SURVEY OF ERRONEOUS PENALTIES
IMPOSED BY IRS
RELATIVE TO EMPLOYMENT RETURNS
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Final Report for
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SUMMARY

Approximately one-fourth of the 9 million penalties assessed on employment tax returns by the Internal Revenue Service in 1986 were later cancelled, or "abated" -- largely because they were assessed in error. This study, based on a survey of small businesses, was undertaken for several purposes:

(1) To examine the reasons for the large number of erroneous penalty assessments on employment tax returns.

(2) To determine the extent to which small business taxpayers elect to pay erroneous penalty assessments instead of attempting to have the penalty removed.

(3) To suggest ways of easing the burden of IRS procedures on small businesses.

Data from the survey show that 26 percent of all business taxpayers claimed that they were assessed penalties on employment returns. Of taxpayers receiving penalty assessments, 64 percent claimed to have had erroneous assessments, and of these, 89 percent said that they protested. The taxpayers surveyed claimed that IRS agreed that the assessment was erroneous in 66 percent of these protests. Taxpayers claimed that in 35 percent of erroneously issued penalty assessments, 3 or more notices were sent by the IRS after the taxpayer protested (even when the IRS agreed that the assessment was erroneous). In 64 percent of erroneous issuances, respondents claimed that proof was offered which clearly indicated an IRS or bank error.

The survey produced a number of recommendations for procedural changes in order to ease the burden of the collection process. These are summarized as follows:

* Upon receipt of a protest from the taxpayer, the IRS should place a hold on further action until the issue is resolved.

* The IRS should establish a quality control program aimed at reducing errors made by banks in processing Federal Tax Deposit monies and by IRS Service Centers in processing returns.
* The IRS should review and improve the clarity of notices and letters.

* In the penalty notice, the IRS should provide the name of a specific contact person who can resolve the dispute on first contact or by reply in a short period of time.

* The IRS should provide a sufficient number of toll free telephone lines (and personnel) so that the taxpayer does not have to wait long or get many busy signals.

* The IRS should issue a warning, instead of a penalty, if the taxpayer has not had a penalty asserted for the same reason in the last 3 years.

* The IRS should be more speedy and thorough in replying to taxpayers. Better trained and supervised personnel are needed in units that handle correspondence from taxpayers.

* The IRS should provide non-technical taxpayer educational material on employment returns and Federal Tax Deposit requirements.

* An administrative tolerance of several days should be used in determining whether a Federal Tax Deposit was made in a timely fashion.

* Legislation should be enacted requiring the IRS to pay taxpayers for expenses incurred in obtaining an abatement of an erroneously assessed penalty.

Because the survey was based on a sample taken from a list which did not contain businesses started under three years ago, the data represent only businesses that were active in 1984 and which remained in business through mid-1987.
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I INTRODUCTION

This study was conducted in connection with the U. S. Small Business Administration's responsibility under PL 94-305 to represent the interests of small business before Congress and Federal agencies. The specific objectives of the study were:

(a) to examine the reasons for the large number of erroneous penalty assessments on small business employment tax returns.

(b) to determine the extent to which small business taxpayers elect to pay erroneous penalties instead of attempting to have the penalty removed.

(c) to suggest ways to ease the burden of erroneous assessments on small firms through revision of IRS procedures and/or business educational efforts.

Penalty assessments may be imposed for:

(1) failure to timely file a required tax return: Form 941 - Employer's Quarterly Federal Tax Return or, Form 940 - Employer's Annual Federal Unemployment (FUTA) Tax Return. In this study, information returns associated with employment (such as Form W2) are not considered.

(2) failure to pay all taxes due with the filing of the return.

(3) non-compliance with certain requirements of the Federal Tax Deposit (FTD) system, for example, failing to make the required deposits when they are due or making them in insufficient amount or sending the deposits to a place other than the authorized depository (generally a bank that is a member of the Federal Reserve System).
Employment tax returns (particularly the Form 941) are extremely important in collection of revenue needed to run the federal government. Approximately 3/4 of total federal revenues are collected in conjunction with Form 941 and the related deposits made through the Federal Tax Deposit (FTD) system. These revenues include the amounts withheld from employees' wages for income and social security taxes as well as employers' share of the social security taxes. Employers are required to withhold from the employees' wages an amount specified in Circular E (Employer's Tax Guide). Income taxes withheld, along with the employer's and employees' portions of social security taxes, must be deposited to the Treasury Department's account at a bank within the time specified by Circular E. The Federal Tax Deposit form, Form 941 and relevant portions of Circular E are shown in the appendix.

The most accurate data available on penalty assessments for employment returns and abatement of such penalties is found in the IRS Commissioner's Annual Report (Table 14, 'Civil Penalties Assessed and Abated'). These data have been summarized for recent years in Table A. A penalty is abated when the penalty and any interest which may have resulted from the penalty is removed. The law authorizes the IRS to abate a penalty when the taxpayer can show that the offense for which it was imposed resulted from a "reasonable cause".

By far, the most frequent cause for abating a penalty on an employment return is that the IRS assessed the penalty in error. An erroneous penalty can be abated only if the taxpayer "protests" (i.e. complains that it is erroneous and should be removed). Instances in which the taxpayer elected to pay the penalty without protesting are not, of course, reflected in the number of abatements shown in Table A.

Penalties assessed for untimely deposits have declined dramatically in the last two years, from over 5 million to under 1 million. However, the percent of assessments issued erroneously has doubled, from 19 to 36 percent. Erroneous penalty assessments can result from taxpayer errors in completing the FTD deposit slip, from bank errors, from Federal Reserve District errors, or from IRS Service Center errors in processing the return or the data from the banking system.
The number of penalties assessed for delinquent filing of returns has not increased significantly over the past decade but the percentage of penalties abated has increased four fold, from 6 to 24 percent. Almost half of this increase took place in 1986 alone. These are clearly errors which involve only the IRS Service Centers since the banking system is not involved. Such penalties are correctly assessed when a return is filed later than the due date.

Penalties assessed for Failure to Pay have been steadily increasing for the past decade, from 2.3 million in 1978 to 5.2 million in 1986. Over the same period, the percentage of these assessments abated has nearly doubled, from 13 to 23 percent. The result is a quadrupling of abated penalty assessments for Failure to Pay. IRS related errors in issuing these assessments are clearly difficulties with the IRS Service Centers.

The 2.2 million penalty assessments challenged by taxpayers in 1986 represent a considerable expense and annoyance to the small business owners who receive them. They also pose a burden to the IRS, which is not prepared to handle the large volume of taxpayers' protests. Attempts by the taxpayers to settle their problems over the telephone is an exercise in frustration. Correspondence takes several months and sometimes much longer. In the meantime, the IRS continues to send notices of payment due. Sometimes the IRS threatens to seize assets even after the taxpayer has successfully communicated the nature of the problem with the IRS.

It is not possible to pinpoint the exact reasons for errors at the IRS Service Centers from the survey -- only a study of Service Center operations can provide this information. It is possible, however, to make recommendations for a reduction of errors and a more speedy resolution of erroneous penalties.
Table A

EMPLOYMENT TAX RETURNS
PERCENTAGE OF PENALTY ASSESSMENTS WHICH HAVE BEEN ABATED

<table>
<thead>
<tr>
<th>Year</th>
<th>Untimely Deposit</th>
<th>Delinquent Filing</th>
<th>Failure to Pay</th>
<th>Total of Penalty</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Assessed (1000)</td>
<td>Percent Abated</td>
<td>Assessed (1000)</td>
<td>Percent Abated</td>
</tr>
<tr>
<td>1986</td>
<td>985</td>
<td>36</td>
<td>2,614</td>
<td>24</td>
</tr>
<tr>
<td>1985</td>
<td>2,445</td>
<td>38</td>
<td>2,393</td>
<td>14</td>
</tr>
<tr>
<td>1984</td>
<td>5,159</td>
<td>19</td>
<td>2,486</td>
<td>11</td>
</tr>
<tr>
<td>1983</td>
<td>4,454</td>
<td>19</td>
<td>2,251</td>
<td>11</td>
</tr>
<tr>
<td>1982</td>
<td>4,649</td>
<td>14</td>
<td>2,280</td>
<td>9</td>
</tr>
<tr>
<td>1981</td>
<td>2,772</td>
<td>11</td>
<td>2,304</td>
<td>7</td>
</tr>
<tr>
<td>1980</td>
<td>3,013</td>
<td>8</td>
<td>2,194</td>
<td>7</td>
</tr>
<tr>
<td>1979</td>
<td>2,620</td>
<td>8</td>
<td>2,248</td>
<td>6</td>
</tr>
<tr>
<td>1978</td>
<td>2,051</td>
<td>8</td>
<td>2,080</td>
<td>6</td>
</tr>
</tbody>
</table>

8,781 25
9,247 29
11,902 20
10,505 19
10,345 15
8,096 12
7,839 11
7,364 10
6,502 9
problems result from monthly payments of Form 941 tax liab-
ilities instead of more frequent deposits which are requir-
ed because the undeposited tax liability has exceeded the
upper threshold amount of $3000 (for the current deposit
rules, see page 9 of "Circular E" which is reproduced in
the appendix). In many cases, a business might be making
deposits as frequently as eight times per month. This is
an argument for raising the upper threshold of the Federal
Tax Deposit system.

