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TAXPAYER RIGHTS - PENALTY, INTEREST, AND REFUND PROVISIONS OF THE IRS RESTRUCTURING & REFORM ACT

By Victor Sy, CPA, MBA

1. **Suspension of interests and penalties:** Penalties and interests accrue when taxes are not paid. Taxpayers understand this situation. However, taxpayers get upset when surprise notices of delinquencies arrive after a long period of peace as one tries to forget IRS problems into oblivion. It is indeed true that some of us have wishful thoughts that the IRS (Service) has somehow forgotten. The Service never forgets.

New Act: The new law suspends interests and penalties unless notice is sent within 18 months after the due date of return or the date of actual filing. Note that the suspension of penalties and interests applies only to tax returns that are filed on time (April 15) or extended due date (August 15 or October 15). This provision applies only to individuals. For tax years beginning January 1, 2004, the 18-month period even is shortened to one year.

2. **Interest rates on overlapping underpayments and overpayments:** If you have noticed your tax bills and tax refunds, you always pay a higher interest rate on what you owe the IRS and receive a lower interest rate on what they owe you. The spread between the overlapping underpayments and overpayments could reach as high as 4.5% for some corporations. While the Service has started netting interests for the same tax period and taxes for different tax periods, there was no authority for the IRS to net an overpayment against an underpayment for different types of taxes. This is called "global interest netting."

New Act: Congress has essentially equalized the interest rate between overpayments and underpayments for any period of mutual indebtedness between a taxpayer and the IRS. No interests will be imposed on either underpayment or overpayment interests that run simultaneously on equal amounts. The effective interest rate becomes zero. This is accomplished by raising overpayments by individuals to 3% over the short-term rate; thus, equalizing the underpayment and overpayment rates. For example, global netting can be used to net income taxes against self-employment taxes, and employment taxes against excise taxes.

Here is a **bummer**: You bear the burden of showing entitlement to any netting of interests. In other words, they require you to perform the initial computation and submit it with supporting documents. This is probably more beneficial to the business community where the tax savings can get as high as 4.5%.

3. **Computation of interest and penalty charges:** It is upsetting to taxpayers who receive bills from the IRS with substantial increases because of penalties and interests. It is even more upsetting when taxpayers have no idea on how penalties and interests are computed. I know this because we get complaints from clients and the public at large when their tax deficiencies have ballooned to as high as 150 to 200%. While most taxpayers realize that penalties and interests accrue on their liabilities, some taxpayers refuse to understand that there are indeed additions to taxes that are not paid on time. It is quite difficult to explain how these are computed when some taxpayers refuse to understand the logic behind penalties and interests in the first place.

New Act: The new law provides some Tylenol caplets to upset taxpayers in the form of computation of interests and penalties. The Internal Revenue Code now requires detailed computation to be printed right in the face of the bill.

4. **Failure to deposit penalty:** The IRS applies deposits received using the first-in, first-out (FIFO) method wherein deposits are credited to the oldest past due underpayments within the same return. It is understandable that the IRS follows this procedure so they can get the oldest tax liabilities off their books and earn more penalties on the new underpayments. At the same time, however, a problem develops when a taxpayer misses a deposit early but makes succeeding deposits on time. Because the first deposit was not made on time, all succeeding

payments are also not made on time. In other words, this shortfall in the early deposits causes cascading penalties with a domino effect.

New Act: You may now designate the period to which payments apply. However, it is rather confusing and quite disappointing that the new provisions indicate that you may not make that election with your deposit. It is most logical that the designation be made on the check when you make your payment. This is not the case. The designation is allowed only after a penalty notice is sent. It must be made within 90 days after that.

Comment: These new rules will be popular in the areas of payroll taxes. This is significant because penalties on undeposited payments maximizes at 25%. It is, therefore, in your best interest to apply payments to the latest returns where penalties are still accruing as opposed to the oldest returns where penalties have already maxed out. If you owe delinquent payroll taxes, it is therefore worthy of your time to keep track of delinquencies and designate your payments to say, December 1998 returns, instead of March 1996 returns.

5. **Responsible parties to trust fund recovery penalty:** When payroll taxes are not paid, the IRS goes after persons who are responsible for collecting and paying employment taxes but willfully fail to do so. Payroll taxes are comprised of two types: amounts withheld from employees (trust fund) and amounts payable by the employer. The Service understands the non-payment of the employer's portion during financial crisis; however, agents are enthusiastic when businesses fail to turn over amounts withheld from employees that they are merely holding in trust for the government. The Service then goes after persons who are personally liable. Thus, if more than one person is liable for the penalty, each person who actually pays the penalty is entitled to recover from the others.

New Act: The IRS may now disclose information on the other responsible persons to an attorney-in-fact to allow the persons who paid to recover from the others who did not pay.

6. **IRS refund offset for State income tax debts:** The IRS currently collects past-due child support and debts owed to other federal agencies from taxpayers who expect refunds from their tax returns. The IRS subtracts the amount of debt from the refund and pays the net refund to the taxpayer.

New Act: The new law mandates that state income tax may be offset against Federal tax refunds. Do not be surprised if the federal income tax refund that you expect is reduced because of an unpaid State tax liability. The Act, however, requires the State to notify you by Certified Mail with Return Receipt and to allow you 60 days within which to pay the tax due.

7. **Reasons for disallowance of refund:** the Examination Division of the IRS must review Claims for refunds within 30 days after receipt. If a claim is denied, the IRS issues a form letter stating that such claim cannot be considered.

New Act: The IRS must provide taxpayers with an explanation of the disallowance of any refund claim. This requirement applies whether a refund is totally or partially disallowed so taxpayers can appropriately respond to such disallowance.