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REPORT
105–174

INTERNAL REVENUE SERVICE RESTRUCTURING AND REFORM ACT OF 1998

APRIL 22, 1998.—Ordered to be printed

Mr. ROTH, from the Committee on Finance, submitted the following

REPORT

[To accompany H.R. 2676]

The Committee on Finance, to which was referred the bill (H.R. 2676) to amend the Internal Revenue Code of 1986 to restructure and reform the Internal Revenue Service, and for other purposes, having considered the same, reports favorably thereon with an amendment and recommends that the bill as amended do pass.

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I. LEGISLATIVE BACKGROUND

A. COMMITTEE ACTION

Committee consideration

The Committee on Finance marked up H.R. 2676 (the "Internal Revenue Service Restructuring and Reform Act of 1998") on March 31, 1998. The Committee adopted Chairman Roth's amendment in the nature of a substitute, as amended, and ordered the bill, as amended, favorably reported by a roll call vote of 12–0 (20–0 including proxy votes). The bill also includes tax technical corrections provisions.

Committee and subcommittee hearings

The Committee held several public hearings during the 105th Congress as part of its investigation of the operations and structure of the Internal Revenue Service ("IRS'). A series of investigative hearings were held by the full committee on September 23–25, 1997, which examined both the internal and public conduct of the IRS. The Finance Committee's Subcommittee on Taxation and IRS Oversight held a field hearing in Oklahoma City, Oklahoma on December 3, 1997, regarding IRS management and operations in the Oklahoma-Arkansas District.

The Finance Committee continued public hearings on IRS administration, including taxpayer rights, on January 28 and 29 and on February 5, 11, and 25, 1998. The hearing on February 11, 1998, focused on the tax treatment of "innocent spouses."

B. COMMISSION REPORT

The National Commission on Restructuring the Internal Revenue Service (the "Commission") was established to review the practices of the IRS and to make recommendations for modernizing and improving its efficiency and taxpayer services. The Commission report was issued on June 25, 1997,[1] and contained recommendations relating to executive branch governance and management of the IRS, Congressional oversight of the IRS, personnel flexibilities, customer service and compliance, technology modernization, electronic filing, tax law simplification, taxpayer rights and financial accountability.

S. 1096 (the "Internal Revenue Service Restructuring and Reform Act of 1997"), introduced on July 30, 1997, by Senators Kerrey and Grassley, generally followed the Commission's recommendations. A similar bill, H.R. 2676, was passed by the House on November 5, 1997.[2]

[1] Report of the National Commission on Restructuring the Internal Revenue Service, "A Vision for a New IRS," June 25, 1997.

[2] The House Committee on Ways and Means reported H.R. 2676 on October 31, 1997 (H. Rept. 105–364). H.R. 2676 was amended by the House to include (as new Title VI) the provisions of H.R. 2645 ("Tax Technical Corrections Act of 1997") as reported by the House Committee on Ways and Means on October 29, 1997 (H. Rept. 105–356).

II. EXPLANATION OF THE BILL

TITLE I. EXECUTIVE BRANCH GOVERNANCE AND MANAGEMENT OF THE IRS

A. IRS RESTRUCTURING AND CREATION OF IRS OVERSIGHT BOARD

1. IRS mission and restructuring (secs. 1001 and 1002 of the bill)

Present Law

IRS mission statement

The IRS mission statement provides that:

> The purpose of the Internal Revenue Service is to collect the proper amount of tax revenue at the least cost; serve the public by continually improving the quality of our products and services; and perform in a manner warranting the highest degree of public confidence in our integrity and fairness.

IRS organizational plan

Under Reorganization Plan No. 1 of 1952, the Internal Revenue Service ("IRS") is organized into a 3-tier geographic structure with a multi-functional National Office, Regional Offices, and District Offices. A number of IRS reorganizations have occurred since then, but no major changes have been made to the basic 3-tier structure. Presently, as a result of a 1995 reorganization, there is a Regional Commissioner, a Regional Counsel and a Regional Director of Appeals for each of the following 4 regions: (1) the Northeast Region (headquartered in New York); (2) the Southeast Region (Atlanta); (3) the Midstates Region (Dallas); and (4) the Western Region (San Francisco). There are 33 District Offices, 10 service centers, and 3 computing centers.

Reasons for Change

The Committee believes that a key reason for taxpayer frustration with the IRS is the lack of appropriate attention to taxpayer needs. At a minimum, taxpayers should be able to receive from the IRS the same level of service expected from the private sector. For example, taxpayer inquiries should be answered promptly and accurately; taxpayers should be able to obtain timely resolutions of problems and information regarding activity on their accounts; and taxpayers should be treated fairly and courteously at all times. The Commissioner of Internal Revenue has indicated his interest in improving customer service. The Committee believes that taxpayer service is of such importance that the Committee should not only support the Commissioner's efforts, but also mandate that a key part of the IRS mission must be taxpayer service.

The Commissioner has announced a broad outline of a plan to reorganize the structure of the IRS in order to help make the IRS more oriented toward assisting taxpayers and providing better taxpayer service. Under this plan, the present regional structure would be replaced with a structure based on units that serve particular groups of taxpayers with similar needs. The Commissioner has currently identified four different groups of taxpayers with similar needs: individual taxpayers, small businesses, large businesses, and the tax-exempt sector (including employee plans, exempt organizations and State and local governments). Under this structure, each unit would be charged with end-to-end responsibility for serving a particular group of taxpayers. The Commissioner believes that this type of structure will solve many of the problems taxpayers encounter now with the IRS. For example, each of the 33 district offices and 10 service centers are now required to deal with every kind of taxpayer and every type of issue. The proposed plan would enable IRS personnel to understand the needs and problems affecting particular groups of taxpayers, and better address those issues. The present-law structure also impedes continuity and accountability. For example, if a taxpayer moves, the responsibility for the taxpayer's account moves to another geographical area. Further, every taxpayer is serviced by both a service center and at least one district. Thus, many taxpayers have to deal with different IRS offices on the same issues. The proposed structure would eliminate many of these problems.

The Committee believes that the current IRS organizational structure is one of the factors contributing to the inability of the IRS to properly serve taxpayers and the proposed structure would help enable the IRS to better serve taxpayers and provide the necessary level of services and accountability to taxpayers. The Committee supports the Commissioner in his efforts to modernize and update the IRS and believes it appropriate to provide statutory direction for the reorganization of the IRS.

Explanation of Provision

The IRS is directed to revise its mission statement to provide greater emphasis on serving the public and meeting the needs of taxpayers.

The IRS Commissioner is directed to restructure the IRS by eliminating or substantially modifying the present-law three-tier geographic structure and replacing it with an organizational structure that features operating units serving particular groups of taxpayers with similar needs. The plan is also required to ensure an independent appeals function within the IRS. As part of ensuring an independent appeals function, the reorganization plan is to prohibit ex parte communications between appeals officers and other IRS employees to the extent such communications appear to compromise the independence of the appeals officers. The legality of IRS actions will not be affected pending further appropriate statutory changes relating to such a reorganization (e.g., eliminating statutory references to obsolete positions).

Effective Date

The provision is effective on the date of enactment.

2. Establishment and duties of IRS Oversight Board (sec. 1101 of the bill and sec. 7802 of the Code)

Present Law

Under present law, the administration and enforcement of the internal revenue laws are performed by or under the supervision of the Secretary of the Treasury.[3] The Secretary has delegated the responsibility to administer and enforce the Internal Revenue laws to the Commissioner. The Commissioner has the final authority of the IRS concerning the substantive interpretation of the tax laws as reflected in legislative and regulatory proposals, revenue rulings, letter rulings, and technical advice memoranda. Under present law, the duties of the Chief Counsel of the IRS are prescribed by the Secretary. The Secretary has delegated authority over the Chief Counsel to General Counsel of the Treasury. The General Counsel has delegated authority to serve as the legal adviser to the Commissioner to the Chief Counsel.

Federal employees are subject to rules designed to prevent conflicts of interest or the appearance of conflicts of interest. The rules applicable to any particular employee depend in part on whether the employee is a regular, full-time Federal Government employee or a special government employee, the length of service of the employee and the pay grade of the employee. A "special government employee" is, in general, an officer or employee of the executive or legislative branch of the U.S. government who is appointed or employed to perform (with or without compensation) for not to exceed 130 days during any period of 365 days, temporary duties either on a full-time or intermittent basis. Violations of the ethical conduct rules are generally punishable by imprisonment for up to 1 year (5 years in the case of wilful conduct), a civil fine, or both. The amount of the fine with respect to each violation cannot exceed the greater of $50,000 or the compensation received by the employee in connection with the prohibited conduct.

Under the ethical conduct rules, all Federal Government employees (including special government employees) are precluded from participating in a matter in which the employee (or a related party) has a financial interest. In addition, special government employees cannot represent a party (whether or not for compensation) or receive compensation for representation of a party[4] in relation to a matter (1) in which the employee has at any time participated personally and substantially, or (2) which is pending in the department or agency of the Government in which the special government employee is serving. In the case of a special government employee who has served in a department no more than 60 days during the immediately preceding 365 days, item (2) does not apply. Thus, for example, such an individual can receive compensation for representational services with respect to matters pending in the department in which the employee serves, as long as it is not a matter involv-

[3] Code sec. 7801(a).

[4] The prohibition on receipt of compensation applies regardless of whether the services are performed by the Federal employee or someone else. For example, it would preclude a Federal employee from sharing in the compensation received by a partner of the Federal employee with respect to covered matters.

ing parties in which the employee personally and substantially participated.[5]

The conflict of interest rules also impose restrictions on what a Federal Government employee can do after leaving the Government. Under these rules, senior level officers and employees (including special government employees) who served at least 60 days cannot represent anyone other than the United States before the individual's former department or agency for 1 year after terminating employment. Whether an employee is a senior level officer or employee is determined by pay grade. The one-year post employment restriction does not apply to special government employees who serve less than 60 days during the 365–day period before termination of employment.[6]

Federal employees with pay grades above certain levels (and who have at least 60 days of service) are required to file annually public financial disclosures.

Reasons for Change

The Committee believes that a well-run IRS is critical to the operation of our tax system. Public confidence in the IRS must be restored so that our system of voluntary compliance will not be compromised. The Committee believes that most Americans are willing to pay their fair share of taxes, and that public confidence in the IRS is key to maintaining that willingness.

The National Commission on Restructuring the IRS (the "Restructuring Commission") conducted a year-long study of the IRS and found that a number of factors contribute to current IRS management problems. The Restructuring Commission found that, while the Treasury is responsible for IRS oversight, it has generally provided little consistent strategic oversight or guidance to the IRS. The Secretary and Deputy Secretary have many other broad responsibilities and generally leave the IRS largely independent. The average tenure of an IRS Commissioner is under 3 years, as is the average tenure of senior Treasury officials responsible for IRS oversight. Many of the issues that need to be addressed by the IRS require expertise in various areas, particularly management and technology.

The Restructuring Commission concluded the following:

> problems throughout the IRS cannot be solved without focus, consistency and direction from the top. The current

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[5] More stringent rules apply to regular Federal Government employees. Such employees cannot receive compensation for representational services (whether rendered by the individual or another) in matters in which the United States is a party or has a direct and substantial interest before any department, agency or court. In addition, a Federal Government employee cannot act as agent or attorney (whether or not for compensation) for prosecuting any claim against the United States or act as agent or attorney for anyone before any department, agency, or court in which the United States is a party or has a direct and substantial interest.

[6] All Federal Government employees are permanently prohibited from representing a party other than the government in connection with a particular matter (1) in which the government is a party or has an interest, (2) in which the individual participated personally and substantially, and (3) which involved a specific party or parties at the time of their participation. In addition, Federal employees cannot, within 2 years after terminating employment, represent any person other than the United States in connection with any matter (1) in which the government is a party or has a direct and substantial interest, (2) which the person knows or reasonably should know was actually pending under his or her official responsibility within one year before termination of employment, and (3) which involved a specific party or parties at the time it was pending

> structure, which includes Congress, the President, the Department of the Treasury, and the IRS itself, does not allow the IRS to set and maintain consistent long-term strategy and priorities, nor to develop and execute focused plans for improvement. Additionally, the structure does not ensure that the IRS budget, staffing and technology are targeted toward achieving organizational success.

The Committee shares the concerns of the Commission, and believes that fundamental change in IRS management and oversight is essential. The Committee believes that a new management structure that will bring greater expertise in needed areas, and more focus and continuity will help the IRS to become an efficient, responsive, and respected agency that acts appropriately in carrying out its functions.

The Committee believes that private sector input is a necessary part of any new management structure. The Committee believes that appropriate ethics rules should be applied to the private sector members of the new IRS management in order to enhance the ability of such members to demonstrate impartiality in the performance of their duties, while not unduly restricting the available pool of potential candidates.

The Committee is aware that the taxpaying public does not relish contacts with the agency responsible for collecting taxes. Nevertheless, by establishing a new management structure that will better enable the IRS to develop and fulfill long-term goals, the Committee believes the IRS will provide better service and reduce IRS contact with taxpayers. The Committee is also aware that changes being made to IRS management structure are not the final step, and that continued oversight of the IRS, by Congress as well as the Administration, is necessary in order to ensure long-term progress.

Explanation of Provision

Duties, responsibilities, and powers of the IRS Oversight Board

The bill provides for the establishment within the Treasury Department of the Internal Revenue Service Oversight Board (referred to as the "Board"). The general responsibilities of the Board are to oversee the IRS in the administration, management, conduct, direction, and supervision of the execution and application of the internal revenue laws. As part of its oversight responsibilities, the Board has the responsibility to ensure that the organization and operation of the IRS allows it to carry out its mission. The Board will sunset September 30, 2008.

The Board has the following specific responsibilities: (1) to review and approve strategic plans of the IRS, including the establishment of mission and objectives (and standards of performance) and annual and long-range strategic plans; (2) to review the operational functions of the IRS, including plans for modernization of the tax administration system, outsourcing or managed competition, and training and education; (3) to review and approve the Commissioner's plans for major reorganization of the IRS (except that the approval authority does not apply to the reorganization provided for under the bill); and (4) to review operations of the IRS in order to ensure the proper treatment of taxpayers. The Board also has the following specific responsibilities relating to management: (1) to recommend to the President candidates for Commissioner (and to recommend the removal of the Commissioner); (2) taking into account the recommendations, if any, of the Commissioner, to recommend to the Secretary 3 candidates for appointment as the National Taxpayer Advocate from individuals who have a background in customer service and tax law, and experience representing individual taxpayers (and to recommend the removal of the National Taxpayer Advocate); (3) to review the Commissioner's selection, evaluation, and compensation of IRS senior executives who have program management responsibility over significant functions of the IRS; (4) and to review procedures of the IRS relating to financial audits.

In addition, the Board will review and approve the budget request of the IRS prepared by the Commissioner, submit such budget request to the Secretary, and ensure that the budget request supports the annual and long-range strategic plans of the IRS. The Secretary is required to submit the budget request approved by the Board to the President, who is required to submit such request, without revision, to the Congress together with the President's annual budget request for the IRS. The bill does not affect the ability of the President to include, in addition, his own budget request relating to the IRS.

It is intended that the Board will reach a formal decision on all matters subject to its review. With respect to those matters over which the Board has approval authority, the Board's decisions will be determinative.

The Board has no responsibilities or authority with respect to the development and formulation of Federal tax policy relating to existing or proposed internal revenue laws. In addition, the Board has no authority (1) to intervene in specific taxpayer cases, including compliance activities involving specific taxpayers such as criminal investigations, examinations, and collection activities, (2) to engage in specific procurement activities of the IRS (e.g., selecting vendors or awarding contracts), or (3) to intervene in specific individual personnel matters.

Board members would have limited access to confidential tax return and return information under section 6103. This limited access would permit the Board to receive such information (i.e., information that has not been redacted to remove confidential tax return and return information) from the Treasury IG for Tax Administration or the Commissioner in connection with reports made to the Board. This access to section 6103 information does not include the taxpayer's name, address, or taxpayer or employer identification number. The Board members are subject to the anti-browsing rules applicable to IRS employees under present law.[7]

In exercising its duties, it is expected that the members of the Board shall maintain appropriate confidentiality (e.g., regarding enforcement matters).

The Board is required to report each year regarding the conduct of its responsibilities. The annual report shall be provided to the

[7] The provision does not affect the Secretary's (or Deputy Secretary's) or the Commissioner's access to section 6103 information or the application of the anti-browsing rules to the Secretary (or Deputy Secretary) or the Commissioner.

President and the House Committees on Ways and Means, Government Reform and Oversight, and Appropriations and the Senate Committees on Finance, Governmental Affairs, and Appropriations. In addition, the Board is required to report to the Ways and Means and Finance Committees if the IRS does not address problems identified by the Board.

It is expected that the Treasury Department will no longer utilize the IRS Management Board once the new Board created by the bill is in place, as the functions of the IRS Management Board would be taken over by the new Board.

Composition of the Board

The Board is composed of 9 members. Six of the members are so-called "private-life" members who are not otherwise Federal officers or employees. These private-life members are appointed by the President, with the advice and consent of the Senate. The other members are: (1) the Secretary (or, if the Secretary so designates, the Deputy Secretary); (2) the Commissioner; and (3) a representative from an employee organization that represents a substantial number of IRS employees and who is appointed by the President, with the advice and consent of the Senate. In appointing the representative of an employee organization, the President is not required to choose an individual recommended by the employee organization, but may choose whoever the President determines to be an appropriate representative of the employee organization.