In 64 percent of the cases in which the IRS agreed
that the penalty assessment was erroneous, the taxpayers
reportedly offered clear and convincing evidence (such as
cancelled checks) to support their claim (Table 5). In an
additional 3 percent of cases, the IRS reportedly accepted
the taxpayer's claim of "reasonable cause". In still other
cases there was "reasonable cause" which the taxpayer did
not claim because he or she did not know if it would be
accepted.

The percentage of erroneous penalties reported by
industry is given on Table 6. As indicated on that table,
the construction business (which had 9 percent of all
taxpayers in the survey) had 41 percent of taxpayers with
penalties (compared with 26 percent overall), but only 46
percent of these taxpayers had erroneous penalties
(compared with 64 percent overall).

One of the most valuable results of the survey was the
employers' suggestions for easing the paperwork and admini-
strative burden on small businesses (Table 7). These
suggestions form the basis for many of the recommendations
made in this study. For these recommendations, see pages
24 to 31.
ERRONEOUS PENALTIES ASSESSED BY IRS ASSOCIATED WITH PAYROLL TAXES

1. Did your firm have any employees during 1986?
   ☐ YES ☐ NO (go to question 17)

2. Was there a penalty imposed by IRS for 1986 Employer's Federal Tax Return (Form 941) or for a 1985 Annual Unemployment (FUTA) Form 940 return?
   ☐ YES ☐ NO (go to question 15)

3. For which return(s) was a penalty imposed?
   ☐ Form 940 1985 ☐ 941 1st Q 1986 ☐ 941 2nd Q 1986 ☐ 941 3rd Q 1986

4. Were any of these penalties INCORRECTLY imposed?
   ☐ YES ☐ NO (go to question 15)

5. For which return was a penalty imposed in error?
   ☐ 940 1985 ☐ 941 1st Q 1986 ☐ 941 2nd Q 1986 ☐ 941 3rd Q 1986

Answer questions 6 through 14 only with reference to the last return checked on question 5. If there was more than one penalty imposed, answer these questions with respect to penalties incorrectly imposed.

6. Did you protest to IRS that penalty should not have been imposed?
   ☐ YES ☐ NO (go to question 9)

7. Did IRS agree that penalty was imposed in error?
   ☐ YES ☐ NO (state reason of IRS for not agreeing)

8. What proof did you submit that the penalty was in error?

After supplying the required proof, how many additional IRS notices did you receive on this same assessment? (go to question 11)

9. Why did you not protest (check all that apply)?
   ☐ Advice of accountant ☐ Did not want hassle
   ☐ Amount too small to warrant time and/or cost to protest
   ☐ Other, specify

10. Even though you did not protest, what proof did you have that the penalty was imposed in error?
QUESTIONNAIRE CODING

Several of the questions are open ended and require coding for tabulation. The coding used is given below by question number.

Question #7
2 = No reason
3 = Not a reasonable cause
4 = No error
8 = Not settled yet
9 = No response

Question #8 -- first part
1 = Cancelled check
2 = Employment record
3 = Deposit card with tellers initials & time
4 = Copy of tax return
5 = Exception under Rule #4
6 = Letter of explanation
7 = 1 and 4
8 = 1 and 2
9 = 1 and 3
A = Penalty warranted but not calculated correctly
B = 1 and 6
C = Other
E = Reasonable cause
F = No proof
X = None given

Question #8 -- second part
The number given in the questionnaire or if not a number:
4 = several
8 = many

Question #9
1 = Advice of accountant
2 = Did not want hassle
3 = Amount too small to warrant time
A = 1 and 2
B = 1 and 3
C = 2 and 3
D = Protested to bank
Question #11
1 = None
2 = Credited wrong account
3 = Failure to file return
4 = Reported wrong tax amount
5 = Check returned - NSF
6 = Failed to make contribution to state for unemployment insurance
7 = Taxpayer used incorrect EIN
8 = Mixed deposits of different quarters

Question #12
1 = Change of staff
2 = On vacation
3 = Death of a relative
4 = No deposit slips
5 = Accident
9 = Unknown

Question #14
1 = No deposit form or EIN
2 = Ran out of deposit forms
3 = The IRS delayed in sending forms

Question #17
01 = Retail
02 = Wholesale
03 = Manufacturing
04 = Construction (incl. residential & contractor)
05 = Transportation (incl. auto repair & service)
06 = Professional personal services (doctor, dentist, optometrist, funeral home, hospital, personal care home, veterinarian)
07 = Business services (CPA, legal, insurance, advertising, data entry, consultant, messenger, manufacturer's rep., typesetter, architect, cleaning, printing, software
08 = Financial
09 = Non profit
10 = Real Estate (incl. motel, apt., warehouse, elderly housing, property management, sales)
11 = Food service (incl. fast food & restaurants)
12 = Entertainment (incl. camp, movie, golf, club, radio station)
13 = Miscellaneous
14 = Education
15 = Farming
16 = Other personal services (heating & air conditioning, barber, plumber, travel agent, dry cleaning, parking, car wash, TV repair, gas station, diet consultant, garbage collection, investment advisor, child care, landscape maintenance)
99 = Unknown
Question #19

A = Reduce bank errors in transmitting FTD monies
B = Less frequent deposits
C = Less paperwork and/or forms
D = Less changing of tax forms
E = Should not have penalty for few days late or first time errors
F = Need more expeditious replies or action by the IRS
G = Change 3 day deposit rule and 1/8 month to something more easy to understand
H = Need more competent IRS personnel
I = Need omnibusman to keep the IRS off our back
J = Need to clarify instructions, reason for penalty, letters
K = Too much paperwork needed for proof
L = Response to taxpayer replies is not expeditious or thorough
M = The IRS should assign a specific person to handle case and answer questions. Give direct contact toll free number which is not always busy.
O = The IRS should pay attention to "final out"
P = Employees should pay their own payroll tax instead of employer doing it
Q = Attitude of the IRS people is arrogant and/or intimidating
R = There should not be a penalty on errors made by the IRS
S = Taxpayer should be compensated for expenses caused by IRS errors
T = Do not penalize honest errors
U = Need to educate businessmen re forms, deposit rules and/or reasonable cause
V = Allow additional reporting & deposit time on payroll taxes related to third party paid benefits
W = Unknown, not decipherable
Z = Not acceptable suggestion such as don't penalize small business or let taxpayer pay later, or just complaining, or curb the power of the IRS
L = Verify quarter indicated is correct before sending penalty on correct quarter and refund on incorrect quarter
2 = Allow 1 or 2 employees "without all of this mess"
3 = Other
SAMPLE SELECTION

The only file suitable to sample for this study was the Small Business Administration Master Establishment List (MEL). This file consists of 8.9 million names and addresses of firms and establishments in the United States. It was created by matching the Dun's Market Identifier (DMI) file with the Market Data Retrieval (MDR) file (a Yellow Pages telephone listing) in 1984. The MDR portion lists 3.4 million businesses with name, address, geographic code, SIC code, telephone number, and industry. The DMI portion includes this information and provides statistics on employment, sales, and age of firm for an additional 5.5 million firms and establishments. The DAB segment of the MEL should have been sampled so as to give a zero chance of selection to branches of multi-establishment organizations. This was inadvertently not done and was not discovered until after the first mailing. The data file was corrected by deleting all selected branch establishments from the returned questionnaires and from the sample control file for further mailings. Similarly, religious organizations, governmental units and large companies were deleted from the sample because the study was targeting small business.

