxes of \$110,000 at the time of filing the corporate tax return this taxpayer would be denied an extension based on the safe harbor recommended by TIGTA. Although the taxpayer meets the requirement of paying at least 90 percent of the current year’s taxes, they would not be granted an extension under this recommendation. This taxpayer would not be treated as a similarly situated taxpayer who may owe \$90,000 of \$200,000 required taxes at the time a tax return is filed with an automatic six-month extension. The amount paid (\$110,000) on the normal due date of the return represents less than 90 percent of the taxes required to be shown on the return; but, due to the safe harbor in the TIGTA recommendation for revised regulations, this taxpayer will escape any penalties, since the \$90,000 balance due is less than \$100,000.

IMPLEMENTATION DATE

Recommendations 1a, 1b, 1d, and 1e - The Extension to file study team will begin work on August 15, 2004. We anticipate the team will complete their study within one year.

Recommendations 1c and 1f – N/A

RESPONSIBLE OFFICIAL(S)

Recommendations 1a, 1b, 1d, and 1e - Director, Payment Compliance, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN

Recommendations 1a, 1b, 1d, and 1e -The Program Manager, Penalty and Interest will head the study team and report back through the Acting Deputy Director, Compliance Policy.

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RECOMMENDATION 2

Once the above changes to the IRS regulations have been implemented to ensure the objective and equitable treatment of payment noncompliance by corporate taxpayers, the IRS Commissioner should consider further changing the regulations to eliminate the requirement that taxable corporations must apply, either on paper or electronically, to the IRS to receive extensions of time to file tax returns. This action should be taken under authority granted in I.R.C Section 6081(a) for granting reasonable extensions of time to file of up to six months.

CORRECTIVE ACTION

We believe further study must be done regarding your recommendation, particularly since we completed a June 18, 1999 study which raised serious concerns about similar proposals. We will utilize the study team that was put in place to address the recommendations from the prior TIGTA audit on individual extensions to file.

IMPLEMENTATION DATE

The Extension to File study team will begin work on August 15, 2004. We anticipate the team will complete their study within one year.

RESPONSIBLE OFFICIAL(S)

Director, Payment Compliance, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN

The Program Manager, Penalty and Interest will head the study team and report back through the Acting Deputy Director, Compliance Policy.

RECOMMENDATION 3

The IRS Commissioner should develop a legislative proposal for submission to the Department of the Treasury to change I.R.C. Sections 6651(d) and 6621(c) to require assessment of higher interest and FTP Penalties, starting the day after the normal tax return due date, on any corporate income tax delinquency of \$100,000 or more related to a return that, for any reason, was not filed by the normal tax return due date.

CORRECTIVE ACTION

We will incorporate this issue into the study team that was put in place to address the recommendations from the prior TIGTA audit on individual extensions to file. The team will determine if it is appropriate to develop a legislative proposal for submission to the Department of Treasury, Office of Tax Policy.

IMPLEMENTATION DATE

The Extension to File study team will begin work on August 15, 2004. We anticipate the team will complete their study within one year.

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RESPONSIBLE OFFICIAL(S)

Director, Payment Compliance, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN

The Program Manager, Penalty and Interest will head the study team and report back through the Acting Deputy Director, Compliance Policy.

If you have any questions, please call me at (202) 622-0600 or Robert L. Hunt, Acting Deputy Director, Compliance Policy, Small Business/Self-Employed Division, at (202) 283-2200.