The private-life members of the Board will be appointed without regard to political affiliation and based solely on their expertise in the following areas: (1) management of large service organizations; (2) customer service; (3) the Federal tax laws, including administration and compliance; (4) information technology; (5) organization development; and (6) the needs and concerns of taxpayers. In the aggregate, the private-life members of the Board should collectively bring to bear expertise in these enumerated areas.

A private-life Board member and the employee representative Board member may be removed at the will of the President. In addition, the Secretary (or Deputy Secretary) and the IRS Commissioner are automatically removed from the Board upon his or her termination of employment as such.

Compensation of Board members

The private-life members of the Board will be compensated at a rate of $30,000 per year, except that the Chair would be compensated at a rate of $50,000 a year. The other Board members will receive no compensation for their services as a Board member. All members of the Board are entitled to travel expenses for purposes of attending Board meetings or visiting IRS offices in connection with Board functions.

Ethical conduct rules

Private-life members

Under the bill, the private-life Board members are subject to the public financial disclosure rules applicable to Federal government employees above certain pay grades and who have at least 60 days of service. Thus, the private-life Board members are required to file a public financial disclosure report for purposes of confirmation, annually during their tenure on the Board, and upon termination of appointment.

The ethical conduct rules applicable to private-life Board members depend on whether or not such members are determined to be "special government employees" under the present-law rules. It is expected that they generally will be. In that case, they will be subject, at a minimum, to the ethical conduct rules applicable to special government employees. In addition, during their term as a Board member, a private-life Board member cannot represent any party (whether or not for compensation) with respect to (1) any matter before the Board or the IRS, (2) any tax-related matter before the Treasury Department or (3) any court proceeding with respect to a matter described in (1) or (2). Thus, for example, the day after appointment to the Board, a private-life Board member could not meet with representatives of the IRS or Treasury on behalf of a client or the Board member's corporate employer with respect to proposed tax regulations. On the other hand, the Board member could, for example, represent clients before the U.S. Customs Service. The special rules applicable to private-life Board members generally do not preclude the Board member from sharing in compensation from representation of clients by another person (e.g., a partner of the Board member) before the IRS or Treasury.[8]

In addition, private-life Board members are subject to the 1-year post employment restriction applicable to individuals above certain pay grades and who have served at least 60 days (whether or not the members are special government employees under the present-law rules).

If the Board members are determined not to be special government employees under the present-law rules, then they will be subject to the ethical conduct rules relating to regular Federal Government employees.

Representative of employee organization

In general, the bill provides that the employee representative or Board member is subject to the same ethical conduct rules as the private-life Board members. However, the bill modifies the otherwise applicable ethical conduct rules so that they do not preclude the employee representative from carrying out his or her duties as a Board member and his or her duties with respect to the employee organization. In particular, the employee representative is not prohibited from (1) representing the interests of the employee organization before the Federal Government on any matter, or (2) acting on a Board matter because the employee organization has a financial interest in the matter. In addition, the employee representative

[8] Certain limitations to this exception to the otherwise applicable ethical rules would apply. For example, this exception would not apply if the matter was one in which the Board member personally and substantially participated. Similarly, the Board member could not act with respect to a matter in which he or she has a personal financial interest, including the potential to receive a share in compensation as a result of another's representation.

can continue to receive his or her compensation from the employee organization.[9]

The employee representative is subject to the same public financial disclosure rules as the private-life Board members. In addition, the employee organization is required to provide an annual financial report with the House Ways and Means Committee and the Senate Finance Committee. Such report is required to include the compensation paid to the individual serving on the Board, the compensation of individuals employed by the employee organization, and membership dues collected by the organization.

The employee representative is subject to the same 1-year post employment restriction applicable to the private-life Board members, except to the extent the representative is acting in his capacity as a representative of the employee organization.

Administrative matters

Term of appointments

The 6 private-life Board members will be appointed for 5-year terms. The private-life members may serve no more than two 5-year terms. Board member terms will be staggered, as a result of a special rule providing that some private-life members first appointed to the Board would serve terms of less than 5 years. Under this rule, 2 members first appointed will have a term of 2 years, 2 for a term of 4 years, and 2 for a term of 5 years. The terms of the initial Board members will run from the date of employment. Subsequent terms will run from expiration of the previous term. A Board member appointed to fill a vacancy before the expiration of a term will be appointed to the remainder of the term. Of course, such a member could be appointed to subsequent 5-year term.

Chair of the Board

The members of the Board are to elect a Chair from the private-life members for a 2-year term. Except as otherwise provided by a majority of the Board, the authority of the Chair includes the authority to hire appropriate staff, call meetings, establish committees, establish the agenda for meetings, and develop rules for the conduct of business.

Meetings

The Board is required to meet on a regular basis (as determined necessary by the Chair), but no less frequently than quarterly. The Board can meet privately, and is not subject to public disclosure laws.

A quorum of 5 members is required in order for the Board to conduct business. Actions of the Board can be taken by a majority vote of those members present and voting.

Staffing

The Chair is authorized to hire (and terminate) such personnel as the Chair finds necessary to enable the Board to carry out its

[9] Certain limitations on this exception would apply. For example, the rules relating to bribery would continue to apply. In addition, the employee representative would be precluded from acting on a matter in which he or she has a financial interest.

duties. In addition, the Board will have such staff as detailed by the Commissioner or from another Federal agency at the request of the Chair of the Board. The Chair can procure temporary and intermittent services under section 3109(b) of title 5 of the U.S. Code.

Claims against Board members

The private-life members of the Board have no personal liability under Federal law with respect to any claim arising out of or resulting form an act or omission by the Board member within the scope of service as a Board member. The bill does not limit personal liability for criminal acts or omissions, wilful or malicious conduct, acts or omissions for private gain, or any other act or omission outside the scope of service as a Board member. The bill does not affect any other immunities and protections that may be available under applicable law or any other right or remedy against the United States under applicable law, or limit or alter the immunities that are available under applicable law for Federal officers and employees.

Effective Date

The provision relating to the Board is effective on the date of enactment. The President is directed to submit nominations for Board members to the Senate within 6 months of the date of enactment. The legality of the actions of the IRS are not affected pending appointment of the Board.

B. APPOINTMENT AND DUTIES OF IRS COMMISSIONER AND CHIEF COUNSEL AND OTHER PERSONNEL

1. IRS Commissioner and other personnel (secs. 1102(a) and 1104 of the bill and secs. 7803 and 7804 of the Code)

Present Law

Within the Department of the Treasury is a Commissioner of Internal Revenue, who is appointed by the President, with the advice and consent of the Senate. The Commissioner has such duties and powers as may be prescribed by the Secretary.[10] The Secretary has delegated to the Commissioner the administration and enforcement of the internal revenue laws.[11] The Commissioner generally does not have authority with respect to tax policy matters.[12]

The Secretary is authorized to employ such persons as the Secretary deems appropriate for the administration and enforcement of the internal revenue laws and to assign posts of duty.

Explanation of Provision

As under present law, the Commissioner is appointed by the President, with the advice and consent of the Senate, and may be

[10] Code sec. 7802(a).
[11] Treasury Order 150–10 (April 22, 1982).
[12] See, e.g., Treasury Order 111–2 (March 16, 1981), which delegates to the Assistant Secretary (Tax Policy) the exclusive authority to make the final determination of the Treasury Department's position with respect to issues of tax policy arising in connection with regulations, published Revenue Rulings and Revenue Procedures, and tax return forms and to determine the time, form and manner for the public communication of such position.

removed at will by the President. Under the bill, one of the qualifications of the Commissioner is demonstrated ability in management. The Commissioner is appointed to a 5-year term, beginning with the date of appointment. The Commissioner may be reappointed for more than one 5-year term. The Board recommends candidates to the President for the position of Commissioner; however, the President is not required to nominate for Commissioner a candidate recommended by the Board. The Board has the authority to recommend the removal of the Commissioner.

The Commissioner has such duties and powers as prescribed by the Secretary. Unless otherwise specified by the Secretary, such duties and powers include the power to administer, manage, conduct, direct, and supervise the execution and application of the internal revenue laws or related statutes and tax conventions to which the United States is a party, to exercise the IRS' final authority concerning the substantive interpretation of the tax laws, to recommend to the President a candidate for Chief Counsel (and recommend the removal of the Chief Counsel), and to recommend candidates for the position of National Taxpayer Advocate to the IRS Board. If the Secretary determines not to delegate such specified duties to the Commissioner, such determination will not take effect until 30 days after the Secretary notifies the House Committees on Ways and Means, Government Reform and Oversight, and Appropriations, and the Senate Committees on Finance, Governmental Affairs, and Appropriations. The Commissioner is to consult with the Board on all matters within the Board's authority (other than the recommendation of candidates for Commissioner and the recommendation to remove the Commissioner).

Unless otherwise specified by the Secretary, the Commissioner is authorized to employ such persons as the Commissioner deems proper for the administration and enforcement of the internal revenue laws and is required to issue all necessary directions, instructions, orders, and rules applicable to such persons. Unless otherwise provided by the Secretary, the Commissioner will determine and designate the posts of duty.

Effective Date

The provisions relating to the Commissioner are effective on the date of enactment. The provision relating to the 5-year term of office applies to the Commissioner in office on the date of enactment. The 5-year term runs from the date of appointment.

2. IRS Chief Counsel (sec. 1102(a) and sec. 7803 of the Code)

Present Law

The President is authorized to appoint, by and with the consent of the Senate, an Assistant General Counsel of the Treasury, who is the Chief Counsel of the IRS. The Chief Counsel is the chief law officer for the IRS and has such duties as may be prescribed by the Secretary. The Secretary has delegated authority over the Chief Counsel to the Treasury General Counsel. The Chief Counsel does not report to the Commissioner, but to the Treasury General Counsel. As delegated by the Treasury General Counsel, the duties of the Chief Counsel include: (1) to be the legal advisor to the Commissioner and his or her officers and employees; (2) to furnish such legal opinions as may be required in the preparation and review of rulings and memoranda of technical advice and the performance of other duties delegated to the Chief Counsel; (3) to prepare, review, or assist in the preparation of proposed legislation, treaties, regulations and Executive Orders relating to laws affecting the IRS; (4) to represent the Commissioner in cases before the Tax Court; (5) to determine what civil actions should be brought in the courts under the laws affecting the IRS and to prepare recommendations to the Department of Justice for the commencement of such actions and to authorize or sanction commencement of such actions.

Explanation of Provision

As under present law, the Chief Counsel is appointed by the President, with the advice and consent of the Senate. Under the bill, the Chief Counsel is not an Assistant General Counsel of the Treasury and reports directly to the Commissioner.

The Chief Counsel has such duties and powers as prescribed by the Secretary. Unless otherwise specified by the Secretary, these duties include the duties currently delegated to the Chief Counsel as described above. If the Secretary determined not to delegate such specified duties to the Chief Counsel, such determination is subject to the same notice requirement applicable to changes in the delegation of authority with respect to the Commissioner.

Effective Date

The provision is generally effective on the date of enactment. The provision providing that the Chief Counsel reports directly to the Commissioner is effective 90 days after the date of enactment.

C. STRUCTURE AND FUNDING OF THE EMPLOYEE PLANS AND EXEMPT ORGANIZATIONS DIVISION ("EP/EO") (SEC. 1102 OF THE BILL AND SEC. 7803 OF THE CODE)

Present Law

Prior to 1974, no one specific office in the IRS had primary responsibility for employee plans and tax-exempt organizations. As part of the reforms contained in the Employee Retirement Income Security Act of 1974 ("ERISA"), Congress statutorily created the Office of Employee Plans and Exempt Organizations ("EP/EO") under the direction of an Assistant Commissioner.[13] EP/EO was created to oversee deferred compensation plans governed by sections 401–414 of the Code and organizations exempt from tax under Code section 501(a).

In general, EP/EO was established in response to concern about the level of IRS resources devoted to oversight of employee plans and exempt organizations. The legislative history of Code section 7802(b) states that, with respect to administration of laws relating to employee plans and exempt organizations, "the natural tendency is for the Service to emphasize those areas that produce revenue

[13] Code section 7802(b).

rather than those areas primarily concerned with maintaining the integrity and carrying out the purposes of exemption provisions."[14]

To provide funding for the new EP/EO office, ERISA authorized the appropriation of an amount equal to the sum of the section 4940 excise tax on investment income of private foundations (assuming a rate of 2 percent) as would have been collected during the second preceding year plus the greater of the same amount or $30 million.[15] However, amounts raised by the section 4940 excise tax have never been dedicated to the administration of EP/EO, but are transferred instead to general revenues. Thus, the level of EP/EO funding, like that of the rest of the IRS, is dependent on annual Congressional appropriations to the Treasury Department.

Reasons for Change

To facilitate the reorganization of the IRS along functional lines, the Committee believes that the statutory provision requiring the establishment of the Office of Employee Plans and Exempt Organizations under the direction of an Assistant Commissioner should be eliminated. In addition, because the funding formula for EP/EO set forth in section 7802(b)(2) would, if utilized, result in an unstable level of funding that may bear little or no relation to the amount of financial resources actually required by the EP/EO division, the Committee believes that it is appropriate to repeal the funding mechanism.

Explanation of Provision

The bill eliminates the statutory requirement contained in section 7802(b) that there be an "Office of Employee Plans and Exempt Organizations" under the supervision and direction of an Assistant Commissioner. The Committee intends that a comparable structure be created administratively to ensure that adequate resources within the IRS are devoted to oversight of the tax-exempt sector.

In addition, because the funding formula for EP/EO set forth in section 7802(b)(2) would, if utilized, result in an unstable level of funding that may bear little or no relation to the amount of financial resources actually required by the EP/EO division, the bill repeals the funding mechanism. Thus, the appropriate level of funding for EP/EO is, consistent with current practice, subject to annual Congressional appropriations, as are other functions within the IRS. In this regard, however, the Committee believes that, given the magnitude of the sectors EP/EO is charged with regulating, as well as the unique nature of its mandate, an adequately funded EP/EO is extremely important to the efficient and fair administration of the Federal tax system. Accordingly, financial resources for EP/EO should not be constrained on the basis that EP/EO is a "non-core" IRS function; rather, EP/EO, like all functions of the IRS, should be funded so as to promote the efficient and fair administration of the Federal tax system.

For example, it is important to allocate sufficient funds for EP/EO staffing adequately to monitor and assist businesses in estab-

[14] S. Rept. 93–383, 108 (1973). See also H. Rept. 93–807, 104 (1974).
[15] Code section 7802(b)(2).

lishing and maintaining retirement plans. Recently, in Revenue Procedure 98–22, the IRS announced the expansion of the self-correction programs it offers employers to encourage companies to identify and correct errors without incurring significant penalties. These changes are welcomed, and it is not intended that the elimination of the statutory requirement contained in section 7802(b)(1) or the self-funding mechanism described in section 7802(b)(2) impede the implementation of these and EP/EO's other programs and activities. Rather, it is intended that there be adequate funding for EP/EO, including these self-correction programs that will encourage the establishment and continuation of retirement plans to increase coverage of American workers while protecting the rights of employees to benefits under these plans and maintaining the integrity and purposes of the exemption provisions.

Effective Date

The provision is effective on the date of enactment.

D. TAXPAYER ADVOCATE (SECS. 1102 (A), (C), AND (D) OF THE BILL AND SEC. 7803(C) OF THE CODE)

Present Law

Taxpayer Advocate

In 1996, the Taxpayer Bill of Rights 2 ("TBOR 2") established the position of Taxpayer Advocate, which replaced the position of Taxpayer Ombudsman, created in 1979 by the IRS. The Taxpayer Advocate is appointed by and reports directly to the IRS Commissioner.

TBOR 2 also created the Office of the Taxpayer Advocate. The functions of the office are (1) to assist taxpayers in resolving problems with the IRS, (2) to identify areas in which taxpayers have problems in dealings with the IRS, (3) to propose changes (to the extent possible) in the administrative practices of the IRS that will mitigate those problems, and (4) to identify potential legislative changes that may mitigate those problems.

Taxpayer assistance orders

Taxpayers can request that the Taxpayer Advocate issue a taxpayer assistance order ("TAO") if the taxpayer is suffering or about to suffer a significant hardship as a result of the manner in which the internal revenue laws are being administered. A TAO may require the IRS to release property of the taxpayer that has been levied upon, or to cease any action, take any action as permitted by law, or refrain from taking any action with respect to the taxpayer.

Under present law, the direct point of contact for taxpayers seeking taxpayer assistance orders is a problem resolution officer appointed by a District Director or a Regional Director of Appeals. The Taxpayer Advocate has designated the authority to issue taxpayer assistance orders to the local and regional problem resolution officers.

Reports of the Taxpayer Advocate

The Taxpayer Advocate is required to report annually to the House Committee on Ways and Means and the Senate Finance Committee on the objectives of the Taxpayer Advocate for the upcoming fiscal year. This report is required to be provided no later than June 30 of each calendar year and is to contain full and substantive analysis, in addition to statistical information.

The Taxpayer Advocate is also required to report annually to the House Committee on Ways and Means and the Senate Finance Committee on the activities of the Taxpayer Advocate during the most recently ended fiscal year. This report is required to be provided no later than December 31 of each calendar year, and is to contain full and substantive analysis, in addition to statistical information. This report is also required to: (1) identify the initiatives the Taxpayer Advocate has taken on improving taxpayer services and IRS responsiveness; (2) contain recommendations received from individuals with the authority to issue TAOs; (3) contain a summary of at least 20 of the most serious problems encountered by taxpayers, including a description of the nature of such problems; (4) contain an inventory of the items described in (1), (2), and (3) for which action has been taken and the result of such action; (5) contain an inventory of the items described in (1), (2), and (3) for which action remains to be completed and the period during which each item has remained on such inventory; (6) contain an inventory of the items described in (1), (2) and (3) for which no action has been taken, the period during which the item has remained on the inventory, the reasons for the inaction, and identify any IRS official who is responsible for the inaction; (7) identify any TAO that was not honored by the IRS in a timely manner; (8) contain recommendations for such administrative and legislative action as may be appropriate to resolve problems encountered by taxpayers; (9) describe the extent to which regional problem resolution officers participate in the selection and evaluation of local problem resolution officers, and (10) include such other information as the Taxpayer Advocate deems advisable.