There were two stages to the sample selection process. In the first stage, approximately 100,000 establishments were selected from the DAB segment (a rate of 1 out of 50) and approximately 10,000 establishments were selected from the MDR segment (a rate of 3 out of 1000). The selection method was the fifth and sixth digits of the telephone number for DAB and fourth, fifth and sixth digits for MDR. The second stage selection assured a representative geographic composition. The DAB segment file was ordered by ZIP code and ten sub-samples were selected by choosing every one hundredth entry after a random start. Also, the MDR segment file was ordered by ZIP code and two sub-samples were selected by taking every fourteenth entry after a random start.

SURVEY EXECUTION

Four mailings of the questionnaire were made with the following results:

<table>
<thead>
<tr>
<th>Mailing</th>
<th>Returned by P.O.</th>
<th>Deleted *</th>
<th>Completed **</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>1836</td>
<td>1216</td>
<td>453</td>
</tr>
<tr>
<td>2</td>
<td>327</td>
<td>443</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>370</td>
<td>346</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>156</td>
<td>200</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>2689</td>
<td>1216</td>
<td>1442</td>
</tr>
</tbody>
</table>

* 693 sample members were deleted because they were branch establishments and 523 were deleted government units, religious organizations, or large companies.

** 163 of the completed returns indicated no employees. 94 indicated that they were government, large company, religious, out of business, or refused to fill out the form. Also 6 were eliminated as duplicates.

Of the 1,442 responses received, 257 were deleted. This left 1,185 usable responses out of an initial mailing of 9,966. The apparent low response rate is attributable to defects of the list from which the sample was selected (as is indicated by the following):

- 2689 Returned by the Post Office as undeliverable
- 1216 Deleted prior to mailing as branches, governments, large companies and religious organizations.
- 163 Responses saying no employees
- 94 Responses deleted as government, large companies and religious organizations
- 1344 Out-of-business segment of non-respondents not returned by the Post Office (as estimated by the telephone survey)
- 1008 Non-responses having no employees (as estimated by the telephone survey)
- 6514 Total
Thus the total number of businesses on the list which is comparable to the number of businesses responding is 3452 and the response rate on this basis is 34 percent.

A control listing of the sample by replicate was maintained. Although the respondent was not asked for his or her identity, it was usually possible to identify respondents from the type of business, the postmark and the replicate (which was coded by our return Post Office box). Also the respondents frequently identified themselves. Thus it was possible, in many cases, to avoid sending another request when a response was received. Additional requests were, of course, not sent in the case of returns by the Post Office. Since it was not always possible to identify the respondent, our cover letter for the second and subsequent mailing requested that a questionnaire not be returned if one had previously been returned. This request was not always followed. Therefore, returned questionnaires were checked for duplicates which were deleted if found.

Telephone follow-up of one replicate of the sample was conducted. For this replicate there were 400 members who did not respond to any of the four mailings. The results of this survey were as follows:

- 28% out of business
- 21% had no employees
- 15% refused information
- 24% said that they had no penalties
- 3% said they had penalties (12 respondents) but only 2 said that the penalties were erroneous
- 7% resulted in no contact with the persons who could provide the information (3 calls were made)
- 1% were deleted as government, branches or large companies

Weights were determined for the DAB segment as follows:
(population no. of companies) / (non-branch sample elements)
or (5507000 - 529000) / (9966 - 693) = 537.
The MDR segment contained branch establishments which were not identified as such. Therefore, the initial weight was divided by the number of places at which business was conducted (question #18). The initial weight for the MDR segment was determined as follows:
(population establishments) / (sample establishments)
or (3370000 / 1832) = 1841.
LIMITATIONS OF THE DATA

The principal limitation of the data is that it reflects only small businesses which are and have been in business for at least 2 1/2 years. This represents a major noncomparability with IRS data. Businesses which started after 1984 are not on the list from which the sample was drawn (the MEL). Such new firms might be expected to have significant problems because they are unfamiliar with the intricacies of the payroll tax system. Businesses which ceased operations since 1984 and which were on the MEL are also not represented.

In addition to businesses, certain other organizations are liable for the payment of withholding and FICA taxes: nonprofit organizations, religious organizations, governmental units, etc. They have been deleted from the mailing. Large organizations (over 500 employees) have also been deleted. About 12 percent of organizations on the list had no employees. They are not reflected in IRS data since they are not liable for employment taxes.

In making estimates from a sample, it is frequently assumed that the non-respondent group is similar in characteristics to the group which responded. We do not believe that such an assertion for this survey would be valid. Telephone follow-up of non-response was done for one replicate of the DAB segment of the sample. The results of this effort are given in the section "Survey Plan and Execution". Because so much of the list population is not reflected in returned questionnaires (66 percent) and because we believe that the character of the IRS population is somewhat different than the population represented by the questionnaire, we have presented data in percentage form rather than as level estimates of the population.

Another major limitation is that the data on erroneous penalties do not apply to all penalties claimed to be erroneous. Such data were requested only for the last of the first 3 quarters of 1986, or if none of these were claimed to involve an erroneous penalty, the 1985 Form 940. This was done in order to keep the questionnaire simple. Thus data on the reason for the penalty involves only those penalties which were claimed to be erroneous and favors such penalties.
for Form 941. The Form 940 specified on the questionnaire was for the 1985 year; the fourth quarter 1986 Form 941 was not included because of the timing of the survey. This is another source of non-comparability with the IRS report.

As might be expected, the tabulated sample has a greater proportion of larger firms than the list from which the sample was drawn. The data are as follows:

<table>
<thead>
<tr>
<th>Employee Size</th>
<th>Percent on the Population List</th>
<th>Percent in the Sample</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 - 4</td>
<td>53</td>
<td>35</td>
</tr>
<tr>
<td>5 - 9</td>
<td>23</td>
<td>20</td>
</tr>
<tr>
<td>10 - 19</td>
<td>12</td>
<td>16</td>
</tr>
<tr>
<td>20 - 49</td>
<td>8</td>
<td>13</td>
</tr>
<tr>
<td>50 - 99</td>
<td>3</td>
<td>5</td>
</tr>
<tr>
<td>over 99</td>
<td>2</td>
<td>4</td>
</tr>
</tbody>
</table>

The difference reflects the fact that a larger proportion of smaller companies has gone out of business in the past three years, and that larger firms have better response rates.
II THE SURVEY

This survey was conducted by mailing approximately 8,500 questionnaires to businesses selected from the Master Establishment List (MEL) maintained by the Small Business Administration (see pages 7 - 22 for information on the questionnaire, coding for tabulations, sample design, survey execution, data limitations, and final tabulations).

Nationally, 26 percent of taxpayers claimed to have had penalties imposed and of these, 64 percent reported penalties which were erroneous (Table 1). Of those reporting erroneous penalties, 89 percent reportedly protested the penalty and for 66 percent of these it was claimed that the IRS agreed that it was erroneous.

Differences in responses from one region to another were small in the penalties imposed, but fairly large, from 56 to 77 percent, in the percentage of penalties which were imposed erroneously. There is also a large variation reported in the percentage of protested penalties which the IRS agreed were in error (ranging from 59 to 74 percent).

Penalty assessments relating to Form 940 were claimed to be in error for 68 percent of recipients (Table 2). Most taxpayers (62 percent) received Form 941 erroneous penalty assessments for only 1 quarter, although 11 percent received penalty assessments for two quarters and 13 percent for three quarters.

Further, respondents claimed that even when the IRS agreed that the penalty was imposed erroneously it was not unusual for three or more notices to be sent by the IRS (Table 3). The receipt of these additional notices, after the taxpayer has followed procedures to have the issue resolved (and even when the IRS has agreed that the assessment is erroneous), causes considerable irritation, confusion and expense for the small business owners. Generally, small businesses with 50 or more employees protested if the penalty was wrongly imposed but many of the smallest companies did not protest even when they thought the IRS was in error.

