

Background

Oregon's income tax system is largely based on voluntary reporting as the Department of Revenue does not have all the information necessary, such as credits, subtractions, or dependents, to calculate an individual's or corporation's tax. Penalties are tools used to encourage filing returns, accurate reporting, and timely payment of taxes.

In 1987, the Legislative Assembly adopted a 20-percent penalty for substantial understatement of taxable income. The penalty was applicable when the amount of understated taxable personal income exceeded \$15,000, or \$25,000 for understated taxable income of a corporation. These thresholds remained unchanged until 2015 when the statute was amended to align with the IRS penalty for substantial understatement of tax.

The substantial understatement of tax penalty began in 2015 with thresholds of \$2,400 for personal income tax and \$3,500 for corporation income or excise tax. Those thresholds are indexed to inflation and have increased to \$2,650 and \$3,850 respectively, for tax year 2022. The penalty amount remains 20-percent of the understated tax amount. The penalty can now be imposed when the taxpayer overstates credits or other items that are not reflected in taxable income but result in an understatement of tax.

Administration

The Department of Revenue imposes the substantial understatement of tax penalty when the understated tax is discovered in audit. Each audited return is analyzed to determine if the penalty is applicable – this penalty is not automatically imposed, and a very small percentage of returns filed are subject to audit. Taxpayers can demonstrate why the penalty should not be imposed by documenting the substantial authority for the treatment of the item or adequately disclose the tax treatment of the item and the reasonable basis for the tax treatment to the auditor or on the return. Additionally, the taxpayer may request a waiver of the penalty after it has been imposed, by showing there was reasonable cause for the understatement and that they acted in good faith.

For tax year 2018, the department imposed the substantial understatement of tax penalty on approximately 1,200 audited personal income tax returns and approximately 70 audited corporation income and excise tax returns. If HB 2577 were in effect, there would not have been any penalty imposed for 2018 personal income tax audited returns and seven 2018 corporation income and excise tax returns would receive the penalty.

Federal Penalty

The IRS imposes a 20-percent penalty for substantial understatement of tax of more than 10-percent of the correct tax or \$5,000, whichever is greater, on individual taxpayers. For corporations, the penalty applies when the understated tax exceeds the lesser of 10-percent or \$10 million.

Agency Contact

Xann Culver, Policy Coordinator xann-marie.f.culver@dor.oregon.gov (971) 304-5377

Marjorie Taylor, Legislative Director marjorie.taylor@dor.oregon.gov (503) 476-7644