The reports of the Taxpayer Advocate are to be submitted directly to the Congressional Committees without prior review or comment from the Commissioner, Secretary, any other officer or employee of the Treasury, or the Office of Management and Budget.

Reasons for Change

The Committee believes that the Taxpayer Advocate serves an important role within the IRS in terms of preserving taxpayer rights and solving problems that taxpayers encounter in their dealings with the IRS. To that end, it is appropriate that the IRS Oversight Board have input in the selection of the Taxpayer Advocate. Due to the enhanced powers of the Taxpayer Advocate in TBOR2 and this bill, the Committee has been advised that the Taxpayer Advocate should be appointed by the Secretary to avoid constitutional problems. In addition, the Committee believes that the Taxpayer Advocate should have experience appropriate to the position and that the Taxpayer Advocate's objectivity would be best preserved by limiting prior and future employment with the IRS. The Committee also believes that the reporting requirements of the Taxpayer Advocate should be targeted not only towards solving problems with the IRS but also towards preventing problems before they arise.

The Committee believes that the Taxpayer Advocate must have broad discretion to provide relief to taxpayers. In determining whether a taxpayer assistance order should be issued, the Taxpayer Advocate should consider certain factors as constituting a "significant hardship" for the taxpayer. In addition to providing relief if the taxpayer is about to suffer a significant hardship, the Taxpayer Assistance Order should be issued in other appropriate situations, such as if there is an immediate threat of adverse action, if there has been a delay of more than 30 days in resolving the taxpayer's account problems, the taxpayer will have to pay significant costs if relief is not granted, or the taxpayer will suffer irreparable injury, or long-term adverse impact, if relief is not granted. The Committee believes that the Taxpayer Advocate should have flexibility to issue a TAO under any appropriate circumstances, not only when one of the listed factors exists.

Explanation of Provision

National Taxpayer Advocate

The bill renames the Taxpayer Advocate the "National Taxpayer Advocate." The bill provides that the IRS Oversight Board is to recommend to the Secretary 3 candidates for National Taxpayer Advocate from among individuals with a background in customer service as well as tax law and with experience representing individual taxpayers. The Secretary is required to choose a National Taxpayer Advocate from among the individuals recommended by the Oversight Board. An individual may be appointed as the National Taxpayer Advocate only if the individual was not an officer or employee of the IRS during the 2–year period ending with such appointment and the individual agrees not to accept employment with the IRS for at least 5 years after ceasing to be the National Taxpayer Advocate.

The bill replaces the present-law problem resolution system with a system of local Taxpayer Advocates who report directly to the National Taxpayer Advocate and who will be employees of the Taxpayer Advocate's Office, independent from the IRS examination, collection, and appeals functions. The National Taxpayer Advocate has the responsibility to evaluate and take personnel actions (including dismissal) with respect to any local Taxpayer Advocate or any employee in the Office of the National Taxpayer Advocate. In conjunction with the Commissioner, the National Taxpayer Advocate is required to develop career paths for local Taxpayer Advocates.

The National Taxpayer Advocate is required to monitor the coverage and geographical allocation of the local Taxpayer Advocates, develop guidance to be distributed to all IRS officers and employees outlining the criteria for referral of taxpayer inquires to local taxpayer advocates, ensure that the local telephone number for the local taxpayer advocate is published and available to taxpayers.

Each local Taxpayer Advocate may consult with the appropriate supervisory personnel of the IRS regarding the daily operation of the office of the Taxpayer Advocate. At the initial meeting with any taxpayer seeking the assistance of the Office of the Taxpayer Advocate, the local taxpayer advocate is required to notify the taxpayer that the Office operated independently of any other IRS office and reports directly to Congress through the National Taxpayer Advocate. At the discretion of the local taxpayer advocate, the advocate shall not disclose to the IRS any contact with or information provided by the taxpayer. Each local office of the Taxpayer Advocate is to maintain a separate phone, facsimile, and other electronic communication access, and a separate post office address.

The IRS would be required to publish the taxpayer's right to contact the local Taxpayer Advocate on the statutory notice of deficiency.

Taxpayer assistance orders

The provision expands the circumstances under which a TAO may be issued. The bill provides that a "significant hardship" is deemed to occur if one of the following four factors exists: (1) there is an immediate threat of adverse action; (2) there has been a delay of more than 30 days in resolving the taxpayer's account problems; (3) the taxpayer will have to pay significant costs (including fees for professional services) if relief is not granted; or (4) the taxpayer will suffer irreparable injury, or a long-term adverse impact, if relief is not granted. These factors are not an exclusive list of what constitutes a significant hardship; a TAO may also be issued in other circumstances in which it is determined that the taxpayer is or will suffer a significant hardship. The Taxpayer Advocate is also authorized to issue a TAO in any circumstances that the Taxpayer Advocate considers appropriate for the issuance of a TAO.

In determining whether to issue a TAO in cases in which the IRS failed to follow applicable published guidance (including procedures set forth in the Internal Revenue Manual), the Taxpayer Advocate is to construe the matter in a manner most favorable to the taxpayer.

Reports of the National Taxpayer Advocate

The provision requires the annual report regarding the activities of the National Taxpayer Advocate for the most recently ended fiscal year to (in addition to the information required under present law): (1) identify areas of the tax law that impose significant compliance burdens on taxpayers or the IRS, including specific recommendations for remedying such problems; and (2) identify the 10 most litigated issues for each category of taxpayers, including recommendations for mitigating such disputes.

Effective Date

The provision is generally effective on the date of enactment. During the period before the appointment of the IRS Oversight Board, the National Taxpayer Advocate shall be appointed by the Secretary (taking into consideration individuals nominated by the Commissioner) from among individuals who have a background in customer service as well as tax law and experience in representing individual taxpayers. The provision providing that the Taxpayer Advocate reports directly to the Commissioner, the provision providing that the Taxpayer Advocate is appointed by the Secretary, and the restrictions on previous and subsequent employment of the Taxpayer Advocate do not apply to the individual serving as the Taxpayer Advocate on the date of enactment.

E. TREASURY OFFICE OF INSPECTOR GENERAL; IRS OFFICE OF THE CHIEF INSPECTOR (SECS. 1102 AND 1103 OF THE BILL, SEC. 7803(D) OF THE CODE, AND SECS. 2, 8D, AND 9 OF THE INSPECTOR GENERAL ACT OF 1978)

Present Law

Treasury Inspector General

The Treasury Office of Inspector General ("Treasury IG") was established in 1988 and charged with conducting independent audits, investigations and review to help the Department of Treasury accomplish its mission, improve its programs and operations, promote economy, efficiency and effectiveness, and prevent and detect fraud and abuse. The Treasury IG derives its statutory authority under the Inspector General Act of 1978, as amended ("IG Act of 1978").

Appointment and qualifications

The IG Act of 1978 provides that the Treasury IG is selected by the President, with the advice and consent of the Senate, without regard to political affiliation and solely on the basis of integrity and demonstrated ability in accounting, auditing, financial analysis, law, management analysis, public administration, or investigations. The Treasury IG can be removed from office by the President. The President must communicate the reasons for such removal to both Houses of Congress.

Duties and responsibilities

The Treasury IG generally is authorized to conduct, supervise and coordinate internal audits and investigations relating to the programs and operations of the Treasury, including all of its bureaus and offices.[16] Special rules apply, however, with respect to the Treasury IG's jurisdiction over ATF, Customs, the Secret Service and the IRS—the four so-called "law enforcement bureaus." Upon its establishment, the Treasury IG assumed the internal audit functions previously performed by the offices of internal affairs of ATF, Customs and the Secret Service. Although the Treasury IG was granted oversight responsibility for the internal investigations performed by the Office of Internal Affairs of ATF, the Office of Internal Affairs of Customs, and the Office of Inspections of the Secret Service, the internal investigation or inspection functions of these offices remained with the respective bureaus. The Treasury IG did not assume responsibility for either the internal

[16] The Treasury Department organization includes the Departmental offices as well as the Bureau of Alcohol, Tobacco and Firearms ("ATF"), the Office of the Comptroller of the Currency ("OCC"), the U.S. Customs Service ("Customs"), the Bureau of Engraving and Printing, the Federal Law Enforcement Training Center, the Financial Management Service, the U.S. Mint, the Bureau of the Public Debt, the U.S. Secret Service ("Secret Service"), the Office of Thrift Supervision, and the IRS.

audit or inspection functions of the IRS Office of the Chief Inspector. However, it was directed to oversee the internal audits and internal investigations performed by the IRS Office of the Chief Inspector.

The Commissioner and the Treasury IG have entered into two Memorandums of Understanding ("MOUs")[17] to clarify the respective roles of the IRS Office of the Chief Inspector and the Treasury IG in two primary areas: (1) the investigation of allegations of wrongdoing by IRS executives and employees in situations where the independence of the Office of the Chief Inspector could be questioned, and (2) oversight by the Treasury IG of the IRS Office of the Chief Inspector.[18] Pursuant to the 1990 MOU, the Commissioner agreed to transfer 21 FTEs and $1.9 million from the IRS appropriation to the Treasury IG appropriation to be used for the following purposes: (1) oversight of the operations of the Office of the Chief Inspector; (2) conduct of special reviews of IRS operations; (3) investigation of allegations of misconduct concerning the Commissioner, the Senior Deputy Commissioner, and employees of the IRS Office of the Chief Inspector; and (4) investigation of allegations of misconduct where the independence of the IRS Office of the Chief Inspector might be questioned. With respect to item (4), the Commissioner and Treasury IG agreed that all allegations of misconduct involving IRS executives and managers (Grade 15 and above), as well as any other allegation involving "significant or notorious" matters were to be referred to the Treasury IG, and that investigations arising out of such referrals generally would be conducted by the Treasury IG.

In general, under the IG Act of 1978, Inspectors General are instructed to report expeditiously to the Attorney General whenever the Inspector General has reasonable grounds to believe there has been a violation of Federal criminal law. However, in matters involving criminal violations of the Internal Revenue Code, the Treasury IG may report to the Attorney General only those offenses under section 7214 of the Code (unlawful acts of revenue officers or agents, including extortion, bribery and fraud) without the consent of the Commissioner.

Authority

The Treasury IG reports to and is under the general supervision of the Secretary of the Treasury, acting through the Deputy Secretary. In general, the Secretary cannot prevent or prohibit the Treasury IG from initiating, carrying out, or completing any audit or investigation or from issuing any subpoena during the course of any audit or investigation.

However, section 8D of the IG Act of 1978 grants the Secretary authority to prohibit audits or investigations by the Treasury IG under certain circumstances. In particular, the Treasury IG is under the authority, direction, and control of the Secretary with re-

[17] The first MOU was entered into in 1990 and the second in 1994.

[18] Treasury Directive 40–01 (September 21, 1992) reiterates that the Treasury IG is responsible for investigating alleged misconduct on the part of IRS employees at the grade 15 level and above, all employees of the Office of the Chief Inspector. In addition, Treasury Directive 40–01 states that the Treasury IG is responsible for investigating alleged misconduct on the part of Office of Chief Counsel employees (excluding employees of the National Director, Office of Appeals).

spect to audits or investigations, or the issuance of subpoenas, which require access to sensitive information concerning: (1) ongoing criminal investigations or proceedings; (2) undercover operations; (3) the identity of confidential sources, including protected witnesses; (4) deliberations and decisions on policy matters, including documented information used as a basis for making policy decisions, the disclosure of which could reasonably be expected to have a significant influence on the economy or market behavior; (5) intelligence or counterintelligence matters; (6) other matters the disclosure of which would constitute a serious threat to national security or to the protection of certain persons. With respect to audits, investigations or subpoenas that require access to the above-listed information, the Secretary may prohibit the Treasury IG from carrying out such audit, investigation or subpoena if the Secretary determines that such prohibition is necessary to prevent the disclosure of such information or to prevent significant impairment to the national interests of the United States. The Secretary must provide written notice of such a prohibition to the Treasury IG, who must, in turn, transmit a copy of such notice to the Committees on Government Reform and Oversight and Ways and Means of the House and the Committees on Governmental Affairs and Finance of the Senate.

Access to taxpayer returns and return information

The Treasury IG has access to taxpayer returns and return information under section 6103(h)(1) of the Code. However, such access is subject to certain special requirements, including the requirement that the Treasury IG notify the IRS Office of the Chief Inspector (or the Deputy Commissioner in certain circumstances) of its intent to access returns and return information.

Reporting requirements

Under the IG Act of 1978, the Treasury IG reports to the Congress semiannually on its activities. Reports from the Treasury IG are transmitted to the Committees on Government Reform and Oversight and Ways and Means of the House and the Committees on Governmental Affairs and Finance of the Senate.

Resources

For fiscal year 1997, the Treasury IG had 296 FTEs and total funding of $29.7 million. 174 FTEs were assigned to the Treasury IG's audit function and 61 were assigned to the investigative function. The remaining FTEs were divided among the following functions: evaluations, legal, program, technology and administrative support. Of the total Treasury IG FTEs, approximately 23 were used for IRS oversight activities in fiscal year 1997.

IRS Office of Chief Inspector

The IRS Office of the Chief Inspector (also known as the "Inspection Service") was established on October 1, 1951, in response to publicity revealing widespread corruption in the IRS. At the time of its creation, President Harry S. Truman stated, "A strong, vigorous inspection service will be established and will be made completely independent of the rest of the Internal Revenue Service."

Appointment of the Chief Inspector

In 1952, the Office of the Assistant Commissioner (Inspection) was established. The office was redesignated as the Office of the Chief Inspector on March 25, 1990. The Chief Inspector is appointed by the Commissioner. In this regard, pursuant to Treasury Director 40–01, the Commissioner must consult with the Treasury IG before selecting candidates for the position of Chief Inspector (and all other senior executive service ("SES") positions in the Office of the Chief Inspector). The Commissioner must also consult with the Treasury IG regarding annual performance appraisals for the Chief Inspector and other SES officials.

The Office of the Chief Inspector consists of a National Office and the offices of the Regional Inspectors. The offices of the Regional Inspectors are located in the same cities and have the same geographic boundaries as the offices of the four IRS Regional Commissioners. The Regional Inspectors report directly to the Chief Inspector.

Duties and responsibilities

The Office of the Chief Inspector generally is responsible for carrying out internal audits and investigations that: (1) promote the economic, efficient, and effective administration of the nation's tax laws; (2) detect and deter fraud and abuse in IRS programs and operations; and (3) protect the IRS against external attempts to corrupt or threaten its employees. The Chief Inspector reports directly to the Commissioner and Deputy Commissioner of the IRS.

The IRS Inspection Service is divided into three functions: Internal Security, Internal Audit, and Integrity Investigations and Activities. Internal Security's responsibilities include criminal investigations (employee conduct, bribery, assault and threat and investigations of non-IRS employees for acts such as impersonation, theft, enrolled agent misconduct, disclosure, and anti-domestic terrorism) investigative support activities (including forensic lab, computer investigative support, and maintenance of law enforcement equipment), protection, and background investigations.

Internal Audit is responsible for providing IRS management with independent reviews and appraisals of all IRS activities and operations. In addition, Internal Audit makes recommendations to improve the efficiency and effectiveness of programs and to assist IRS officials in carrying out their program and operational responsibilities. In this regard, Internal Audit generally conducts performance reviews (program audits, system development audits, internal control audits) and financial reviews (financial statement audits and financial related reviews).

Integrity Investigations and Activities are joint internal audit and internal security operations undertaken as a proactive effort to detect and deter fraud and abuse within the IRS. Integrity Investigations and Activities also includes the UNAX Central Case Development Center. The Center was developed in October, 1997, in response to the Taxpayer Browsing Protection Act of 1997. Its purpose is to detect unauthorized accesses to IRS computer systems by IRS employees and to refer such instances to Internal Security investigators for further investigation.

Authority

The Chief Inspector derives specific and general authority from delegation by the Commissioner and Deputy Commissioner. In addition, under section 7608(b) of the Code, the Chief Inspector is authorized to perform certain functions in connection with the duty of enforcing any of the criminal provisions of the Code, including executing and serving search and arrest warrants, serving subpoenas and summonses, making arrests without warrant, carrying firearms, and seizing property subject to forfeiture under the Code.

Access to taxpayer returns and return information

The Office of the Chief Inspector has full access to taxpayer returns and return information.

Reporting requirements

The Office of the Chief Inspector reports facts developed through its internal audit and internal security activities to IRS management officials, who are charged with the responsibility of reviewing IRS activities. The results of the Chief Inspector's internal audit and internal security activities also are reported to the Treasury IG and are included in the Treasury IG's semiannual reports to Congress.

Internal audit reports prepared by the Office of the Chief Inspector are provided monthly to the Government Accounting Office, as well as to the House and Senate Appropriations Committees. In addition, a monthly list of Internal Audit reports is provided to Treasury and the Office of Management and Budget. Reports of Investigation regarding criminal conduct are referred to the Department of Justice for prosecution.

Resources

The IRS Office of the Chief Inspector had 1,202 FTEs for 1997 and total funding of $100.1 million. Of these FTEs, approximately 442 performed Internal Audit functions, 511 performed Internal Security functions, and 94 performed Integrity Investigations and Activities. Of the remaining FTEs, approximately 95 were dedicated to information technology functions and 60 staffed the offices of the Chief Inspector and the Regional Inspectors.