Taxpayers with a very small number of employees (less than four) had a considerably smaller percentage of penalties imposed (Table 4). This may indicate that fewer
## TABLE 1

**PENALTY ASSESSMENTS REPORTED BY IRS REGION**

<table>
<thead>
<tr>
<th>IRS Region</th>
<th>Percentage of Taxpayers with Penalty Imposed</th>
<th>Percentage of Taxpayers with Penalty Having Error</th>
<th>Percentage of Taxpayers with Erroneous Penalty Who Protested</th>
<th>Percentage of Taxpayers for Which IRS Agreed Penalty Was in Error</th>
</tr>
</thead>
<tbody>
<tr>
<td>Southeast</td>
<td>24</td>
<td>61</td>
<td>95</td>
<td>74</td>
</tr>
<tr>
<td>Western</td>
<td>29</td>
<td>69</td>
<td>95</td>
<td>68</td>
</tr>
<tr>
<td>Mid-Atlantic</td>
<td>25</td>
<td>57</td>
<td>88</td>
<td>76</td>
</tr>
<tr>
<td>MidWest</td>
<td>29</td>
<td>77</td>
<td>94</td>
<td>59</td>
</tr>
<tr>
<td>Southwest</td>
<td>21</td>
<td>60</td>
<td>82</td>
<td>72</td>
</tr>
<tr>
<td>N. Atlantic</td>
<td>28</td>
<td>56</td>
<td>80</td>
<td>60</td>
</tr>
<tr>
<td>Central</td>
<td>28</td>
<td>61</td>
<td>85</td>
<td>66</td>
</tr>
<tr>
<td>All Regions</td>
<td>26</td>
<td>64</td>
<td>89</td>
<td>66</td>
</tr>
</tbody>
</table>
### TABLE 2

**PERCENTAGE OF TAXPAYERS CLAIMING PENALTY ASSESSMENTS BY FORM TYPE**

<table>
<thead>
<tr>
<th>FORM</th>
<th>Percentage of Taxpayers Who Had Penalty Assessments</th>
<th>Percentage of Erroneous Penalties for Taxpayers with Penalties</th>
</tr>
</thead>
<tbody>
<tr>
<td>940 (1985)</td>
<td>29</td>
<td>68</td>
</tr>
<tr>
<td>941 (1986)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1st Quarter</td>
<td>35</td>
<td>52</td>
</tr>
<tr>
<td>2nd Quarter</td>
<td>41</td>
<td>68</td>
</tr>
<tr>
<td>3rd Quarter</td>
<td>46</td>
<td>47</td>
</tr>
<tr>
<td>3 Quarters</td>
<td>13</td>
<td>42</td>
</tr>
<tr>
<td>2 Quarters</td>
<td>11</td>
<td>32</td>
</tr>
<tr>
<td>1 Quarter only</td>
<td>62</td>
<td>68</td>
</tr>
</tbody>
</table>
## Table 3

NUMBER OF NOTICES CLAIMED TO HAVE BEEN RECEIVED AFTER PROTEST

<table>
<thead>
<tr>
<th>Number of Penalty Notices Errorously Sent</th>
<th>Percentage of Penalties that IRS Agreed were Erroneous</th>
<th>Percentage of Total Erroneously Issued Assessments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Zero</td>
<td>63</td>
<td>30</td>
</tr>
<tr>
<td>1</td>
<td>84</td>
<td>11</td>
</tr>
<tr>
<td>2</td>
<td>73</td>
<td>25</td>
</tr>
<tr>
<td>3</td>
<td>82</td>
<td>16</td>
</tr>
<tr>
<td>4 or several</td>
<td>20</td>
<td>6</td>
</tr>
<tr>
<td>5</td>
<td>67</td>
<td>3</td>
</tr>
<tr>
<td>6</td>
<td>100</td>
<td>2</td>
</tr>
<tr>
<td>7</td>
<td>100</td>
<td>1</td>
</tr>
<tr>
<td>Many</td>
<td>25</td>
<td>7</td>
</tr>
</tbody>
</table>

Note: This tabulations includes only one protested erroneous assessment per taxpayer regardless of the number of such assessments which were imposed.
### Table 4

**PENALTIES REPORTED ASSESSED BY EMPLOYEE SIZE**

<table>
<thead>
<tr>
<th>Number of Employees</th>
<th>Percent of T/P</th>
<th>Percentage of T/P with Imposed Penalty in Error</th>
<th>Percentage of T/P with Penalty Having Error</th>
<th>Percentage of T/P Having Error IRS Agreed Penalty was in Error</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>13</td>
<td>62</td>
<td>89</td>
<td>75</td>
</tr>
<tr>
<td>2</td>
<td>21</td>
<td>63</td>
<td>81</td>
<td>68</td>
</tr>
<tr>
<td>3</td>
<td>18</td>
<td>49</td>
<td>90</td>
<td>78</td>
</tr>
<tr>
<td>4</td>
<td>25</td>
<td>48</td>
<td>83</td>
<td>60</td>
</tr>
<tr>
<td>5 - 9</td>
<td>28</td>
<td>65</td>
<td>95</td>
<td>69</td>
</tr>
<tr>
<td>10 - 14</td>
<td>30</td>
<td>69</td>
<td>96</td>
<td>71</td>
</tr>
<tr>
<td>15 - 24</td>
<td>27</td>
<td>53</td>
<td>88</td>
<td>71</td>
</tr>
<tr>
<td>25 - 49</td>
<td>20</td>
<td>60</td>
<td>67</td>
<td>38</td>
</tr>
<tr>
<td>50 - 74</td>
<td>48</td>
<td>74</td>
<td>100</td>
<td>86</td>
</tr>
<tr>
<td>75 - 99</td>
<td>39</td>
<td>57</td>
<td>100</td>
<td>75</td>
</tr>
<tr>
<td>over 99</td>
<td>29</td>
<td>73</td>
<td>91</td>
<td>70</td>
</tr>
<tr>
<td>unknown</td>
<td>36</td>
<td>80</td>
<td>79</td>
<td>41</td>
</tr>
<tr>
<td>All Taxpayers</td>
<td>26</td>
<td>64</td>
<td>89</td>
<td>66</td>
</tr>
</tbody>
</table>

**Note:** T/P = Taxpayer
Table 5

PROOF CLAIMED TO HAVE BEEN OFFERED THAT THE PENALTY WAS ERRONEOUS

<table>
<thead>
<tr>
<th>Type of Proof Offered</th>
<th>Percentage of Taxpayers Who Claimed Erroneous Penalties</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cancelled Check *</td>
<td>48</td>
</tr>
<tr>
<td>Employment Records</td>
<td>5</td>
</tr>
<tr>
<td>FTD Slip</td>
<td>8</td>
</tr>
<tr>
<td>Copy of Return</td>
<td>3</td>
</tr>
<tr>
<td>Letter of Explanation</td>
<td>13</td>
</tr>
<tr>
<td>Reasonable Cause</td>
<td>3</td>
</tr>
<tr>
<td>Other Reasons</td>
<td>4</td>
</tr>
<tr>
<td>No Reason Given</td>
<td>15</td>
</tr>
</tbody>
</table>

* Includes 15% which offered both cancelled check and one of the next four reasons.
Table 6

ERRONEOUS PENALTIES CLAIMED BY INDUSTRY

<table>
<thead>
<tr>
<th>Industry</th>
<th>Percentage of All Taxpayers</th>
<th>Percentage of Taxpayers with Penalties</th>
<th>Taxpayers with Erroneous Penalties as a Percentage of Taxpayers with Penalties</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail</td>
<td>22</td>
<td>22</td>
<td>62</td>
</tr>
<tr>
<td>Wholesale</td>
<td>6</td>
<td>22</td>
<td>54</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>8</td>
<td>41</td>
<td>61</td>
</tr>
<tr>
<td>Construction</td>
<td>9</td>
<td>41</td>
<td>46</td>
</tr>
<tr>
<td>Transportation</td>
<td>2</td>
<td>38</td>
<td>76</td>
</tr>
<tr>
<td>Agriculture</td>
<td>2</td>
<td>12</td>
<td>67</td>
</tr>
<tr>
<td>Financial</td>
<td>2</td>
<td>13</td>
<td>100</td>
</tr>
<tr>
<td>Real Estate</td>
<td>4</td>
<td>22</td>
<td>70</td>
</tr>
<tr>
<td>Education</td>
<td>1</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Professional Service</td>
<td>11</td>
<td>18</td>
<td>60</td>
</tr>
<tr>
<td>Other Personal Service</td>
<td>10</td>
<td>28</td>
<td>63</td>
</tr>
<tr>
<td>Food Service</td>
<td>3</td>
<td>28</td>
<td>60</td>
</tr>
<tr>
<td>Entertainment</td>
<td>1</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Business Services</td>
<td>12</td>
<td>30</td>
<td>69</td>
</tr>
<tr>
<td>Non-Profit</td>
<td>2</td>
<td>10</td>
<td>100</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>3</td>
<td>23</td>
<td>86</td>
</tr>
<tr>
<td>Unknown</td>
<td>2</td>
<td>66</td>
<td>100</td>
</tr>
</tbody>
</table>
Table 7