Reasons for Change

The Committee believes that the current IRS Office of the Chief Inspector lacks sufficient structural and actual autonomy from the agency it is charged with monitoring and overseeing. Further, the current relationship between the Treasury IG and the IRS Office of the Chief Inspector does not foster appropriate oversight over the IRS. The Committee believes that the establishment of an independent Inspector General within the Department of Treasury whose primary focus and responsibility will be to audit, investigate, and evaluate IRS programs will improve the quality as well as the credibility of IRS oversight.

Explanation of Provision

In general

The bill establishes a new, independent, Treasury Inspector General for Tax Administration ("Treasury IG for Tax Administration") within the Department of Treasury. The IRS Office of the Chief Inspector is eliminated, and all of its powers and responsibilities are transferred to the Treasury IG for Tax Administration. The Treasury IG for Tax Administration has the powers and responsibilities generally granted to Inspectors General under the IG Act of 1978, without the limitations that currently apply to the Treasury IG under section D of the Act. The role of the existing Treasury IG is redefined to exclude responsibility for the IRS. The Treasury IG for Tax Administration is under the supervision of the Secretary of Treasury, with certain additional reporting to the Board and the Congress.

Appointment and qualifications of Treasury IG for Tax Administration

The Treasury IG for Tax Administration is selected by the President, with the advice and consent of the Senate. The Treasury IG for Tax Administration can be removed from office by the President. The President must communicate the reasons for such removal to both Houses of Congress.

The Treasury IG for Tax Administration must be selected without regard to political affiliation and solely on the basis of integrity and demonstrated ability in accounting, auditing, financial analysis, law, management analysis, public administration, or investigations. In addition, however, the Treasury IG for Tax Administration should have experience in tax administration and demonstrated ability to lead a large and complex organization. The Treasury IG for Tax Administration may not be employed by the IRS within the two years preceding and the five years following his or her appointment.

The Treasury IG for Tax Administration is required to appoint an Assistant Inspector General for Auditing and an Assistant Inspector for Inspections. Under the bill, such appointees, as well as any Deputy Inspector General(s) appointed by the Treasury IG for Tax Administration, may not be employed by the IRS within the two years preceding and the five years following their appointments.

Duties and responsibilities of Treasury IG for Tax Administration

The Treasury IG for Tax Administration has the present-law duties and responsibilities currently delegated to the Treasury IG with respect to the IRS. In addition, the Treasury IG for Tax Administration assumes all of the duties and responsibilities currently delegated to the IRS Office of the Chief Inspector. The Treasury IG for Tax Administration has jurisdiction over IRS matters, as well as matters involving the Board.

Accordingly, the Treasury IG for Tax Administration is charged with conducting audits, investigations, and evaluations of IRS programs and operations (including the Board) to promote the economic, efficient and effective administration of the nation's tax laws and to detect and deter fraud and abuse in IRS programs and operations. In this regard, the Treasury IG for Tax Administration specifically is directed to evaluate the adequacy and security of IRS technology on an ongoing basis. In addition, the Treasury IG for Tax Administration is responsible for protecting the IRS against external attempts to corrupt or threaten its employees. The Treasury IG for Tax Administration is charged with investigating allegations of criminal misconduct (e.g., Code sections 7212 , 7213, 7214, 7216 and new section 7217), as well as administrative misconduct (e.g., violations of the Taxpayer Bill of Rights and the Taxpayer Bill of Rights 2, the Office of Government Ethics Standards of Ethical Conduct and the IRS Supplemental Standards of Ethical Conduct).

In addition, the bill directs the Treasury IG for Tax Administration to implement a program periodically to audit at least one percent of all determinations (identified through a random selection process) where the IRS has asserted either section 6103 (directly or in connection with the Freedom of Information Act or the Privacy Act) or law enforcement considerations (i.e., executive privilege) as a rationale for refusing to disclose requested information. The program must be implemented within 6 months after establishment of the Treasury IG for Tax Administration. The Treasury IG for Tax Administration is directed to report any findings of improper assertion of section 6103 or law enforcement considerations to the Board.

Further, the Treasury IG for Tax Administration is directed to establish a toll-free confidential telephone number for taxpayers to register complaints of misconduct by IRS employees and to publish the telephone number in IRS Publication 1.

There are no restrictions on the Treasury IG for Tax Administration's ability to refer matters to the Department of Justice. Thus, the Treasury IG for Tax Administration is required to report to the Attorney General whenever the Treasury IG for Tax Administration has reasonable grounds to believe that there has been a violation of Federal criminal law.

Authority of Treasury IG for Tax Administration

The Treasury IG for Tax Administration reports to and is under the general supervision of the Secretary of Treasury. Under the bill, the Secretary cannot prevent or prohibit the Treasury IG for Tax Administration from initiating, carrying out, or completing any audit or investigation or from issuing any subpoena during the course of any audit or investigation.

Under the bill, the Treasury IG for Tax Administration must provide to the Board all reports regarding IRS matters on a timely basis and conduct audits or investigations requested by the Board. The Treasury IG for Tax Administration also must, in a timely manner, conduct such audits or investigations and provide such reports as may be requested by the Commissioner.

In carrying out the duties and responsibilities described above, the Treasury IG for Tax Administration has the present-law authority generally granted to Inspectors General under the IG Act of 1978. The limitations on the authority of the Treasury IG under such Act do not apply to the Treasury IG for Tax Administration.

In addition, the Treasury IG for Tax Administration has the authority granted to the IRS Office of the Chief Inspector under present-law Code section 7608, including the right to execute and serve search and arrest warrants, to serve subpoenas and summonses, to make arrests without warrant, to carry firearms, and to seize property subject to forfeiture under the Code.

Resources

To ensure that the Treasury IG for Tax Administration has sufficient resources to carry out his or her duties and responsibilities under the bill, all but 300 FTEs from the IRS Office of the Chief Inspector are transferred to the Treasury IG for Tax Administration. Such FTEs include all of the FTEs performing investigative functions in the Office of the Chief Inspector Internal Security and Integrity Investigations and Activities. In addition, the 21 FTEs previously transferred from Inspection to Treasury IG pursuant to the 1990 MOU to perform oversight of the IRS are transferred to the Treasury IG for Tax Administration.

The Commissioner will retain approximately 300 FTEs from the IRS Office of the Chief Inspector to staff an audit function (including support staff) for internal IRS management purposes. Like other IRS functions, however, this audit function is subject to oversight and review by the Treasury IG for Tax Administration.

Access to taxpayer returns and return information

Taxpayer returns and return information are available for inspection by the Treasury IG for Tax Administration pursuant to section 6103(h)(1). Thus, the Treasury IG for Tax Administration has the same access to taxpayer returns and return information as does the Chief Inspector under present law.

Reporting requirements

The Treasury IG for Tax Administration is subject to the semiannual reporting requirements set forth in section 5 of the IG Act of 1978. As under present law, reports are made to the Committees on Government Reform and Oversight and Ways and Means of the House and the Committees on Governmental Affairs and Finance of the Senate. The reports must contain the information that is required to be reported by the Treasury IG with respect to the IRS under present law, as well as information regarding the source, nature and status of taxpayer complaints and allegations of serious misconduct by IRS employees received by the IRS or by the Treasury IG for Tax Administration. In addition, the Treasury IG for Tax Administration is required to report annually on certain additional information (e.g., regarding the use of enforcement statistics in evaluating IRS employees, the implementation of various taxpayer rights protections, and IRS employee terminations and mitigations) required by the bill.

Treasury IG

The Treasury IG generally continues to have its present-law responsibilities and authority with respect to all Treasury functions other than the IRS and the Board. However, the Treasury IG generally does not have access to taxpayer returns and return information under section 6103 (unless the Secretary specifically authorizes such access).

The Treasury IG for Tax Administration operates independently of the Treasury IG. The Secretary of Treasury is directed to establish procedures pursuant to which the Treasury IG for Tax Administration and the Treasury IG shall coordinate audits and investigations in cases involving overlapping jurisdiction.

The Treasury IG continues to have responsibility for providing an opinion on the Department of Treasury's consolidated financial statement as required under the Chief Financial Officer Act. The Treasury IG for Tax Administration is responsible for rendering an opinion on the IRS custodial and administrative accounts (to the extent the Government Accounting Office does not exercise its option to preempt under the CFO Act).

Effective Date

The provision is effective 180 days after the date of enactment.

F. PROHIBITION ON EXECUTIVE BRANCH INFLUENCE OVER TAXPAYER AUDITS (SEC. 1105 OF THE BILL AND NEW SEC. 7217 OF THE CODE)

Present Law

There is no explicit prohibition in the Code on high-level Executive Branch influence over taxpayer audits and collection activity.

The Internal Revenue Code prohibits disclosure of tax returns and return information, except to the extent specifically authorized by the Internal Revenue Code (sec. 6103). Unauthorized disclosure is a felony punishable by a fine not exceeding $5,000 or imprisonment of not more than five years, or both (sec. 7213). An action for civil damages also may be brought for unauthorized disclosure (sec. 7431).

Reasons for Change

The Committee believes that the perception that it is possible that high-level Executive Branch influence over taxpayer audits and collection activity could occur has a negative influence on taxpayers' views of the tax system. Accordingly, the Committee believes that it is appropriate to prohibit such influence.

Explanation of Provision

The bill makes it unlawful for a specified person to request that any officer or employee of the IRS conduct or terminate an audit or otherwise investigate or terminate the investigation of any particular taxpayer with respect to the tax liability of that taxpayer. The prohibition applies to the President, the Vice President, and employees of the executive offices of either the President or Vice President, as well as any individual (except the Attorney General) serving in a position specified in section 5312 of Title 5 of the United States Code (these are generally Cabinet-level positions). The prohibition applies to both direct requests and requests made through an intermediary. In the case of a law enforcement action authorized by the Attorney General, discussions involving specified persons with respect to that law enforcement action shall not be considered to be requests made through an intermediary.

Any request made in violation of this rule must be reported by the IRS employee to whom the request was made to the Chief Inspector of the IRS. The Chief Inspector has the authority to investigate such violations and to refer any violations to the Department of Justice for possible prosecution, as appropriate. Anyone convicted of violating this provision will be punished by imprisonment of not more than 5 years or a fine not exceeding $5,000 (or both).

Three exceptions to the general prohibition apply. First, the prohibition does not apply to a request made to a specified person by or on behalf of a taxpayer that is forwarded by the specified person to the IRS. This exception is intended to cover two types of situations. The first situation is where a taxpayer (or a taxpayer's representative) writes to a specified person seeking assistance in resolving a difficulty with the IRS. This exception permits the specified person who receives such a request to forward it to the IRS for resolution without violating the general prohibition. The second situation that this first exception is intended to cover is an audit or investigation by the IRS of a Presidential nominee. Under present law (sec. 6103(c)), nominees for Presidentially appointed positions consent to disclosure of their tax returns and return information so that background checks may be conducted. Sometimes an audit or other investigation is initiated as part of that background check. The Committee anticipates that any such audit or investigation that is part of such a background check will be encompassed within this first exception.

The second exception to the general prohibition applies to requests for disclosure of returns or return information under section 6103 if the request is made in accordance with the requirements of section 6103.

The third exception to the general prohibition applies to requests made by the Secretary of the Treasury as a consequence of the implementation of a change in tax policy.

Effective Date

The provision applies to violations occurring after the date of enactment.

G. IRS PERSONNEL FLEXIBILITIES (SECS. 1201–1205 OF THE BILL AND NEW CHAPTER 95 OF TITLE 5, U.S.C.)

Present Law

The IRS is subject to the personnel rules and procedures set forth in title 5, United States Code. Under these rules, IRS employees generally are classified under the General Schedule or the Senior Executive Service.

Reasons for Change

The Committee believes that as part of restructuring the IRS, the Commissioner should have the ability to bring in experts and the flexibility to revitalize the current IRS workforce. The current hiring practices often inhibit the ability of the Commissioner to change the IRS' institutional culture. Commissioner Rossotti has indicated that in order to maximize efforts to transform the IRS into an efficient, modern and responsive agency, the ability to recruit and retain a top-notch leadership and technical team is critical.

The Committee believes the IRS needs the flexibility to recruit employees from the private sector, to redesign its salary and incentive structures to reward employees who meet their objectives, and to hold non-performers accountable. Personnel and pay flexibilities are necessary prerequisites for larger fundamental changes in the IRS.

The Committee wants to support the Commissioner's initiatives to reposition the current IRS workforce as part of implementing a new organization designed around the needs of taxpayers.

Explanation of Provision

In general

The bill amends title 5 of the United States Code to provide certain personnel flexibilities to the IRS. In general, the bill provides that the IRS exercise the personnel flexibilities consistently with existing rules relating to merit system principles, prohibited personnel practices, and preference eligibles. In those cases where the exercise of personnel flexibilities would affect members of the employees' union, such employees' will not be subject to the exercise of any flexibility unless there is a written agreement between the IRS and the employees' union. Negotiation impasses between the IRS and the employees' union may be appealed to the Federal Services Impasse Panel.

Senior management and technical positions

Streamlined critical pay authority

The bill provides a streamlined process for the Secretary of the Treasury, or his delegate, to fix the compensation of, and appoint up to 40 individuals to, designated critical technical and professional positions, provided that: (1) the positions require expertise of an extremely high level in a technical, administrative or professional field and are critical to the IRS; (2) exercise of the authority is necessary to recruit or retain an individual exceptionally well qualified for the position; (3) designation of such positions is approved by the Secretary; (4) the terms of such appointments are limited to no more than four years; (5) appointees to such positions are not IRS employees immediately prior to such appointment; and (6) the total annual compensation for any position (including performance bonuses) does not exceed the rate of pay of the Vice President (currently $175,400).

These appointments are not subject to the otherwise applicable requirements under title 5. All such appointments will be excluded from the collective bargaining unit and the appointments will not be subject to approval of the Office of Management and Budget ("OMB") or the Office of Personnel Management ("OPM").

The streamlined authority will be limited to a period of 10 years.

Critical pay authority

The bill provides OMB with authority to set the pay for certain critical pay positions requested by the Secretary under section 5377 of title 5 of the United States Code at levels higher than authorized under current law. These critical pay positions would be critical, technical, administrative and professional positions other than those designated under the streamlined authority. Under the bill, OMB is authorized to approve requests for critical position pay up to the rate of pay of the Vice President (currently $175,400).

Recruitment, retention and relocation incentives

The bill authorizes the Secretary to vary from the existing provisions governing recruitment, retention and relocation incentives. The authority will be for a period of 10 years and will be subject to OPM approval.

Career-reserve Senior Executive Service ("SES") positions

The bill broadens the definition of a "career reserved position" in the SES to include a limited emergency appointee or a limited term appointee who, immediately upon entering the career-reserved position, was serving under a career or a career-conditional appointment outside the SES or whose limited emergency or limited term appointment is approved in advance by OPM. The number of appointments to these SES positions will be limited to up to 10 percent of the total number of SES positions available to the IRS. These positions will be limited to a 3-year term, with the option of extending the term for 2 more 3-year terms.

Variable compensation

The bill provides the Secretary with the authority to provide performance bonus awards to IRS senior executives of up to one-third of the individual's annual compensation. The bonus award would be based on meeting preset performance goals established by the IRS. An individual's total annual compensation, including the bonus, cannot exceed the rate of pay of the Vice President. The authority will not be subject to OPM approval.

It is anticipated that the bonuses will not be available to more than 25 IRS senior executives annually.

General workforce

Performance management system

The bill permits the Secretary to establish a new performance management system which will maintain individual accountability by: (1) establishing one or more retention standards for each employee related to the work of the employee and expressed in terms of performance; (2) providing for periodic performance evaluations to determine whether employees are meeting the applicable retention standard; and (3) taking appropriate action, in accordance with applicable laws, with respect to any employee whose performance does not meet established retention standards.

The bill requires that the performance management system provide for: (1) establishing goals or objectives for individual, group or organizational performance and taxpayer service surveys; (2) communicating such goals or objectives to employees; and (3) using such goals or objectives to make performance distinctions among employees or groups of employees.

It is intended that in no event will performance measures be used which rank employees or groups of employees based on enforcement results, establish dollar goals for assessments or collections, or otherwise undermine fair treatment of taxpayers.

Awards

The bill provides the Secretary the authority to establish an awards program for IRS employees. The program will be designed to provide incentives for and recognition of individual, group and organizational achievements. The Secretary will have the authority to provide awards between $10,000 and $25,000 without OPM approval.

These awards will be based on performance under the new performance management system, and in no case will awards be made (or performance measured) based on tax enforcement results.

Workforce classification and pay banding

The bill provides the Secretary with authority to establish one or more broad band pay systems covering all or any portion of the IRS workforce, subject to OPM criteria. At a minimum, the OPM criteria will have to: (1) ensure that the pay band system maintain the concept of equal pay for substantially equal work; (2) establish the minimum and maximum number of grades that may be combined into pay bands; (3) establish requirements for setting minimum and maximum rates of pay in a pay band; (4) establish requirements for adjusting the pay of an employee within a pay band; (5) establish requirements for setting the pay of a supervisory employee in a pay band; and (6) establish requirements and methodologies for setting the pay of an employee upon conversion to a broad-banded system, initial appointment, change of position or type of appointment and movement between a broad-banded system and another pay system.

Workforce staffing

The bill provides the IRS with flexibility in filling certain permanent appointments with qualified temporary employees. A qualified temporary employee is defined as a temporary employee of the IRS with at least two years of continuous service, who has met all applicable retention standards and who meets the minimum qualifications for the vacant position.