SUGGESTIONS BY RESPONDENTS

<table>
<thead>
<tr>
<th>Suggestion</th>
<th>Percentage of all Suggestions</th>
</tr>
</thead>
<tbody>
<tr>
<td>More Expeditious or Thorough Action or Reply by IRS</td>
<td>19</td>
</tr>
<tr>
<td>Clarify Instructions, Letters &amp; Reasons for Penalty</td>
<td>17</td>
</tr>
<tr>
<td>Assign Specific Knowledgeable Person &amp; Toll Free No.</td>
<td>13</td>
</tr>
<tr>
<td>More Competent IRS Personnel</td>
<td>7</td>
</tr>
<tr>
<td>Less Paperwork and/or Forms</td>
<td>6</td>
</tr>
<tr>
<td>Less Frequent FTD</td>
<td>5</td>
</tr>
<tr>
<td>Attitude of IRS Personnel is Arrogent or Intimidating</td>
<td>3</td>
</tr>
<tr>
<td>Change 1/8 Month -- 3 Day Rule</td>
<td>3</td>
</tr>
<tr>
<td>No Penalty for Few Days Late or 1st Time Error</td>
<td>3</td>
</tr>
<tr>
<td>Need to Educate Businesses re Forms &amp; FTD Rules</td>
<td>2</td>
</tr>
<tr>
<td>Reduce Banking Errors</td>
<td>2</td>
</tr>
<tr>
<td>Don't Penalize Honest Errors</td>
<td>1</td>
</tr>
<tr>
<td>Verify that the Checked Quarter is Correct</td>
<td>1</td>
</tr>
<tr>
<td>Unknown</td>
<td>1</td>
</tr>
<tr>
<td>Not Acceptable Suggestion</td>
<td>17</td>
</tr>
<tr>
<td>Other</td>
<td>6</td>
</tr>
</tbody>
</table>
ADDITIONAL OBSERVATIONS

Penalties for late FTD deposits might result from mailing the deposit to the bank instead of making it in person. Responses to question #13 indicated that 82 percent of the taxpayers who had a penalty for untimely FTD had made the payment to the bank "in person". A few of the respondents blamed the banks for not crediting their payments immediately in order to get interest-free use of the funds. We have no information as to whether there is any validity to this claim. IRS can make such a determination by a comparison of the dates on proofs submitted with the date on which the bank gave credit for the deposit. If the bank has been using a "float time", then obviously the taxpayer should not be penalized. IRS has the responsibility to either stop this practice or to allow a tolerance before imposing a penalty for untimely deposit.

Question #14 was inserted to determine the prevalence of penalty assessments because deposits are made to a district office instead of to a depository bank. The question also dealt with difficulties in obtaining deposit forms. There is no evidence from this survey that penalty assessments for deposits to the district office are a problem. The sample, however, does not contain businesses that began in the past three years, and situation may be different for new businesses. There were some complaints about the length of time it took to get deposit forms from IRS.

Tabulation of question #15 indicates that the use of an accountant (or payroll service) was not related to the issuance of penalty assessments. For those taxpayers with penalty assessments, 58 percent used an accountant or payroll service whereas 62 percent of all taxpayers used such a service.
III RECOMMENDATIONS

In the past several decades, costs have been rising faster than the IRS budget, putting pressure on the means to maintain the high quality of service to which the IRS aspires. In the zeal to produce the highest revenue for the resources provided, the IRS has not given due cognizance (in our view) to the cost its procedures have imposed on the taxpayer. The goodwill and respect of the taxpayer is essential to effective tax administration. This goodwill should not be jeopardized by a short-sighted policy to save the money that would otherwise be spent ensuring that the taxpayer is treated fairly. It is, therefore, urged that cost considerations not be cited as the reason for not instituting any of the recommendations given below.

ADMINISTRATIVE

(1) Upon receipt of a protest from the taxpayer, the IRS should place a hold on further action, such as sending more notices or allowing the account to proceed to delinquent status, until the issue is resolved.

(2) The IRS should establish a quality control program aimed at reducing the errors made by the Federal Reserve Banks in processing FTD monies and by the IRS Service Centers with respect to returns processing.

(3) The IRS should review its notices and letters to improve clarity. We suggest that the IRS conduct studies similar to the focus group studies which have been conducted in recent years for the income tax returns.

(4) The IRS should specify in the notice of penalty a specific person to contact about the problem. This person should be able to resolve the issue over the phone either on the first contact or by prompt reply.

(5) The IRS should provide a sufficient number of toll-free telephone lines so the taxpayer does not have to wait a long time on the line or get many busy signals.

(6) The IRS should issue a warning statement instead of a penalty if the taxpayer has not had a penalty asserted for the same reason within the last three years.
(7) The IRS should be more speedy and thorough in its replies to taxpayers. Better trained and supervised personnel are needed in the units that handle replies from taxpayers.

(8) The IRS should provide taxpayer educational material relative to employment returns and FTD requirements. This material should be in non-technical language and should not include material which is unlikely to apply to small businesses.

(9) An administrative tolerance of several days should be used in determining whether a Federal Tax Deposit was made in a timely fashion.

LEGISLATIVE

(1) Legislation should be enacted requiring the IRS to pay taxpayers for expenses which they have incurred in obtaining an abatement of penalties (and interest when appropriate) which resulted from errors of the IRS.
IV DISCUSSION OF RECOMMENDATIONS

The preceding proposals are suggested by the data tabulated from the survey questionnaire, especially the part that asks for respondent recommendations.

(1) Table 3 shows that additional notices are usually sent by the IRS after the taxpayer has protested that the penalty was erroneous. Two or three notices were typical, although as many as six or seven had been sent. Furthermore, such notices were sent whether or not the IRS agreed that the penalty was erroneously assessed. The practice of IRS in continuing to send notices after the problem is supposed to be resolved or is in the process of being resolved is source of both confusion and frustration to the taxpayer. Clearly notices should not be sent in cases where the IRS agrees an error has been made. Nor should they be sent during the time that the IRS is investigating whether the penalty should be abated. When the IRS wishes to assure that premature contact does not take place with a taxpayer because there is a possibility of criminal prosecution, a hold procedure is used. As long as this hold stays in the computer, no notices or other action is issued. When the hold is removed, normal computer procedures are followed. It should be feasible to adopt a similar procedure with respect to the specific tax module which is involved in the protested penalty assessment.

(2) While respondents claimed that some of the penalty assessments were abated for "reasonable cause" (such as illness or death of a bookkeeper), the vast majority of erroneous penalties were reported to be the result of errors made in processing the tax information. That these errors result from data processing is evidenced by the large number of times that IRS reportedly agreed that the penalties were erroneous (Table 4) and the type of proof reportedly offered by the taxpayer (Table 5). Such errors may be reduced through a vigorous quality control program. Some aspects of this program will involve only the IRS Service Centers and some will involve the data processing operations of the Federal Reserve System. We recommend that the quality control program be coordinated in the National Office and that excessive errors pinpointed by the tabulations be referred to the quality control supervisor of the appropriate Service Center. Similarly, excessive errors of specific Federal Reserve Districts should be referred to the appropriate office of the Federal Reserve District involved.
Errors giving rise to a penalty for insufficient or late Federal Tax Deposits can result from processing errors at an IRS Service Center, errors at the bank in which the deposits were made, or from errors of processing data to a computer tape by the relevant Federal Reserve District. The IRS Business Masterfile contains information that will enable a relatively inexpensive quality control program, and we recommend that the IRS utilize this data for that purpose. The masterfile record contains the reason for the penalty and whether it was abated. The ZIP code of the taxpayer will also identify both the IRS Service Center and the Federal Reserve District involved. The percent of assessments for late or insufficient tax deposits for Form 941 that are abated should be tabulated weekly by both the IRS Service Centers and the Federal Reserve Districts. Penalties imposed for reasons other than late or insufficient tax deposits should also be tabulated by the IRS Service Center and a similar quality control activity should be pursued.