The bill authorizes the IRS to establish category rating systems for evaluating job applicants, under which qualified candidates are divided into two or more quality categories on the basis of relative degrees of merit, rather than assigned individual numerical ratings. Managers will be authorized to select any candidate from the highest quality category, and will not be limited to the three highest ranked candidates. In administering these category rating systems, the IRS generally will be required to list preference eligibles ahead of other individuals within each quality category. The appointing authority, however, could select any candidate from the highest quality category, as long as existing requirements relating to passing over preference eligibles are satisfied.

The bill authorizes the IRS to establish probation periods for IRS employees of up to 3 years, when it is determined that a shorter period will not be sufficient for an employee to demonstrate proficiency in a position.

Voluntary separation incentives

The bill provides authority to the IRS to use Voluntary Separation Incentive Pay ("buyouts") through December 31, 2002. The use of voluntary separation incentive is not intended to necessarily reduce the total number of Full Time Equivalents ("FTE") positions in the IRS.

Demonstration projects

The bill provides the IRS with authority to conduct one or more demonstration projects through a streamlined process. The authority will enable the IRS to test new approaches to Human Resource Management. The bill provides authority to the Secretary and OPM to waive the termination of a demonstration project, thereby making it permanent. At least 90 days prior to waiving the termination date OPM will be required to publish a notice of such intent in the Federal Register and inform the appropriate Committees (including the House Ways and Means Committee, the House Government Reform and Oversight Committee, the Senate Finance Committee and the Senate Governmental Affairs Committee) of both Houses of Congress in writing.

Performance measures

The IRS is directed to develop employee performance measures that favor taxpayer service and prohibit awarding merit pay or bonuses that are based on enforcement quotas, goals, or statistics.

Violations for which IRS employees may be terminated

The bill requires the IRS to terminate an employee for certain proven violations committed by the employee in connection with the performance of official duties. The violations include: (1) failure to obtain the required approval signatures on documents authorizing the seizure of a taxpayer's home, personal belongings, or business assets; (2) providing a false statement under oath material to a matter involving a taxpayer; (3) falsifying or destroying documents to avoid uncovering mistakes made by the employee with respect to a matter involving a taxpayer; (4) assault or battery on a taxpayer or other IRS employee; (5) violation of the civil rights of a taxpayer or other IRS employee; (6) violations of the Internal Revenue Code, Treasury Regulations, or policies of the IRS (including the Internal Revenue Manual) for the purpose of retaliating or harassing a taxpayer or other IRS employee; and (7) wilful misuse of section 6103 for the purpose of concealing data from a Congressional inquiry.

The bill provides non-delegable authority to the Commissioner to determine that mitigating factors exist, that, in the Commissioner's sole discretion, mitigate against terminating the employee. The bill also provides that the Commissioner, in his sole discretion, may establish a procedure which will be used to determine whether an individual should be referred for such a determination by the Commissioner. The Treasury IG is required to track employee terminations and terminations that would have occurred had the Commissioner not determined that there were mitigation factors and include such information in the IG's annual report.

IRS employee training program

The bill requires the IRS to place a high priority on employee training and to adequately fund employee training programs. The bill also requires the IRS to provide to the Congressional tax writing committees a comprehensive multi-year plan to: (1) ensure adequate customer service training; (2) review the organizational design of customer service; (3) implement a performance development system; and (4) provide, in fiscal year 1999, sixteen to twenty-four hours of conflict management training for collection employees.

Effective Date

The provision, other than the IRS employee training program provision, is effective on the date of enactment. The provision relating to the IRS employee training program is effective 90 days after the date of enactment.

TITLE II. ELECTRONIC FILING

A. ELECTRONIC FILING OF TAX AND INFORMATION RETURNS (SEC. 2001 OF THE BILL)

Present Law

Treasury Regulations section 1.6012–5 provides that the Commissioner may authorize a taxpayer to elect to file a composite return in lieu of a paper return. An electronically filed return is a composite return consisting of electronically transmitted data and certain paper documents that cannot be electronically transmitted.

The IRS periodically publishes a list of the forms and schedules that may be electronically transmitted, as well as a list of forms, schedules, and other information that cannot be electronically filed.

During the 1997 tax filing season, the IRS received approximately 20 million individual income tax returns electronically.

Reasons for Change

The Committee believes that the implementation of a comprehensive strategy to encourage electronic filing of tax and information returns holds significant potential to benefit taxpayers and make the IRS returns processing function more efficient. For example, the error rate associated with processing paper tax returns is approximately 20 percent, half of which is attributable to the IRS and half to error in taxpayer data. Because electronically-filed returns usually are prepared using computer software programs with built-in accuracy checks, undergo pre-screening by the IRS, and experience no key punch errors, electronic returns have an error rate of less than one percent. Thus, the Committee believes that an expansion of electronic filing will significantly reduce errors (and the resulting notices that are triggered by such errors). In addition, taxpayers who file their returns electronically receive confirmation from the IRS that their return was received.

Explanation of Provision

The provision states that the policy of Congress is to promote paperless filing, with a long-range goal of providing for the filing of at least 80 percent of all tax returns in electronic form by the year 2007. The provision requires the Secretary of the Treasury to establish a strategic plan to eliminate barriers, provide incentives, and use competitive market forces to increase taxpayer use of electronic filing. The provision requires all returns prepared in electronic form but filed in paper form to be filed electronically, to the extent feasible, by the year 2002.

The provision requires the Secretary to create an electronic commerce advisory group and to report annually to the tax-writing committees on the IRS's progress in implementing its plan to meet the goal of 80 percent electronic filing by 2007.

Effective Date

The provision is effective on the date of enactment.

B. DUE DATE FOR CERTAIN INFORMATION RETURNS (SEC. 2002 OF THE BILL AND SEC. 6071 OF THE CODE)

Present Law

Information such as the amount of dividends, partnership distributions, and interest paid during the calendar year must be supplied to taxpayers by the payors by January 31 of the following calendar year. The payors must file an information return with the IRS with the information by February 28 of the year following the calendar year for which the return must be filed. Under present law, the due date for filing information returns with the IRS is the same whether such returns are filed on paper, on magnetic media, or electronically. Most information returns are filed on magnetic media (such as computer tapes), which are physically shipped to the IRS.

Reasons for Change

The Committee believes that encouraging information return filers to file electronically will substantially increase the efficiency of the tax system by avoiding the need to convert the information from magnetic media or paper to electronic form before return matching.

Explanation of Provision

The provision provides an incentive to filers of information returns to use electronic filing by extending the due date for filing such returns from February 28 (under present law) to March 31 of the year following the calendar year to which the return relates.

The provision also requires the Treasury to issue a study evaluating the merits and disadvantages, if any, of extending the deadline for providing taxpayers with copies of information returns from January 31 to February 15 (Forms W–2 would still be required to be furnished by January 31).

Effective Date

The extension of the due date for filing returns applies to information returns required to be filed after December 31, 1999. The Treasury study is due by December 31, 1998.

C. PAPERLESS ELECTRONIC FILING (SEC. 2003 OF THE BILL AND SEC. 6061 OF THE CODE)

Present Law

Code section 6061 requires that tax forms be signed as required by the Secretary. The IRS will not accept an electronically filed return unless it has also received a Form 8453, which is a paper form that contains signature information of the filer.

A return generally is considered timely filed when it is received by the IRS on or before the due date of the return. If the requirements of Code section 7502 are met, timely mailing is treated as timely filing. If the return is mailed by registered mail, the dated registration statement is prima facie evidence of delivery. As an electronically filed return is not mailed, section 7502 does not apply.

The IRS periodically publishes a list of the forms and schedules that may be electronically transmitted, as well as a list of forms, schedules, and other information that cannot be electronically filed.

Reasons for Change

Electronically filed returns cannot provide the maximum efficiency for taxpayers and the IRS under current rules that require signature information to be filed on paper. Also, taxpayers need to know how the IRS will determine the filing date of a return filed electronically. The Committee believes that more types of returns could be filed electronically if proper procedures were in place. Also, as the IRS shifts to a paperless tax return system, the Committee intends for the IRS to assist taxpayers in shifting to paperless record retention.

Explanation of Provision

The provision requires the Secretary to develop procedures that would eliminate the need to file a paper form relating to signature information. Until the procedures are in place, the provision authorizes the Secretary to provide for alternative methods of signing all returns, declarations, statements, or other documents. An alternative method of signature would be treated identically, for both civil and criminal purposes, as a signature on a paper form.

The provision also provides rules for determining when electronic returns are deemed filed and to make it possible for taxpayers to authorize, on electronically filed returns, persons (such as return preparers) to whom information may be disclosed pursuant to section 6103.

The provision requires the Secretary to establish procedures, to the extent practicable, to receive all forms electronically for taxable periods beginning after December 31, 1998.

Effective Date

The provision is effective on the date of enactment.

D. RETURN-FREE TAX SYSTEM (SEC. 2004 OF THE BILL)

Present Law

Under present law, taxpayers generally are required to calculate their own tax liabilities and submit returns showing their calculations.

Reasons for Change

The Committee believes that it would benefit taxpayers to be relieved, to the extent feasible, from the burden of determining tax liability and filing returns.

Explanation of Provision

The provision requires the Secretary or his delegate to study the feasibility of, and develop procedures for, the implementation of a return-free tax system for appropriate individuals for taxable years beginning after 2007. The Secretary is required annually to report to the tax-writing committees on the progress of the development of such system. The Secretary is required to make the first report on the development of the return-free tax system to the tax-writing committees by June 30, 2000.

Effective Date

The provision is effective on the date of enactment.

E. ACCESS TO ACCOUNT INFORMATION (SEC. 2005 OF THE BILL)

Present Law

Taxpayers who file their returns electronically cannot review their accounts electronically.

Reasons for Change

The Committee believes that it would be desirable for a taxpayer (or the taxpayer's designee) to be able to review that taxpayer's account electronically, but only if all necessary privacy safeguards are in place.

Explanation of Provision

The provision requires the Secretary to develop procedures not later than December 31, 2006, under which a taxpayer filing returns electronically (or the taxpayer's designee under section 6103(c)) could review the taxpayer's own account electronically, but only if all necessary privacy safeguards are in place by that date. The Secretary is required to issue an interim progress report to the tax-writing committees by December 31, 2003.

Effective Date

The provision is effective on the date of enactment.

TITLE III. TAXPAYER PROTECTION AND RIGHTS

A. BURDEN OF PROOF (SEC. 3001 OF THE BILL AND NEW SEC. 7491 OF THE CODE)

Present Law

Under present law, a rebuttable presumption exists that the Commissioner's determination of tax liability is correct.[19] "This presumption in favor of the Commissioner is a procedural device that requires the plaintiff to go forward with prima facie evidence to support a finding contrary to the Commissioner's determination. Once this procedural burden is satisfied, the taxpayer must still carry the ultimate burden of proof or persuasion on the merits. Thus, the plaintiff not only has the burden of proof of establishing that the Commissioner's determination was incorrect, but also of establishing the merit of its claims by a preponderance of the evidence".[20]

The general rebuttable presumption that the Commissioner's determination of tax liability is correct is a fundamental element of the structure of the Internal Revenue Code. Although this presumption is judicially based, rather than legislatively based, there is considerable evidence that the presumption has been repeatedly considered and approved by the Congress. This is the case because the Internal Revenue Code contains a number of civil provisions that explicitly place the burden of proof on the Commissioner in specifically designated circumstances. The Congress would have enacted these provisions only if it recognized and approved of the general rule of presumptive correctness of the Commissioner's determination. A list of these civil provisions follows.

(1) *Fraud.*—Any proceeding involving the issue of whether the taxpayer has been guilty of fraud with intent to evade tax (secs. 7454(a) and 7422(e)).

(2) *Required reasonable verification of information returns.*—In any court proceeding, if a taxpayer asserts a reasonable dispute with respect to any item of income reported on an information returned filed with the Secretary by a third party and the taxpayer has fully cooperated with the Secretary (including providing, within a reasonable period of time, access to and inspection of all witnesses, information, and documents within the control of the taxpayer as reasonably requested by the Secretary), the Secretary has the burden of producing reasonable and probative information concerning such deficiency in addition to such information return (sec. 6201(d)).

(3) *Foundation managers.*—Any proceeding involving the issue of whether a foundation manager has knowingly participated in prohibited transactions (sec. 7454(b)).

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[19] *Welch* v. *Helvering,* 290 U.S. 111, 115 (1933).

[20] *Danville Plywood Corp.* v. *U.S.,* U.S. Cl. Ct., 63 AFTR 2d 89–1036, 1043 (1989); citations omitted.

(4) *Transferee liability*.—Any proceeding in the Tax Court to show that a petitioner is liable as a transferee of property of a taxpayer (sec. 6902(a)).

(5) *Review of jeopardy levy or assessment procedures*.—Any proceeding to review the reasonableness of a jeopardy levy or jeopardy assessment (sec. 7429(g)(1)).

(6) *Property transferred in connection with performance of services*.—In the case of property subject to a restriction that by its terms will never lapse and that allows the transferee to sell only at a price determined under a formula, the price is deemed to be fair market value unless established to the contrary by the Secretary (sec. 83(d)(1)).

(7) *Illegal bribes, kickbacks, and other payments*.—As to whether a payment constitutes an illegal bribe, illegal kickback, or other illegal payment (sec. 162(c) (1) and (2)).

(8) *Golden parachute payments*.—As to whether a payment is a parachute payment on account of a violation of any generally enforced securities laws or regulations (sec. 280G(b)(2)(B)).

(9) *Unreasonable accumulation of earnings and profits*.—In any Tax Court proceeding as to whether earnings and profits have been permitted to accumulate beyond the reasonable needs of the business, provided that the Commissioner has not fulfilled specified procedural requirements (sec. 534).

(10) *Expatriation*.—As to whether it is reasonable to believe that an individual's loss of citizenship would result in a substantial reduction in the individual's income taxes or transfer taxes (secs. 877(e), 2107(e), 2501(a)(4)).

(11) *Public inspection of written determinations*.—In any proceeding seeking additional disclosure of information (sec. 6110(f)(4)(A)).

(12) *Penalties for promoting abusive tax shelters, aiding and abetting the understatement of tax liability, and filing a frivolous income return*.—As to whether the person is liable for the penalty (sec. 6703(a)).

(13) *Income tax return preparers' penalty*.—As to whether a preparer has willfully attempted to understate tax liability (sec. 7427).

(14) *Status as employees*.—As to whether individuals are employees for purposes of employment taxes (pursuant to the safe harbor provisions of section 530 of the Revenue Act of 1978). [21]

Reasons for Change

The Committee is concerned that individual and small business taxpayers frequently are at a disadvantage when forced to litigate with the Internal Revenue Service. The Committee believes that the present burden of proof rules contribute to that disadvantage. The Committee believes that, all other things being equal, facts asserted by individual and small business taxpayers who cooperate with the IRS and satisfy relevant recordkeeping and substantiation requirements should be accepted. The Committee believes that shifting the burden of proof to the Secretary in such circumstances will create a better balance between the IRS and such taxpayers, without encouraging tax avoidance.

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[21] Public Law 95–600 (November 6, 1978), as amended by section 1122 of the Small Business Job Protection Act of 1996 (Public Law 104–188; August 20, 1996).

The Committee believes that it is inappropriate for the IRS to rely solely on statistical information on unrelated taxpayers to reconstruct unreported income of an individual taxpayer. The Committee also believes that, in a court proceeding, the IRS should not be able to rest on its presumption of correctness if it does not provide any evidence whatsoever relating to penalties.

Explanation of Provision

The provision provides that the Secretary shall have the burden of proof in any court proceeding with respect to a factual issue if the taxpayer introduces credible evidence with respect to the factual issue relevant to ascertaining the taxpayer's income tax liability. Four conditions apply. First, the taxpayer must comply with the requirements of the Internal Revenue Code and the regulations issued thereunder to substantiate any item (as under present law). Second, the taxpayer must maintain records required by the Code and regulations (as under present law). Third, the taxpayer must cooperate with reasonable requests by the Secretary for meetings, interviews, witnesses, information, and documents (including providing, within a reasonable period of time, access to and inspection of witnesses, information, and documents within the control of the taxpayer, as reasonably requested by the Secretary). Cooperation also includes providing reasonable assistance to the Secretary in obtaining access to and inspection of witnesses, information, or documents not within the control of the taxpayer (including any witnesses, information, or documents located in foreign countries [22]). A necessary element of cooperating with the Secretary is that the taxpayer must exhaust his or her administrative remedies (including any appeal rights provided by the IRS). The taxpayer is not required to agree to extend the statute of limitations to be considered to have cooperated with the Secretary. Cooperating also means that the taxpayer must establish the applicability of any privilege. Fourth, taxpayers other than individuals must meet the net worth limitations that apply for awarding attorney's fees (accordingly, no net worth limitation would be applicable to individuals). Corporations, trusts, and partnerships whose net worth exceeds $7 million are not eligible for the benefits of the provision. The taxpayer has the burden of proving that it meets each of these conditions, because they are necessary prerequisites to establishing that the burden of proof is on the Secretary.

The burden will shift to the Secretary under this provision only if the taxpayer first introduces credible evidence with respect to a factual issue relevant to ascertaining the taxpayer's income tax liability. Credible evidence is the quality of evidence which, after critical analysis, the court would find sufficient upon which to base a decision on the issue if no contrary evidence were submitted (without regard to the judicial presumption of IRS correctness). A taxpayer has not produced credible evidence for these purposes if the taxpayer merely makes implausible factual assertions, frivolous claims, or tax protestor-type arguments. The introduction of evidence will not meet this standard if the court is not convinced that

[22] Cooperation also includes providing English translations, as reasonably requested by the Secretary.

it is worthy of belief. If after evidence from both sides, the court believes that the evidence is equally balanced, the court shall find that the Secretary has not sustained his burden of proof.