(3) The most frequent suggestion by respondents was for the IRS to improve the clarity of IRS instructions, notices and letters. A frequent comment was that the taxpayer could not determine the reason for the penalty. This comment was made by otherwise sophisticated business persons such as doctors, dentists and lawyers. This has been a problem of long standing with the IRS. We suggest that IRS conduct studies on the clarity of these notices and letters similar to the "focus group" studies conducted in recent years for income tax returns. Taxpayers who had made many deposits, complained that without a listing of dates and amounts of deposits received by the IRS they could not tell which deposit was in question. Consequently, they were forced to do an excessive amount of work to resolve the issue.

(4) & (5) The second most frequently made suggestion was that the IRS specify in the penalty notice a specific person to contact about the problem for which the penalty was imposed. That person should be able to resolve the issue telephonically on the first contact or by a prompt written reply. Contact should be by toll-free number and a sufficient number of phone lines should be provided to expedite the resolution of problems. The delays and inability to reach IRS offices over the telephone have engendered many caustic comments, and do much to erode taxpayer goodwill. The IRS monitors phone calls to assure proper conduct by
its personnel. It should also monitor the waiting period and the number of busy signals given the callers in order to assure that a sufficient number of lines and personnel are provided. These suggestions are made from the perspective of providing good service with the least burden on the small business taxpayer. Current IRS procedures emphasize efficiency from a data operations standpoint. The IRS would prefer to handle incoming correspondence rather than phone queries, but this is not as convenient for the small business taxpayer. Similarly, from the IRS perspective it is easier not to assign particular cases to particular IRS personnel, but this practice results in considerably more expenditure of time forced on the taxpayer. The IRS needs to achieve a better balance between service to the taxpayer and its budgetary considerations.

(6) Most small business taxpayers are not knowledgeable in tax rules and regulations. Most cannot afford the continuing advice of an accountant and are too busy conducting their business to become experts in interpreting confusing forms and instructions. Several respondents complained that it was not justice that they be penalized because of failure to deposit within three banking days when this was the first time that they were required to do so. They said that they paid the penalty and did not realize that they could escape the penalty because of the "exception to rule 4", which is printed in the instructions on the back of the Form 941. Others have complained that they try to follow the rules but that they sometimes face a situation that unavoidably makes them late with a return or a deposit (such as their own illness or that of a secretary). Apparently they are unaware that the penalty can be abated for reasonable cause or they do not know that their circumstances may constitute a "reasonable cause".

With regard to the Form 940, several of the respondents indicated that they were completely confused by the deposit requirements and that they settled for paying the penalty when called upon to do so. Comments such as these indicate a need to simplify the rules, educate the taxpayer, and be more lenient on first-time failures to follow the rules.
The IRS should issue a warning statement instead of a penalty if the taxpayer has not been penalized for the same reason in the last three years. This is not meant to be soft on negligent taxpayers, but to take into account the fact that small taxpayers are not so knowledgeable of the rules and are more subject to unforeseen events such as illness of the person doing the payroll, etc. The purpose of the penalty is to encourage compliance and it should not be asserted as a punishment for ignorance or inadvertence. There are many cases of penalties being excused for "reasonable cause", now authorized by law. This should be broadened to encompass instances where the taxpayer has made a first-time error. This would be equivalent to an abatement for "reasonable cause" without the expense to the IRS and the taxpayer. In addition to reducing expenses, such a procedure would provide the same education for the future as would the assertion of the penalty. It would also bring much needed goodwill to the IRS. In many cases, the penalty would under present rules be abated either under the exception to rule 4 or for "reasonable cause" if the taxpayer knew of such provisions. We believe that the IRS now has the authority to institute this procedure. If the IRS believes it needs to seek statutory authority, we urge it to do so.

(7) Respondents frequently commented that IRS replies or actions with regard to taxpayer contacts should be more expeditious and thorough. Several months to reply was common, and in one case, six months was claimed. There was understandable annoyance with the Service taking so long to reply while demanding a reply to its correspondence within 10 days. There are many comments to the effect that much better trained or more competent personnel are needed in the units which handle replies to taxpayers. Situations cited included several items of correspondence before a correct reaction was obtained even though the correct reaction should have been elicited by the first letter. Many responses were quite caustic with respect to the quality of IRS personnel. We recommend that the Service Center Quality Control Staff develop a program addressing both the quality and timeliness of responses. If the problem is shortage of staff, we recommend that the IRS allocate more of its resources to this area even if it means that manpower must be taken from that allocated to compliance activities, such as audit.
(8) We recommend that the IRS provide educational material on Form 940 and Form 941, including the Federal Tax Deposit requirements. This material should be in non-technical language and should not include material unlikely to apply to small businesses. Items should be covered by example. Many illustrations of what is acceptable as "reasonable cause" for abating a penalty should be included and there should be a comprehensive but easy-to-follow discussion of the circumstances under which penalties are asserted. Educational material has been sent in the past with return forms but it has generally been limited to an announcement of current changes (such as Notice 786, which announced the increase in the failure to deposit penalty) and have not been comprehensive booklets. The IRS does publish a book entitled "TAX GUIDE FOR SMALL BUSINESS". However, it is much too technical and comprehensive for the average small businessman. We recommend that a booklet of the type discussed above be prepared and sent on a one-time basis to each filer of Form 941 and be sent on a continuing basis to each new filer of Form 941. A more aggressive dissemination is needed than is usual for the IRS because the small businessman will likely not even know that it is available unless it is sent to him. As a minimum, it should be advertised by an announcement distributed to all filers, with a booklet made available on request.

(9) There is a massive amount of paperwork (72 million deposits) involving a large number of persons (5.5 million business filers and 34,000 financial institutions) in the Federal Tax Deposit system. This, coupled with the compressed time scale (three banking days when the tax liability is over $3000 in any 1/8th month period) has resulted in a system that is error prone and time-sensitive. In addition to the errors to be expected in processing such massive amounts of data in a decentralized fashion, there may be some banks that have purposely credited monies late in order to use the monies as interest-free float. A cancelled check was available as proof in almost half of the cases for which the taxpayer claimed that the penalty was erroneously imposed (Table 5). The use of an administrative tolerance of several days in determining whether the FTD was timely should substantially reduce the number of erroneous penalties imposed for untimely deposits. There is precedence for this procedure in the administrative tolerance used for imposing the penalty for untimely filing of returns.
There is a massive amount of paperwork (72 million deposits) involving a large number of persons (5.5 million business filers and 34,000 financial institutions) in the Federal Tax Deposit system. This, coupled with the compressed time scale (three banking days when the tax liability is over $3000 in any 1/8th month period) has resulted in a system that is error prone and time-sensitive. In addition to the errors to be expected in processing such massive amounts of data in a decentralized fashion, there may be some banks that have purposely credited monies late in order to use the monies as interest-free float. A cancelled check was available as proof in almost half of the cases for which the taxpayer claimed that the penalty was erroneously imposed (Table 5). The use of an administrative tolerance of several days in determining whether the FTD was timely should substantially reduce the number of erroneous penalties imposed for untimely deposits. There is precedence for this procedure in the administrative tolerance used for imposing the penalty for untimely filing of returns.
Form 941
Employer’s Quarterly Federal Tax Return
(Rev January 1988)

Department of the Treasury
Internal Revenue Service

For Paperwork Reduction Act Notice, see page 2.

Please type or print.

Your name, address, employer identification number, and calendar quarter of return. (If not correct, please change.)

Name (as distinguished from trade name) Date quarter ended
Trade name, if any Employer identification number
Address and ZIP code

If you are not liable for returns in the future, check here. Date final wages paid. 

Complete for First Quarter Only

1a Number of employees (except household) employed in the pay period that includes March 12th. 

1b If you are a subsidiary corporation AND your parent corporation files a consolidated Form 1120, enter parent corporation employer identification number (EIN). 