Nothing in the provision shall be construed to override any requirement under the Code or regulations to substantiate any item. Accordingly, taxpayers must meet applicable substantiation requirements, whether generally imposed [23] or imposed with respect to specific items, such as charitable contributions [24] or meals, entertainment, travel, and certain other expenses. [25] Substantiation requirements include any requirement of the Code or regulations that the taxpayer establish an item to the satisfaction of the Secretary. [26] Taxpayers who fail to substantiate any item in accordance with the legal requirement of substantiation will not have satisfied the legal conditions that are prerequisite to claiming the item on the taxpayer's tax return and will accordingly be unable to avail themselves of this provision regarding the burden of proof. Thus, if a taxpayer required to substantiate an item fails to do so in the manner required (or destroys the substantiation), this burden of proof provision is inapplicable.[27]

The provision also provides that in any instance in which the Secretary uses statistical information from unrelated taxpayers solely to reconstruct an individual taxpayer's income (such as average income for taxpayers in the area in which the taxpayer lives), the burden of proof is on the Secretary with respect to the item of income that was reconstructed by the Secretary.

Further, the provision provides that, in any court proceeding, the Secretary must initially come forward with evidence that it is appropriate to apply a particular penalty to the taxpayer before the court can impose the penalty. This provision is not intended to require the Secretary to introduce evidence of elements such as reasonable cause or substantial authority. Rather, the Secretary must come forward initially with evidence regarding the appropriateness of applying a particular penalty to the taxpayer; if the taxpayer believes that, because of reasonable cause, substantial authority, or a similar provision, it is inappropriate to impose the penalty, it is the taxpayer's responsibility (and not the Secretary's obligation) to raise those issues.

Effective Date

The provision applies to court proceedings arising in connection with examinations commencing after the date of enactment.

[23] See e.g., Sec. 6001 and Treas. Reg. sec. 1.6001–1 requiring every person liable for any tax imposed by this Title to keep such records as the Secretary may from time to time prescribe, and secs. 6038 and 6038A requiring United States persons to furnish certain information the Secretary may prescribe with respect to foreign businesses controlled by the U.S. person.

[24] Sec. 170(a)(1) and (f)(8) and Treas. Reg. sec. 1.170A–13.

[25] See e.g., Sec. 274(d) and Treas. Reg. sec. 1.274(d)–1, 1.274–5T, and 1.274–5A.

[26] For example, sec. 905(b) of the Code provides that foreign tax credits shall be allowed only if the taxpayer establishes to the satisfaction of the Secretary all information necessary for the verification and computation of the credit. Instructions for meeting that requirement are set forth in Treas. Reg. sec. 1.905–2.

[27] If, however, the taxpayer can demonstrate that he had maintained the required substantiation but that it was destroyed or lost through no fault of the taxpayer, such as by fire or flood, existing tax rules regarding reconstruction of those records would continue to apply.

B. PROCEEDINGS BY TAXPAYERS

1. Expansion of authority to award costs and certain fees (sec. 3101 of the bill and sec. 7430 of the Code)

Present Law

Any person who substantially prevails in any action by or against the United States in connection with the determination, collection, or refund of any tax, interest, or penalty may be awarded reasonable administrative costs incurred before the IRS and reasonable litigation costs incurred in connection with any court proceeding. Reasonable administrative costs are defined as (1) any administrative fees or similar charges imposed by the IRS and (2) expenses, costs and fees related to attorneys, expert witnesses, and studies or analyses necessary for preparation of the case, to the extent that such costs are incurred before earlier of the date of the notice of decision by IRS Appeals or the notice of deficiency (sec. 7430(c)(2)). Net worth limitations apply.

Reasonable litigation costs include reasonable fees paid or incurred for the services of attorneys, except that the attorney's fees will not be reimbursed at a rate in excess of $110 per hour (indexed for inflation) unless the court determines that a special factor, such as the limited availability of qualified attorneys for the proceeding, justifies a higher rate.

Rule 68 of the Federal Rules of Civil Procedure (FRCP) provides a procedure under which a party may recover costs if the party's offer for judgment was rejected and the subsequent court judgment was less favorable to the opposing party than the offer. The offering party's costs are limited to the costs (excluding attorney's fees) incurred after the offer was made. The FRCP generally apply to tax litigation in the district courts and the United States Court of Federal Claims.

Code section 7431 permits the award of civil damages for unauthorized inspection or disclosure of return information. The Federal appellate courts are split over whether a party who substantially prevails over the United States in an action under Code section 7431 is eligible for an award of fees and reasonable costs.[28]

Reasons for Change

The Committee believes that taxpayers should be allowed to recover the reasonable administrative costs they incur where the IRS takes a position against the taxpayer that is not substantially justified, beginning at the time that the IRS establishes its initial position by issuing a letter of proposed deficiency which allows the taxpayer an opportunity for administrative review by the IRS Office of Appeals.

The Committee believes that the pro bono publicum representation of taxpayers should be encouraged and the value of the legal services rendered in these situations should be recognized. Where the IRS takes positions that are not substantially justified, it

[28] See *McLarty* v. *United States,* 6 F.2d 545 (8th Cir. 1993) (holding that the taxpayer may not recover fees and costs) and *Huckaby* v. *United States Department of Treasury,* 804 F.2d 297 (5th Cir. 1986) (holding that the taxpayer may recover fees and costs).

should not be relieved of its obligation to bear reasonable administrative and litigation costs because representation was provided the taxpayer on a pro bono basis.

The Committee is concerned that the IRS may continue to litigate issues that have previously been decided in favor of taxpayers in other circuits. The Committee believes that this places an undue burden on taxpayers that are required to litigate such issues. Accordingly, the Committee believes it is important that the court take into account whether the IRS has lost in the courts of appeals of other circuits on similar issues in determining whether the IRS has taken a position that is not substantially justified and thus liable for reasonable administrative and litigation costs.

The Committee believes that settlement of tax cases should be encouraged whenever possible. Accordingly, the Committee believes that the application of a rule similar to FRCP 68 is appropriate to provide an incentive for the IRS to settle taxpayers" cases for appropriate amounts, by requiring reimbursement of taxpayer's costs when the IRS fails to do so.

The Committee believes that when the IRS violates taxpayer's right to privacy by engaging in unauthorized inspection or disclosure activities, it is appropriate to reimburse taxpayers for the costs of their damages.

Explanation of Provision

The provision:

(1) moves the point in time after which reasonable administrative costs can be awarded to the date on which the first letter of proposed deficiency which allows the taxpayer an opportunity for administrative review in the IRS Office of Appeals is sent;

(2) permits awards of reasonable attorney's fees by deleting the hourly rate caps (and the exceptions to those caps);

(3) permits the award of reasonable attorney's fees to specified persons who represent for no more than a nominal fee a taxpayer who is a prevailing party;

(4) provides that in determining whether the position of the United States was substantially justified, the court shall take into account whether the United States has lost in other courts of appeal on substantially similar issues;

(5) provides that if a taxpayer makes an offer after the taxpayer has a right to administrative review in the IRS Office of Appeals, the IRS rejects the offer, and later the IRS obtains a judgment[29] against the taxpayer in an amount that is equal to or less than the taxpayer's offer for the amount of the tax liability (excluding interest), reasonable costs and attorney's fees from the date of the offer would be awarded; and

(6) permits the award of attorney's fees in actions for civil damages for unauthorized inspection or disclosure of taxpayer returns and return information.

The above rules for making awards apply subject to the same net worth limitations as under present law.

[29] A judgment pursuant to a stipulation or a settlement will not be treated as a judgment for this purpose.

Effective Date

The provision applies to eligible costs and services incurred more than 180 days after the date of enactment.

2. Civil damages for collection actions (sec. 3102 of the bill and secs. 7426 and 7433 of the Code)

Present Law

A taxpayer may sue the United States for up to $1 million of civil damages caused by an officer or employee of the IRS who recklessly or intentionally disregards provisions of the Internal Revenue Code or Treasury regulations in connection with the collection of Federal tax with respect to the taxpayer.

Reasons for Change

The Committee believes that taxpayers should also be able to recover economic damages they incur as a result of the negligent disregard of the Code or regulations by an officer or employee of the IRS in connection with a collection matter. The Committee also believes that taxpayers should be able to recover civil damages they incur as a result of a willful violation of the Bankruptcy Code by an officer or employee of the IRS. As third parties may also be subject to IRS collection actions, the Committee believes that it is appropriate to afford them the opportunity to recover damages for unauthorized collection actions.

Explanation of Provision

The provision permits (1) up to $100,000 in civil damages caused by an officer or employee of the IRS who negligently disregards provisions of the Internal Revenue Code or Treasury regulations in connection with the collection of Federal tax with respect to the taxpayer, and (2) up to $1 million in civil damages caused by an officer or employee of the IRS who willfully violates provisions of the Bankruptcy Code relating to automatic stays or discharges. The provision also provides that persons other than the taxpayer may sue for civil damages for unauthorized collection actions. No person is entitled to seek civil damages in a court of law without first exhausting administrative remedies.

Effective Date

The provision is effective with respect to actions of officers or employees of the IRS occurring after the date of enactment.

3. Increase in size of cases permitted on small case calendar (sec. 3103 of the bill and sec. 7463 of the Code)

Present Law

Taxpayers may choose to contest many tax disputes in the Tax Court. Special small case procedures apply to disputes involving $10,000 or less, if the taxpayer chooses to utilize these procedures (and the Tax Court concurs) (sec. 7463). The IRS cannot require the taxpayer to use the small case procedures. The Tax Court generally concurs with the taxpayer's request to use the small case procedures, unless it decides that the case involves an issue that should be heard under the normal procedures. After the case has commenced, the Tax Court may order that the small case procedures should be discontinued only if (1) there is reason to believe that the amount in controversy will exceed $10,000 or (2) justice would require the change in procedure.

Small tax cases are conducted as informally as possible. Neither briefs nor oral arguments are required and strict rules of evidence are not applied. Most taxpayers represent themselves in small tax cases, although they may be represented by anyone admitted to practice before the Tax Court. Decisions in a case conducted under small case procedures are neither precedent for future cases nor reviewable upon appeal by either the government or the taxpayer.

Reasons for Change

The Committee believes that use of the small case procedures should be expanded.

Explanation of Provision

The provision increases the cap for small case treatment from $10,000 to $50,000. The Committee recognizes that an increase of this size may encompass a small number of cases of significant precedential value. Accordingly, the Committee anticipates that the Tax Court will carefully consider IRS objections to small case treatment, such as objections based upon the potential precedential value of the case.

Effective Date

The provision applies to proceedings commenced after the date of enactment.

4. Expansion of Tax Court jurisdiction to responsible person penalties (sec. 3104 of the bill and sec. 6672 of the Code)

Present Law

In general, employers are required to withhold income taxes (sec. 3402) and social security taxes (sec. 3102) from their employee's wages. These withheld taxes constitute a trust in favor of the United States from the time that the employer deducts them from the employee's wages, and the employer is liable to the government for the payment of such taxes (sec. 7501(a)). Section 6672 subjects all persons considered responsible for the withholding and payment of taxes to a penalty equal to the amount of taxes due where the employer fails to turn over such funds to the government (the "responsible person" penalty, also known as the "100 percent" penalty). Generally, the determination of whether a person is a "responsible person" is a question of the person's status, duty, and authority in the context of the business which has failed to collect and pay over taxes required to be withheld. A responsible person penalty may also be imposed on a payroll lender (sec. 3505).

The Tax Court has no jurisdiction over the determination of the correctness of the assessment of the responsible person penalty. Accordingly, as the Tax Court is the only pre-payment forum for the determination of tax liability, the imposition of the responsible person penalty can only be challenged in a refund suit in the appropriate district court or the U.S. Court of Federal Claims after payment of such penalty. The responsible person penalty is a divisible tax. Thus, unlike a refund suit for income taxes, a responsible person need not pay the full amount of the assessment to invoke the jurisdiction of the district court or the U.S. Court of Federal Claims. Instead, the alleged responsible person may commence a refund suit after payment of the portion of the penalty attributable to one employee for one quarter.

Reasons for Change

The Committee is concerned that persons who have a responsible person penalty assessed against them must pay a portion of the penalty before challenging the imposition of the penalty, before there is a judicial determination that they have any liability.

Explanation of Provision

The provision provides Tax Court jurisdiction over the "responsible person" penalty. Accordingly, the responsible person does not have to make a payment before challenging the imposition of the penalty.

Effective Date

The provision applies to penalties imposed after the date of enactment.

5. Actions for refund with respect to certain estates which have elected the installment method of payment (sec. 3105 of the bill and sec. 7422 of the Code)

Present Law

In general, the U.S. Court of Federal Claims and the U.S. district courts have jurisdiction over suits for the refund of taxes, as long as full payment of the assessed tax liability has been made. *Flora* v. *United States,* 357 U.S. 63 (1958), aff'd on reh'g, 362 U.S. 145 (1960). Under Code section 6166, if certain conditions are met, the executor of a decedent's estate may elect to pay the estate tax attributable to certain closely-held businesses over a 14-year period. Courts have held that U.S. district courts and the U.S. Court of Federal Claims do not have jurisdiction over claims for refunds by taxpayers deferring estate tax payments pursuant to section 6166 unless the entire estate tax liability has been paid (i.e., timely payment of the installments due prior to the bringing of an action is not sufficient to invoke jurisdiction). See, e.g., *Rocovich* v. *United States,* 933 F.2d 991 (Fed. Cir. 1991), *Abruzzo* v. *United States,* 24 Ct. Cl. 668 (1991). Under section 7479, the U.S. Tax Court has limited authority to provide declaratory judgments regarding initial or continuing eligibility for deferral under section 6166.

Reasons for Change

The Committee believes that the refund jurisdiction of the U.S. Court of Federal Claims and the U.S. district courts should apply without regard to whether the taxpayer has elected, and the Secretary accepted, the payment of that tax in installments.

Explanation of Provision

The provision grants the U.S. Court of Federal Claims and the U.S. district courts jurisdiction to determine the correct amount of estate tax liability (or refund) in actions brought by taxpayers deferring estate tax payments under section 6166, as long as certain conditions are met. In order to qualify for the provision, (1) the estate must have made an election pursuant to section 6166, (2) the estate must have fully paid each installment of principal and/or interest due (and all non-6166-related estate taxes due) before the date the suit is filed, (3) no portion of the payments due may have been accelerated, (4) there must be no suits for declaratory judgment pursuant to section 7479 pending, and (5) there must be no outstanding deficiency notices against the estate. In general, to the extent that a taxpayer has previously litigated its estate tax liability, the taxpayer would not be able to take advantage of this procedure under principles of res judicata. Taxpayers are not relieved of the liability to make any installment payments that become due during the pendency of the suit (i.e., failure to make such payments would subject the taxpayer to the existing provisions of section 6166(g)(3)).

The provision further provides that once a final judgment has been entered by a district court or the U.S. Court of Federal Claims, the IRS is not permitted to collect any amount disallowed by the court, and any amounts paid by the taxpayer in excess of the amount the court finds to be currently due and payable are refunded to the taxpayer, with interest. Lastly, the provision provides that the two-year statute of limitations for filing a refund action is suspended during the pendency of any action brought by a taxpayer pursuant to section 7479 for a declaratory judgment as to an estate's eligibility for section 6166.

Effective Date

The provision is effective with respect to claims for refunds filed after the date of enactment.

6. Tax Court jurisdiction to review an adverse IRS determination of a bond issue's tax-exempt status (sec. 3106 of the bill and sec. 7478 of the Code)

Present Law

Interest on debt incurred by States or local governments generally is excluded from gross income if the proceeds of the borrowing are used to carry out governmental functions of those entities and the debt is repaid with governmental funds (sec. 103). Interest on debt incurred by those governments where the proceeds are used to finance activities of other persons and the repayment of which is derived from the funds of such other person (e.g., private activity bonds) is taxable unless a specific exception is included in the Code.

In general, an initial determination of whether interest on State or local government bonds is tax-exempt is made by issuers when the bonds are issued. This initial determination is made by reference to how the bond proceeds are "to be used" (sec. 141). Intentional acts after the date of issuance to use bond-financed property (indirectly, a use of bond proceeds) in a manner not qualifying for tax exemption may render interest on the bonds taxable, retroactive to the date of issuance. Like other tax positions taken by taxpayers, this initial determination, and issuer decisions relating to the effect of subsequent actions are subject to review and challenge by the IRS under regular examination procedures.

A State or local government that seeks to issue bonds, the interest on which is intended to be excludable from gross income under section 103, can request a ruling from the IRS regarding the eligibility of such bonds for tax-exemption. The prospective issuer can challenge the IRS's determination (or failure to make a timely determination) in a declaratory judgment proceeding in the Tax Court under Code section 7478. Because bondholders, not issuers, are the parties whose tax liability is affected, issuers are not allowed to litigate the tax-exempt status of the bonds directly after the bonds are issued.

Reasons for Change

The Committee believes that issuers of governmental bonds, as parties with a strong incentive to ensure the continued tax-exemption of outstanding bonds, should have the opportunity to challenge IRS revocations of the tax-exempt status of the bonds, to protect the holders of those bonds and the market better.

Explanation of Provision

The provision extends the declaratory judgment procedures currently applicable to prospective bond issuers to issuers of outstanding bonds. The issuer must provide adequate notice [30] to outstanding bondholders, and the bondholders are authorized to intervene in court proceedings brought under this provision. The statute of limitations on assessment and collection of the tax liability of the bondholders is suspended during the pendency of the proceeding.

Effective Date

The provision applies to determinations of tax-exempt status made after the date of enactment. A special rule provides that, in the case of a determination under a technical advice memorandum the public release of which occurs within one year of the date of enactment, a pleading may be filed not later than 90 days after the date of enactment.

[30] The Committee anticipates that the Tax Court will determine whether the issuer's provision of notice to the bondholders comported with the statutory requirements. Notice provided pursuant to this provision has no effect on any notice that may be required pursuant to any other provision of law.

7. Civil action for release of erroneous lien (sec. 3107 of the bill and sec. 6325 of the Code)

Present Law

Prior to 1995, the provisions governing jurisdiction over refund suits had generally been interpreted to apply only if an action was brought by the taxpayer against whom tax was assessed. Remedies for third parties from whom tax was collected (rather than assessed) were found in other provisions of the Internal Revenue Code. The Supreme Court held in *Williams* v. *United States,* 115 S.Ct. 1611 (1995), however, that a third party who paid another person's tax under protest to remove a lien on the third party's property could bring a refund suit, because she had no other adequate administrative or judicial remedy. In *Williams,* the IRS had filed a nominee lien against property that was owned by the taxpayer's former spouse and that was under a contract for sale. In order to complete the sale, the former spouse paid the amount of the lien under protest, and then sued in district court to recover the amount paid. The Supreme Court held that parties who are forced to pay another's tax under duress could bring a refund suit, because no other judicial remedy was adequate.

Reasons for Change

The Committee believes that third parties should have a mechanism to release an erroneous tax lien. Accordingly, the Committee believes it is appropriate to provide relief similar to that provided to third parties who are subject to wrongful levy of property.

Explanation of Provision

The provision creates an administrative procedure similar to the wrongful levy remedy for third parties in section 7426. Under this procedure, a record owner of property against which a Federal tax lien had been filed could obtain a certificate of discharge of property from the lien as a matter of right. The third party would be required to apply to the Secretary of the Treasury for such a certificate and either to deposit cash or to furnish a bond sufficient to protect the lien interest of the United States. Although the Secretary would determine the amount of the bond necessary to protect the Government's lien interest, the Secretary would have no discretion to refuse to issue a certificate of discharge if this procedure was followed, thus curing the defect in this remedy that the Supreme Court found in *Williams*. A certificate of discharge of property from a lien issued pursuant to the procedure would enable the record owner to sell the property free and clear of the Federal tax lien in all circumstances. The provision also authorizes the refund of all or part of the amount deposited, plus interest at the same rate that would be made on an overpayment of tax by the taxpayer, or the release of all or part of the bond, if the tax liability is satisfied or the Secretary determines that the United States does not have a lien interest or has a lesser lien interest than the amount initially determined.

The provision also establishes a judicial cause of action for third parties challenging a lien that is similar to the wrongful levy remedy in section 7426. The period within which such an action must be commenced would be 120 days after the date the certificate of discharge is issued to ensure an early resolution of the parties' interests. Upon conclusion of the litigation, the IRS would be authorized to apply the deposit or bond to the assessed liability and to refund to the third party any amount in excess of the liability, plus interest, or to release the bond. Actions to quiet title under 28 U.S.C. § 2410 would still be available to persons who did not seek the expedited review permitted under the new statutory procedure.

Effective Date

The provision is effective on the date of enactment.

C. RELIEF FOR INNOCENT SPOUSES AND FOR TAXPAYERS UNABLE TO MANAGE THEIR FINANCIAL AFFAIRS DUE TO DISABILITIES

1. Spousal election to limit joint and several liability on joint return (sec. 3201 of the bill and new sec. 6015 of the Code)

Present Law

Relief from liability for tax, interest and penalties is available for "innocent spouses" in certain circumstances. To qualify for such relief, the innocent spouse must establish: (1) that a joint return was made; (2) that an understatement of tax, which exceeds the greater of $500 or a specified percentage of the innocent spouse's adjusted gross income for the preadjustment (most recent) year, is attributable to a grossly erroneous item of the other spouse; (3) that in signing the return, the innocent spouse did not know, and had no reason to know, that there was an understatement of tax; and (4) that taking into account all the facts and circumstances, it is inequitable to hold the innocent spouse liable for the deficiency in tax. The specified percentage of adjusted gross income is 10 percent if adjusted gross income is $20,000 or less. Otherwise, the specified percentage is 25 percent.

The proper forum for contesting the Secretary's denial of innocent spouse relief is determined by whether an underpayment is asserted or the taxpayer is seeking a refund of overpaid taxes. Accordingly, the Tax Court may not have jurisdiction to review all denials of innocent spouse relief.

Reasons for Change

The Committee is concerned that the innocent spouse provisions of present law are inadequate. The Committee believes that a system based on separate liabilities will provide better protection for innocent spouses than the current system. The Committee generally believes that an electing spouse's liability should be satisfied by the payment of the tax attributable to that spouse's income and that an election to limit a spouse's liability to that amount is appropriate.

The Committee intends that this election be available to limit the liability of spouses for tax attributable to items of which they had no knowledge. The Committee is concerned that taxpayers not be allowed to abuse these rules by knowingly signing false returns, or by transferring assets for the purpose of avoiding the payment of tax by the use of this election. The Committee believes that rules restricting the ability of taxpayers to limit their liability in such situations are appropriate.

The Committee believes that taxpayers need to be informed of their right to make this election and that the IRS is the best source of that information. The Committee also believes that the IRS should take appropriate steps to insure that both spouses are made aware of their tax situation, and not rely on a single notice sent to a single address to inform both spouses.

Explanation of Provision

In general

The bill modifies the innocent spouse provisions to permit a spouse to elect to limit his or her liability for unpaid taxes on a joint return to the spouse's separate liability amount. In the case of a deficiency arising from a joint return, a spouse would be liable only to the extent items giving rise to the deficiency are allocable to the spouse. Special rules apply to prevent the inappropriate use of the election.

Items are generally allocated between spouses in the same manner as they would have been allocated had the spouses filed separate returns. The Secretary may prescribe other methods of allocation by regulation. The allocation of items is to be accomplished without regard to community property laws.

The election applies to all unpaid taxes under subtitle A of the Internal Revenue Code, including the income tax and the self-employment tax. The election may be made at any time not later than 2 years after collection activities begin with respect to the electing spouse. The Committee intends that 2 year period not begin until collection activities have been undertaken against the electing spouse that have the effect of giving the spouse notice of the IRS's intention to collect the joint liability from such spouse. For example, garnishment of wages, a notice of intent to levy against the property of the electing spouse would constitute collection activity against the electing spouse. The mailing of a notice of deficiency and demand for payment to the last known address of the electing spouse, addressed to both spouses, would not.

The Tax Court has jurisdiction of disputes arising from the separate liability election. For example, a spouse who makes the separate liability election may petition the Tax Court to determine the limits on liability applicable under this provision. The Tax Court is authorized to establish rules that would allow the Secretary of the Treasury and the electing spouse to require, with adequate notice, the other spouse to become a party to any proceeding before the Tax Court. The Secretary of the Treasury is required to develop a separate form with instructions for taxpayers to use in electing to limit liability.

Allocations of items

Under the bill, allocation of items of income and deduction follows the present-law rules determining which spouse is responsible for reporting an item when the spouses use the married, filing separate filing status. The Secretary of the Treasury is granted authority to prescribe regulations providing simplified methods of allocating items.

In general, apportionment of items of income are expected to follow the source of the income. Wage income is allocated to the spouse performing the job and receiving the Form W–2. Business and investment income (including any capital gains) is allocated in the same proportion as the ownership of the business or investment that produces the income. Where ownership of the business or investment is held by both spouses as joint tenants, it is expected that any income is allocated equally to each spouse, in the absence of clear and convincing evidence supporting a different allocation.

The allocation of business deductions is expected to follow the ownership of the business. Personal deduction items are expected to be allocated equally between spouses, unless the evidence shows that a different allocation is appropriate. For example, a charitable contribution normally would be allocated equally to both spouses. However, if the wife provides evidence that the deduction relates to the contribution of an asset that was the sole property of the husband, any deficiency assessed because it is later determined that the value of the property was overstated would be allocated to the husband.

Items of loss or deduction are allocated to a spouse only to the extent that income attributable to the spouse was offset by the deduction or loss. Any remainder is allocated to the other spouse.

Income tax withholding is allocated to the spouse from whose paycheck the tax was withheld. Estimated tax payments are generally expected to be allocated to the spouse who made the payments. If the payments were made jointly, the payments are expected to be allocated equally to each spouse, in the absence of evidence supporting a different allocation.

The allocation of items is to be made without regard to the community property laws of any jurisdiction.

If the electing spouse establishes that he or she did not know, and had no reason to know, of an item and, considering all the facts and circumstances, it is inequitable to hold the electing spouse responsible for any unpaid tax or deficiency attributable to such item, the item may be equitably reallocated to the other spouse. In cases where the IRS proves fraud, the IRS may distribute, apportion, or allocate any item between spouses.

Tax deficiencies

If a spouse makes the separate liability election, the liability for deficiencies determined after a joint return is filed is allocated to the spouse whose item gives rise to the deficiency. For example, if a deficiency is assessed after an IRS audit that relates to the husband's income that he failed to report on the return, the entire deficiency is allocated to the husband. If the wife elects separate liability, she owes none of the deficiency. The deficiency is the sole responsibility of the husband who failed to report the income.

If the deficiency relates to the items of both spouses, the separate liability for the deficiency is allocated between the spouses in the same proportion as the net items taken into account in determining the deficiency. If the deficiency arises as a result of the denial of an item of deduction or credit, the amount of the deficiency allocated to the spouse to whom the item of deduction or credit is allocated is limited to the amount of income or tax allocated to such spouse that was offset by the deduction or credit. The remainder of the liability is allocated to the other spouse to reflect the fact that income or tax allocated to that spouse was originally offset by a portion of the disallowed deduction or credit.

For example, a married couple files a joint return with wage income of $100,000 allocable to the wife and $30,000 of self employment income allocable to the husband. On examination, a $20,000 deduction allocated to the husband is disallowed, resulting in a deficiency of $5,600. Under the provision, the liability is allocated in proportion to the items giving rise to the deficiency. Since the only item giving rise to the deficiency is allocable to the husband, and because he reported sufficient income to offset the item of deduction, the entire deficiency is allocated to the husband and the wife has no liability with regard to the deficiency, regardless of the ability of the IRS to collect the deficiency from the husband.

If the joint return had shown only $15,000 (instead of $30,000) of self employment income for the husband, the income offset limitation rule discussed above would apply. In this case, the disallowed $20,000 deduction entirely offsets the $15,000 of income of the husband, and $5,000 remains. This remaining $5,000 of the disallowed deduction offsets income of the wife. The liability for the deficiency is therefore divided in proportion to the amount of income offset for each spouse. In this example, the husband is liable for ¾ of the deficiency ($4,200), and the wife is liable for the remaining ¼ ($1,400).

The rule that the election will not apply to the extent any deficiency is attributable to an item the electing spouse had actual knowledge of is expected to be applied by treating the item as fully allocable to both spouses. For example a married couple files a joint return with wage income of $150,000 allocable to the wife and $30,000 of self employment income allocable to the husband. On examination, an additional $20,000 of the husband's self employment income is discovered, resulting in a deficiency of $9,000. The IRS proves that the wife had actual knowledge of $5,000 of this additional self employment income, but had no knowledge of the remaining $15,000. In this case, the husband would be liable for the full amount of the deficiency, since the item giving rise to the deficiency is fully allocable to him. In addition, the wife would be liable for the amount that would have been calculated as the deficiency based on the $5,000 of unreported income of which she had actual knowledge. The IRS would be allowed to collect that amount from either spouse, while the remainder of the deficiency could be collected from only the husband.

Tax shown on a return, but not paid

The separate liability election also applies in situations where the tax shown on a joint return is not paid with the return. In this case, the amount determined under the separate liability election equals the amount that would have been reported by the electing spouse on a separate return. However, if any item of credit or deduction would be disallowed solely because a separate return is filed, the item of credit or deduction will be computed without regard to such prohibition.[31] Similarly, a base amount and an adjusted base amount will be allowed in the determination of the taxable portion of social security and tier 1 railroad retirement benefits without regard to the rule in section 86(c). The calculation of the tax that would be shown on the separate return does not constitute the filing of a separate return. Other actions whose character may have been dependent upon the joint filing status of the taxpayer (for example, the making of a deductible IRA contribution under section 219) are unaffected by the election.

The separate liability election may not be used to create a refund, or to direct a refund to a particular spouse.

Special rules

Special rules apply to prevent the inappropriate use of the election.

First, if the IRS demonstrates that assets were transferred between the spouses in a fraudulent scheme joined in by both spouses, neither spouse is eligible to make the election under the provision (and consequently joint and several liability applies to both spouses).

Second, if the IRS proves that the electing spouse had actual knowledge that an item on a return is incorrect, the election will not apply to the extent any deficiency is attributable to such item. Such actual knowledge must be established by the evidence and shall not be inferred based on indications that the electing spouse had a reason to know.

Third, the limitation on the liability of an electing spouse is increased by the value of any disqualified assets received from the other spouse. Disqualified assets include any property or right to property that was transferred to an electing spouse if the principle purpose of the transfer is the avoidance of tax (including the avoidance of payment of tax). A rebuttable presumption exists that a transfer is made for tax avoidance purposes if the transfer was made less than one year before the earlier of the payment due date or the date of the notice of proposed deficiency. The rebuttable presumption does not apply to transfers pursuant to a decree of divorce or separate maintenance. The presumption may be rebutted by a showing that the principal purpose of the transfer was not the avoidance of tax or the payment of tax.

Notification of taxpayers

The Internal Revenue Service is required to notify all taxpayers who have filed joint returns of their rights to elect to limit their joint and several liability under this provision. It is expected that notice will appear in appropriate IRS publications, including IRS Publication 1, and in collection related notices sent to taxpayers.

The Internal Revenue Service should, whenever practicable, send appropriate notifications separately to each spouse. For example,

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[31] For example, provisions requiring the filing of a joint return in order to claim a credit such as section 21(e)(2) (dependent care credit), section 22(e)(1) (credit for the elderly and permanently disabled), section 23(f)(1) (adoption credit), section 25A(f)(6) (Hope and lifetime learning credits) and section 32(d) (earned income credit) would not apply under this provision. Section 221(f)(2) (deductions for interest on education loans) would be an example of a rule disallowing a deduction that would not apply.

where notifications are being sent by registered mail, it is expected a separate notice will be sent by registered mail to each spouse. This is intended to increase the likelihood that separated or divorced spouses will each receive such notices, as well as increase the likelihood that the Internal Revenue Service will be made aware of address changes that apply to one, but not both spouses.

Effective Date

The provision applies to any liability for tax arising after the date of enactment and any liability for tax arising on or before such date, but remaining unpaid as of such date.

The period in which an election may be made under the provision will not expire before the date that is 2 years after the date of the first collection action undertaken against the electing spouse on or after the date of enactment that has the effect of giving the spouse notice of the IRS' intention to collect the joint liability from the spouse. However, this rule does not extend the statute of limitations.

An individual may elect under the provision without regard to whether such individual has previously been denied innocent spouse relief under present law.

2. Suspension of statute of limitations on filing refund claims during periods of disability (sec. 3202 of the bill and sec. 6511 of the Code)

Present Law

In general, a taxpayer must file a refund claim within three years of the filing of the return or within two years of the payment of the tax, whichever period expires later (if no return is filed, the two-year limit applies) (sec. 6511(a)). A refund claim that is not filed within these time periods is rejected as untimely.

There is no explicit statutory rule providing for equitable tolling of the statute of limitations. The U.S. Supreme Court has held that Congress did not intend the equitable tolling doctrine to apply to the statutory limitations of section 6511 on the filing of tax refund claims.

Reasons for Change

The Committee believes that, in cases of severe disability, equitable tolling should be considered in the application of the statutory limitations on the filing of tax refund claims.

Explanation of Provision

The provision permits equitable tolling of the statute of limitations for refund claims of an individual taxpayer during any period of the individual's life in which he or she is unable to manage his or her financial affairs by reason of a medically determinable physical or mental impairment that can be expected to result in death or to last for a continuous period of not less than 12 months. Tolling does not apply during periods in which the taxpayer's spouse or another person is authorized to act on the taxpayer's behalf in financial matters.

Effective Date

The provision applies to periods of disability before, on, or after the date of enactment but does not apply to any claim for refund or credit which (without regard to the provision) is barred by the statute of limitations as of January 1, 1998.

D. PROVISIONS RELATING TO INTEREST AND PENALTIES

1. Elimination of interest differential on overlapping periods of interest on income tax overpayments and underpayments (sec. 3301 of the bill and sec. 6621 of the Code)

Present Law

A taxpayer that underpays its taxes is required to pay interest on the underpayment at a rate equal to the Federal short term interest rate plus three percentage points. A special "hot interest" rate equal to the Federal short term interest rate plus five percentage points applies in the case of certain large corporate underpayments.

A taxpayer that overpays its taxes receives interest on the overpayment at a rate equal to the Federal short term interest rate plus two percentage points. In the case of corporate overpayments in excess of $10,000, this is reduced to the Federal short term interest rate plus one-half of a percentage point.