2 Total wages and tips subject to withholding, plus other compensation. 

3 Total income tax withheld from wages, tips, pensions, annuities, sick pay, gambling, etc. 

4 Adjustment of withheld income tax for preceding quarters of calendar year (see instructions) 

5 Adjusted total of income tax withheld 

6 Taxable social security wages paid $ x 15.02% (1502) 

7a Taxable tips reported $ x 15.02% (1502) 

7b Taxable hospital insurance wages paid $ x 2.9% (029) 

8 Total social security taxes (add lines 6, 7a, and 7b) 

9 Adjustment of social security taxes (see instructions for required explanation) 

10 Adjusted total of social security taxes (see instructions) 

11 Backup withholding (see instructions) 

12 Adjustment of backup withholding tax for preceding quarters of calendar year 

13 Adjusted total of backup withholding 

14 Total taxes (add lines 5, 10, and 13) 

15 Advance earned income credit (EIC) payments, if any 

16 Net taxes (subtract line 15 from line 14). This must equal line IV below (plus line IV of Schedule A (Form 941) if you have treated backup withholding as a separate liability) 

17 Total deposits for quarter, including overpayment applied from a prior quarter, from your records 

18 Balance due (subtract line 17 from line 16). This should be less than $500. Pay to IRS 

19 If line 17 is more than line 16, enter overpayment here $ and check if refunded. 

Record of Federal Tax Liability (Complete if line 16 is $500 or more.) See the instructions under rule 4 for details before checking these boxes. Check only if you made eighth-monthly deposits using the 95% rule. Check only if you are a first time 3-banking-day depositor. 

Date wages paid Tax liability do not show federal tax deposits below 

<table>
<thead>
<tr>
<th>First month of quarter</th>
<th>Second month of quarter</th>
<th>Third month of quarter</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st through 3rd</td>
<td>A</td>
<td>I</td>
</tr>
<tr>
<td>4th through 7th</td>
<td>B</td>
<td>J</td>
</tr>
<tr>
<td>8th through 11th</td>
<td>C</td>
<td>K</td>
</tr>
<tr>
<td>12th through 15th</td>
<td>D</td>
<td>L</td>
</tr>
<tr>
<td>16th through 19th</td>
<td>F</td>
<td>M</td>
</tr>
<tr>
<td>20th through 22nd</td>
<td>F</td>
<td>N</td>
</tr>
<tr>
<td>23rd through 25th</td>
<td>G</td>
<td>O</td>
</tr>
<tr>
<td>26th through the last</td>
<td>H</td>
<td>P</td>
</tr>
</tbody>
</table>

Total liability for month I II III 

IV Total for quarter (add lines I, II, and III). This must equal line 16 above 

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete

Signature Date
Employer's Annual Federal Unemployment (FUTA) Tax Return

For Paperwork Reduction Act Notice, see page 2

A. Did you pay all required contributions to state unemployment funds by the due date of Form 940? (See instructions if none required).

- Yes
- No

B. Are you required to pay contributions to only one state?

- Yes
- No

C. If any part of wages taxable for FUTA tax is exempt from state unemployment tax, check the box. (See the Specific Instructions on page 2.)

Part I: Computation of Taxable Wages and Credit Reduction (to be completed by all taxpayers)

1. Total payments (including exempt payments) during the calendar year for services of employees

2. Exempt payments (Explain each exemption shown, attaching additional sheets if necessary)

3. Payments for services of more than $7,000 Enter only the excess over the first $7,000 paid to individual employees not including exempt amounts shown on line 2. Do not use the state wage limitation

4. Total exempt payments (add lines 2 and 3)

5. Total taxable wages (subtract line 4 from line 1). (If any part is exempt from state contributions, see instructions)

6. Additional tax resulting from credit reduction for advance advances to the state listed below (by two-letter Postal Service abbreviation) Enter the wages included in line 5 above for that state and multiply by the rate shown. (See the instructions)

Enter the credit reduction amount here and in Part II, line 2, or Part III, line 4.

Part II: Tax Due or Refund (Complete if you checked the "Yes" box in both questions A and B and did not check the box in C, above)

1. FUTA tax Multiply the wages in Part I, line 5, by .056 and enter here

2. Enter amount from Part I, line 6

3. Total FUTA tax (add lines 1 and 2)

4. Minus Total FUTA tax deposited for the year, including any overpayment applied from a prior year (from your records)

5. Balance due (subtract line 4 from line 3). This should be $100 or less. Pay to IRS

6. Overpayment (subtract line 3 from line 4). Check if it is to be Applied to next return or Refunded

Part III: Tax Due or Refund (Complete if you checked the "No" box in either question A or B or you checked the box in C, above. Also complete Part V)

1. Gross FUTA tax Multiply the wages in Part I, line 5, by .062

2. Maximum credit Multiply the wages in Part I, line 5, by .064

3. Enter smaller of the amount in Part V, line 11, or Part III, line 2

4. Enter amount from Part I, line 6

5. Credit allowable (subtract line 4 from line 3). If zero or less, enter 0.

6. Total FUTA tax (subtract line 5 from line 1)

7. Minus Total FUTA tax deposited for the year, including any overpayment applied from a prior year (from your records)

8. Balance due (subtract line 7 from line 6). This should be $100 or less. Pay to IRS

9. Overpayment (subtract line 6 from line 7). Check if it is to be Applied to next return or Refunded

Part IV: Record of Quarterly Federal Tax Liability for Unemployment Tax (Do not include state liability.)

Quarter: First Second Third Fourth Total for Year

Liability for quarter:

If you will not have to file returns in the future, enter "Final" here (see general instruction "Who Must File") and sign the return.

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief it is true, correct, and complete, and that no part of any payment made to a state unemployment fund claimed as a credit was or is to be deducted from the payments to employees.
Mail or deliver each deposit coupon and a single payment covering the taxes to be deposited. A single payment qualified as a depositary for Federal taxes or to the Federal Reserve Bank or branch (FRB) serving your geographical area. Follow the instructions on the back of the coupon. Make the check or money order payable to the depositary or FRB, where you make your deposit. To help ensure proper crediting of your account, include your employer identification number where applicable.


Deposits at Authorized Financial Institutions.—Authorized depositaries must accept cash, a postal money order drawn to the order of the depositary, or a check or draft drawn against the depositary's funds or assets, on deposit. You can deposit taxes with a check drawn against an authorized financial institution only if the depositary is willing to accept the check. Deposits at FRBs.—If you use a check or deposit at an FRB, please deposit with the FRB that serves your area. The check must be considered by that FRB as an immediate credit item. Generally, immediate credit items include checks drawn against accounts located in the same city as the FRB to which the check is mailed.

Deposit on Time.—The timelessness of deposits will be determined by the date received by an authorized depositary or FRB. However, a deposit received after the due date of the deposit will be considered timely if you show that it was mailed by the second business day after the due date. Note: Deposits of $20,000 or more, which are made by taxpayers required to deposit any taxes more than once a month, must be received by the FRB or deposit to be timely, the 2-day mail rule does not apply to these deposits.

If a deposit that does not comply with the deposit requirements is made at an FRB, that deposit will be dated on collection of the funds by the FRB, regardless of when mailed.

If you hand deliver your deposit to the depositary on the due date, be sure to deliver it before the depositary closes its business day.

Depositing Without a Coupon or EIN.—If you have applied for an employer identification number but have not received it, and you must make a deposit, make the deposit with your Internal Revenue Service Center rather than with a depositary or FRB. Make it payable to IRS and show on your name (as shown on Form SS-4), address, kind of tax, period covered, and date you applied for an EIN. Attach an explanation to the deposit. Pay any of any money or deposit required and have not received them in time to make a deposit, or if you are a new employer and have already received your employer identification number but have not yet received your initial supply of Form 8109-B. This over-the-counter deposit coupon is available at most IRS offices. Deposit Form 8109-B deposit coupons with an authorized depositary or FRB only.

Deposit Record.—For your records, a deposit record is provided with each deposit from the coupon book. The coupon itself will not be returned. It is used to credit your account. Your check or money order is your receipt.

To Claim Credit for Overpayments.—If you deposited more than the right amount of taxes for a quarter, you can ask for the overpayment refunded or applied as a credit to your next return. Penalties.—A 10% penalty is charged when taxes are not deposited when due or when Federal tax deposits are mailed or delivered to IRS offices.

Separate Accounting When Deposits Are Not Made or Withheld Taxes Are Not Paid.—Separate accounting may be required if you do not pay over withheld employment social security tax or income tax deposit required taxes, make required payments, or timely return reports. In this case, you would receive written notice from the district director requiring you to deposit taxes in a special trust account for the U.S. Government. You would also have to pay monthly tax returns on Form 941-M. Employer's Monthly Federal Tax Return. Penalties are provided for not depositing taxes and not meeting payment requirements.

When To Deposit.—The amount of taxes determines the frequency of deposits. You owe these taxes when you pay the wages. You can determine your monthly tax return by following the rules and examples below. You may make deposits each month or at regular intervals for depositing taxes.

Depositing Withheld Income and Social Security Taxes.—

Rule 1.—Less than $500 at end of quarter. If at the end of the calendar quarter your total underdeposited taxes for the quarter are less than $500, you do not have to deposit the taxes. You may pay the tax to IRS with Form 941 (or 941-E), or you may deposit the tax by the end of the next month.

Rule 2.—Less than $500 at the end of any month. If at the end of any month your total underdeposited taxes are less than $500, you do not have to make a deposit. You must pay the taxes over to the IRS within the following month. (See Example A)

Rule 3.—$500 or more but less than $3,000 at the end of any month. If at the end of any month your total underdeposited taxes are $500 or more but less than $3,000, you must deposit the taxes within 15 days after the end of the month. Exceptions: If this occurs at the end of a month and you were required to make a deposit of $3,000 or more, see Example D and E.
Circular E

Summary of Deposit Rules for Social Security Taxes and Withheld Income Tax

<table>
<thead>
<tr>
<th>Deposit Rule</th>
<th>Deposit Due</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) If at the end of the quarter your total undeposited taxes are less than $500</td>
<td>(1) No deposit is required. You may pay the taxes to IRS with Form 941 (or 941-E) or you may deposit the taxes in the deposit account, due date of the return.</td>
</tr>
<tr>
<td>(2) If at the end of any month your total undeposited taxes are less than $500</td>
<td>(2) No deposit is required. You may carry the tax over to the following month.</td>
</tr>
<tr>
<td>(3) If at the end of any month your total undeposited taxes are less than $500</td>
<td>(3) Within 15 days after the end of the month (the deposit is required if you were required to make a deposit for an eighth-monthly period during the month under rule 4). However, if this occurs within an eighth-monthly period, deposit any balance due by the due date of the return.</td>
</tr>
<tr>
<td>(4) If at the end of any eighth-monthly period the total wages paid in the period is $1,054 or more but less than $3,000</td>
<td>(4) Within 3 banking days after the end of that period (May 5 days, see Deposit Instructions for State and Local Government Employers for additional information).</td>
</tr>
</tbody>
</table>

Depositing Federal Unemployment (FUTA) Taxes.—For deposit purposes, figure FUTA tax quarterly. Deposit any amount due by the last day of the first month after the quarter ends.

B. Determining whether you must deposit FUTA tax for an eighth-monthly period. If the total wages paid for the eighth-monthly period are $100 or less, you do not have to deposit that period's FUTA taxes. If the total wages paid for the period is more than $100, deposit the taxes during the first month after the quarter.

C. If the tax reportable on Form 940 (including any credit reduce under Code section 3302(c)), minus any deposits for the year, is more than $100, deposit all of the taxes by January 31. If the tax, minus deposits for the year (deposits are $100 or less, you may either deposit or pay it with Form 940 by January 31.

14. Filing the Quarterly Return of Withheld Income Tax and Social Security Taxes

Form 941.—Generally, all employers who are subject to income tax withholding or social security taxes must file Form 941 quarterly. However, there are the following exceptions:

(a) Employers who report only withheld income tax or who withheld the medicare portion only of social security tax. These include certain state and local governments that pay annuities, pensions, and sick pay. These employers should use Form 941-E.

(b) Household employers reporting social security taxes and withheld income tax. Report these on Form 492. Page 5
Federal Tax Deposit (FTD) Checklist

<table>
<thead>
<tr>
<th>Form 8109 (Rev. 1/97)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>FTD REORDER FORM</strong></td>
</tr>
<tr>
<td>Mark the &quot;X&quot; in the box only if there is a change in Employee Identification Number (EIN or Name) An address change here changes your address on the FTD coupon only</td>
</tr>
</tbody>
</table>

**EIN:** 12-2-14-7890 111111

**Name:** LILIAN SMITH & PAUL JONES

**Address:** L & P GRAPHICS

**City:** ANYTOWN MD

**Telephone number:**

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**Please fill out forms in #2 pencil.**
Federal Tax Deposit Coupon
Form 8109
1. Verify your name and employer identification number (EIN) on the preprinted label. This will ensure that your deposit is applied to the proper account. To indicate a change, place an "X" in the box and enter the correct name and EIN. DO NOT MAKE ADDRESS CHANGES. Address changes should only be made when reordering coupons on Form 8109A. (See below.)

2. Write in the money amount—do not type. Also, do not enter dollar signs, commas, decimal points, or leading zeroes. If your deposit is for whole dollars only, be sure to enter "00" in the "CENTS" boxes.

3. To indicate the type of tax, darken the box to the left of the appropriate form. Do not darken the "IRS USE ONLY" box.

4. Always darken the box indicating the quarter that the deposit is for—not the quarter in which you are making the deposit. For payroll, withholding, and excise tax deposits, the quarters are:

   1st quarter - Jan. 1 through Mar. 31
   2nd quarter - Apr. 1 through June 30
   3rd quarter - July 1 through Sept. 30
   4th quarter - Oct. 1 through Dec. 31

For business income tax deposits (this includes the excise tax on net investment income for Form 990-PF filers) darken the first quarter box for deposits made before the end of your tax year. Darken the fourth quarter box for deposits made after the end of the year. Deposits for different types of taxes and for different quarters cannot be combined. Each needs its own deposit coupon.

If you need additional FTD coupons, use Reorder Form 8109A provided in the coupon book. See below for additional information on reordering.

5. Be sure to include your daytime telephone number in the space provided.

FTD Reorder Form
Form 8109A
1. Verify your employer identification number (EIN), name, and address. Check the box if there is any change. If your EIN is incorrect, line through the number and enter the correct EIN.

   there is a change to your name and/or address, enter the new and/or address in this area.

2. FTD coupon books now contain 23 coupons. Request coupon books early enough to make your deposits on time, since it takes five to six weeks to receive your new coupon books. Be sure to mail your reorder to the Internal Revenue Service Center address shown on the reorder form.

Do not make any additional entries on this form, such as "Please rush my order." This results in manually processing your request and may delay receipt of the coupons by approximately two weeks.

4. Be sure to include your daytime telephone number in the space provided.

Federal Tax Deposit Coupon
Form 8109-B
1. Enter the month that your tax year ends in this space if you are filing in the 1120, 990-C, 990-PF, or 980-T box; otherwise, leave it blank. For example, if your tax year ends in January, enter 01; if it ends in December, enter 12.

2. Write in your EIN and the money amount. Do not type it in or use dollar signs, commas, decimal points, or leading zeroes. Be sure to enter "00" in the "CENTS" boxes if your deposit is for whole dollars only.

3. To ensure proper credit to your account, use the name and address as shown on your IRS mailing label found on the current business tax forms mailed to you, such as Form 940, 941, etc. This is your correct IRS account identification.

4. Indicate the type of tax, darken the box to the left of the appropriate form. Do not darken the "IRS USE ONLY" box.

   *Darken the box to the left of the quarter that corresponds to the quarter that the deposit is for—not the quarter in which you are making the deposit. For payroll, withholding, and excise tax deposits, the quarters are:

   1st quarter - Jan. 1 through Mar. 31
   2nd quarter - Apr. 1 through June 30
   3rd quarter - July 1 through Sept. 30
   4th quarter - Oct. 1 through Dec. 31

For business income tax deposits (this includes the excise tax on net investment income for Form 990-PF filers) darken the first quarter box for deposits made before the end of your tax year. Darken the fourth quarter box for deposits made after the end of the year.

If you need coupon books and don't have a Reorder Form 8109A, call the IRS or write your Internal Revenue Service Center and provide the following information: business name, address where you want the coupon books sent, number of coupon books, and EIN. Also include the month in which your tax year ends if you have a Form 1120, Form 990-C, Form 990-PF (with net investment income), Form 990, or Form 2438 filing requirement.

6. Be sure to include your daytime telephone number in the space provided.

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