If a taxpayer has an underpayment of tax from one year and an overpayment of tax from a different year that are outstanding at the same time, the IRS will typically offset the overpayment against the underpayment and apply the appropriate interest to the resulting net underpayment or overpayment. However, if either the underpayment or overpayment has been satisfied, the IRS will not typically offset the two amounts, but rather will assess or credit interest on the full underpayment or overpayment at the underpayment or overpayment rate. This has the effect of assessing the underpayment at the higher underpayment rate and crediting the overpayment at the lower overpayment rate. This results in the taxpayer being assessed a net interest charge, even if the amounts of the overpayment and underpayment are the same.

The Secretary has the authority to credit the amount of any overpayment against any liability under the Code. [32] Congress has previously directed the Internal Revenue Service to implement procedures for "netting" overpayments and underpayments to the extent a portion of tax due is satisfied by a credit of an overpayment. [33]

Reasons for Change

The Committee believes that taxpayers should be charged interest only on the amount they actually owe, taking into account overpayments and underpayments from all open years. The Committee

[32] Code sec. 6402.

[33] Pursuant to TBOR2 (1996), the Secretary conducted a study of the manner in which the IRS has implemented the netting of interest on overpayments and underpayments and the policy and administrative implications of global netting. The legislative history to the General Agreement on Trade and Tariffs (GATT) (1994) stated that the Secretary should implement the most comprehensive crediting procedures that are consistent with sound administrative practice, and should do so as rapidly as is practicable. A similar statement was included in the Conference Report to the Omnibus Budget Reconciliation Act of 1990.

does not believe that the different interest rates provided for overpayments and underpayments were ever intended to result in the charging of the differential on periods of mutual indebtedness.

The Committee is also concerned that current practices provide an incentive to taxpayers to delay the payment of underpayments they do not contest, so that the underpayments will be available to offset any overpayments that are later determined. The Committee believes that this is contrary to sound tax administrative practice and that taxpayers should not be disadvantaged solely because they promptly pay their tax bills.

Explanation of Provision

The provision establishes a net interest rate of zero on equivalent amounts of overpayment and underpayment that exist for any period. Each overpayment and underpayment is considered only once in determining whether equivalent amounts of overpayment and underpayment exist. The special rules that increase the interest rate paid on large corporate underpayments and decrease the interest rate received on corporate underpayments in excess of $10,000 do not prevent the application of the net zero rate. The provision applies to income taxes and self-employment taxes.

Effective Date

The provision applies to interest for calendar quarters beginning after the date of enactment. Until such time as procedures are implemented that allow for the automatic application of this provision by the IRS, the Committee expects that the Secretary will promptly and carefully consider any taxpayer's request to have interest charges recalculated in accordance with this provision. It is expected that the Secretary will extend the statute of limitations on assessment where necessary to allow for the consideration of such requests.

In light of past Congressional statements urging the Secretary to eliminate interest rate differentials in these circumstances, and taking into consideration Congress' belief that the Secretary may do so, the Committee continues to expect that the Secretary will implement the most comprehensive interest netting procedures that are consistent with sound administrative practice, and not only those affected by this provision.

2. Increase in overpayment rate payable to taxpayers other than corporations (sec. 3302 of the bill and sec. 6621(a)(1) of the Code)

Present Law

A taxpayer that underpays its taxes is required to pay interest on the underpayment at a rate equal to the Federal short-term interest rate (AFR) plus three percentage points. A taxpayer that overpays its taxes receives interest on the overpayment at a rate equal to the Federal short-term interest rate (AFR) plus two percentage points.

Reasons for Change

The Committee believes that the interest differential for noncorporate taxpayers should be eliminated.

Explanation of Provision

The provision provides that the overpayment interest rate will be AFR plus three percentage points, except that for corporations, the rate remains at AFR plus two percentage points.

Effective Date

The provision applies to interest for calendar quarters beginning after the date of enactment.

3. Elimination of penalty for individual's failure to pay during period of installment agreement (sec. 3303 of the bill and sec. 6651 of the Code)

Present Law

Taxpayers who fail to pay their taxes are subject to a penalty of one-half percent per month on the unpaid amount, up to a maximum of 25 percent (sec. 6651(a)). If the liability is shown on the return, the penalty begins to accrue on the date prescribed for payment of the tax (with regard to extensions (sec. 6651(a)(2)). If the liability should have been shown on the return but was not, the penalty generally begins to accrue after the date that is 21 days from the date of the IRS notice and demand for payment with respect to such liability (sec. 6651(a)(3)). Taxpayers who make installment payments pursuant to an agreement with the IRS (under sec. 6159) are also subject to this penalty (Treas. reg. sec. 301.6159–1(f) and sec. 6601(b)).

Reasons for Change

The Committee believes that it is inappropriate to apply the penalty for failure to pay taxes to taxpayers who are in fact paying their taxes through an installment agreement.

Explanation of Provision

The provision provides that the penalty for failure to pay taxes is not imposed with respect to the tax liability of an individual for any month in which an installment payment agreement with the IRS (under sec. 6159) is in effect, provided that the individual filed the tax return in a timely manner (including extensions).

Effective Date

The provision is effective for installment agreement payments made after the date of enactment.

4. Mitigation of failure to deposit penalty (sec. 3304 of the bill and sec. 6656(a) of the Code)

Present Law

Deposits of payroll taxes are allocated to the earliest period for which such a deposit is due. If a taxpayer misses or makes an insufficient deposit, later deposits will first be applied to satisfy the shortfall for the earlier period; the remainder is then applied to satisfy the obligation for the current period. If the depositor is not aware this is taking place, cascading penalties may result as payments that would otherwise be sufficient to satisfy current liabilities are applied to satisfy earlier shortfalls.

Code section 6656(c) authorizes the Secretary to waive the failure to make deposit penalty for inadvertent failures by first-time depositors of employment taxes.

Reasons for Change

The Committee believes that the cascading penalty effect is unfair and that depositors should be able to designate payments to minimize its effect.

Explanation of Provision

The provision allows the taxpayer to designate the period to which each deposit is applied. The designation must be made no later than 90 days of the related IRS penalty notice. The provision also extends the authorization to waive the failure to deposit penalty to the first deposit a taxpayer is required to make after the taxpayer is required to change the frequency of the taxpayer's deposits.

Effective Date

The provision applies to deposits made more than 180 days after the date of enactment.

5. Suspension of interest and certain penalties where Secretary fails to contact individual taxpayer (sec. 3305 of the bill and sec. 6404 of the Code)

Present Law

In general, interest and penalties accrue during periods for which taxes are unpaid without regard to whether the taxpayer is aware that there is tax due.

Reasons for Change

The Committee believes that the IRS should promptly inform taxpayers of their obligations with respect to tax deficiencies and amounts due. In addition, the Committee is concerned that accrual of interest and penalties absent prompt resolution of tax deficiencies may lead to the perception that the IRS is more concerned about collecting revenue than in resolving taxpayer's problems.

Explanation of Provision

The provision suspends the accrual of penalties and interest after 1 year if the IRS has not sent the taxpayer a notice of deficiency within 1 year following the date which is the later of (1) the original due date of the return or (2) the date on which the individual taxpayer timely filed the return. The suspension only applies to taxpayers who file a timely tax return. The provision applies only to individuals and does not apply to the failure to pay penalty, in the case of fraud, or with respect to criminal penalties. Interest and penalties resume 21 days after the IRS sends a notice and demand for payment to the taxpayer.

Effective Date

The provision is effective for taxable years ending after the date of enactment.

6. Procedural requirements for imposition of penalties and additions to tax (sec. 3306 of the bill and new sec. 6751 of the Code)

Present Law

Present law does not require the IRS to show how penalties are computed on the notice of penalty. In some cases, penalties may be imposed without supervisory approval.

Reasons for Change

The Committee believes that taxpayers are entitled to an explanation of the penalties imposed upon them. The Committee believes that penalties should only be imposed where appropriate and not as a bargaining chip.

Explanation of Provision

Each notice imposing a penalty is required to include the name of the penalty, the code section imposing the penalty, and a computation of the penalty.

The provision also requires the specific approval of IRS management to assess all non-computer generated penalties unless excepted. This provision does not apply to failure to file penalties, failure to pay penalties, or to penalties for failure to pay estimated tax.

Effective Date

The provision applies to notices issued, and penalties assessed, more than 180 days after the date of enactment.

7. Personal delivery of notice of penalty under section 6672 (sec. 3307 of the bill and sec. 6672(b) of the Code)

Present Law

Any person who is required to collect, truthfully account for, and pay over any tax imposed by the Internal Revenue Code who willfully fails to do so is liable for a penalty equal to the amount of the tax (Code sec. 6672(a)). Before the IRS may assess any such "100-percent penalty," it must mail a written preliminary notice informing the person of the proposed penalty to that person's last known address. The mailing of such notice must precede any notice and demand for payment of the penalty by at least 60 days. The statute of limitations on assessments shall not expire before the date 90 days after the date on which the notice was mailed. These restrictions do not apply if the Secretary finds the collection of the penalty is in jeopardy.

Reasons for Change

The imposition of the 100-percent penalty is a serious matter. The Committee believes that permitting personal service of the preliminary notice required under Code section 6672 may afford taxpayers the opportunity to resolve cases involving the 100-percent penalty at an earlier stage.

Explanation of Provision

The provision permits in person delivery, as an alternative to delivery by mail, of a preliminary notice that the IRS intends to assess a 100-percent penalty. (In some cases, personal delivery may better assure that the recipient actually receives notice.)

Effective Date

The provision is effective on the date of enactment.

8. Notice of interest charges (sec. 3308 of the bill and new sec. 6631 of the Code)

Present Law

Taxpayer generally must pay interest on amounts due to the IRS.

Reasons for Change

The Committee believes that taxpayers should be provided the detail to support the amount of interest charged by the IRS. The computation of interest is a complex calculation, often involving multiple interest rates. The Committee believes that it is appropriate to require the IRS to give notice to the taxpayer that interest is being charged, how it is calculated, and the total amount of the interest.

Explanation of Provision

The provision requires every IRS notice that includes an amount of interest required to be paid by the taxpayer that is sent to an individual taxpayer to include a detailed computation of the interest charged and a citation to the Code section under which such interest is imposed.

Effective Date

The provision applies to notices issued after June 30, 2000.

E. PROTECTIONS FOR TAXPAYERS SUBJECT TO AUDIT OR COLLECTION ACTIVITIES

a. Due Process

i. Due process in IRS collection actions (sec. 3401 of the bill and new secs. 6320 and 6330 of the Code)

Present Law

Levy is the IRS's administrative authority to seize a taxpayer's property to pay the taxpayer's tax liability. The IRS is entitled to seize a taxpayer's property by levy if the Federal tax lien has attached to such property. The Federal tax lien arises automatically where (1) a tax assessment has been made; (2) the taxpayer has been given notice of the assessment stating the amount and demanding payment; and (3) the taxpayer has failed to pay the amount assessed within ten days after the notice and demand.

The IRS may collect taxes by levy upon a taxpayer's property or rights to property (including accrued salary and wages) if the taxpayer neglects or refuses to pay the tax within 10 days after notice and demand that the tax be paid. Notice of the IRS's intent to collect taxes by levy must be given no less than 30 days (90 days in the case of a life insurance contract) before the day of the levy. The notice of levy must describe the procedures that will be used, the administrative appeals available to the taxpayer and the procedures relating to such appeals, the alternatives available to the taxpayer that could prevent levy, and the procedures for redemption of property and release of liens.

The effect of a levy on salary or wages payable to or received by a taxpayer is continuous from the date the levy is first made until it is released.

If the IRS district director finds that the collection of any tax is in jeopardy, collection by levy may be made without regard to either notice period. A similar rule applies in the case of termination assessments.

Reasons for Change

The Committee believes that taxpayers are entitled to protections in dealing with the IRS that are similar to those they would have in dealing with any other creditor. Accordingly, the Committee believes that the IRS should afford taxpayers adequate notice of collection activity and a meaningful hearing before the IRS deprives them of their property. When collection of tax is in jeopardy, the Committee believes it is appropriate to provide notice and a hearing promptly after the deprivation of property. The Committee believes that following procedures designed to afford taxpayers due process in collections will increase fairness to taxpayers.

Explanation of Provision

The provision establishes formal procedures designed to insure due process where the IRS seeks to collect taxes by levy (including by seizure). The due process procedures also apply after the Federal tax lien attaches, but before the notice of the Federal tax lien has been given to the taxpayer.

As under present law, notice of the intent to levy must be given at least 30 days (90 days in the case of a life insurance contract) before property can be seized or salary and wages garnished. During the 30-day (90-day) notice period, the taxpayer may demand a hearing to take place before an appeals officer who has had no prior involvement in the taxpayer's case. If the taxpayer demands a hearing within that period, the proposed collection action may not proceed until the hearing has concluded and the appeals officer has issued his or her determination.

During the hearing, the IRS is required to verify that all statutory, regulatory, and administrative requirements for the proposed collection action have been met. IRS verifications are expected to include (but not be limited to) showings that:

(1) the revenue officer recommending the collection action has verified the taxpayer's liability;

(2) the estimated expenses of levy and sale will not exceed the value of the property to be seized;

(3) the revenue officer has determined that there is sufficient equity in the property to be seized to yield net proceeds from sale to apply to the unpaid tax liabilities; and

(4) with respect to the seizure of the assets of a going business, the revenue officer recommending the collection action has thoroughly considered the facts of the case, including the availability of alternative collection methods, before recommending the collection action.

The taxpayer (or affected third party) is allowed to raise any relevant issue at the hearing. Issues eligible to be raised include (but are not limited to):

(1) challenges to the underlying liability as to existence or amount;

(2) appropriate spousal defenses;

(3) challenges to the appropriateness of collection actions; and

(4) collection alternatives, which could include the posting of a bond, substitution of other assets, an installment agreement or an offer-in-compromise.

Once the taxpayer has had a hearing with respect to an issue, the taxpayer would not be permitted to raise the same issue in another hearing.

The determination of the appeals officer is to address whether the proposed collection action balances the need for the efficient collection of taxes with the legitimate concern of the taxpayer that the collection action be no more intrusive than necessary. A proposed collection action should not be approved solely because the IRS shows that it has followed appropriate procedures.

The taxpayer may contest the determination of the appellate officer in Tax Court by filing a petition within 30 days of the date of the determination. The Tax Court is expected to review the appellate officer's determination for abuse of discretion and also may consider procedural issues, as under present law. The IRS may not take any collection action pursuant to the determination during such 30 day period or while the taxpayer's contest is pending in Tax Court.

IRS Appeals would retain jurisdiction over its determinations. IRS Appeals could enter an order requiring the IRS collection division to adhere to the original determination. In addition, the taxpayer would be allowed to return to IRS Appeals to seek a modification of the original determination based on any change of circumstances.

In the case of a continuous levy, the due process procedures would apply to the original imposition of the levy. Except in jeopardy and termination cases, continuous levy would not be allowed to begin without notice and an opportunity for a hearing. A determination allowing the continuous levy to proceed that is entered at the conclusion of a hearing would be subject to post-determination adjustment on application by the taxpayer. Thus, taxpayers would have the right to have IRS Appeals review any continuous levy and take any changes in circumstances into account.

This provision does not apply in the case of jeopardy and termination assessments. Jeopardy and termination assessments would be subject to post-seizure review as part of the Appeals determination hearing as well as through any existing judicial procedure. A jeopardy or termination assessment must be approved by the IRS District Counsel responsible for the case. Failure to obtain District Counsel approval would render the jeopardy or termination assessment void.

Effective Date

The due process procedures apply to collection actions initiated more than six months after the date of enactment.

b. Examination Activities

i. Uniform application of confidentiality privilege to taxpayer communications with federally authorized practitioners (sec. 3411 of the bill and new sec. 7525 of the Code)

Present Law

A common law privilege of confidentiality exists for communications between an attorney and client with respect to the legal advice the attorney gives the client. Communications protected by the attorney-client privilege must be based on facts of which the attorney is informed by the taxpayer, without the presence of strangers, for the purpose of securing the advice of the attorney. The privilege may not be claimed where the purpose of the communication is the commission of a crime or tort. The taxpayer must either be a client of the attorney or be seeking to become a client of the attorney.

The privilege of confidentiality applies only where the attorney is advising the client on legal matters. It does not apply in situations where the attorney is acting in other capacities. Thus, a taxpayer may not claim the benefits of the attorney-client privilege simply by hiring an attorney to perform some other function. For example, if an attorney is retained to prepare a tax return, the attorney-client privilege will not automatically apply to communications and documents generated in the course of preparing the return.

The privilege of confidentiality also does not apply where an attorney that is licensed to practice another profession is performing such other profession. For example, if a taxpayer retains an attorney who is also licensed as a certified public accountant (CPA), the taxpayer may not assert the attorney-client privilege with regard to communications made and documents prepared by the attorney in his role as a CPA.

The attorney-client privilege is limited to communications between taxpayers and attorneys. No equivalent privilege is provided for communications between taxpayers and other professionals authorized to practice before the Internal Revenue Service, such as accountants or enrolled agents.

Reasons for Change

The Committee believes that a right to privileged communications between a taxpayer and his or her advisor should be available in noncriminal proceedings before the IRS and in noncriminal proceedings in Federal courts with respect to such matters where the IRS is a party, so long as the advisor is authorized to practice before the IRS. A right to privileged communications in such situations should not depend upon whether the advisor is also licensed to practice law.

Explanation of Provision

The provision extends the present law attorney-client privilege of confidentiality to tax advice that is furnished to a client-taxpayer (or potential client-taxpayer) by any individual who is authorized under Federal law to practice before the IRS if such practice is subject to regulation under section 330 of Title 31, United States Code. Individuals subject to regulation under section 330 of Title 31, United States Code include attorneys, certified public accountants, enrolled agents and enrolled actuaries. Tax advice means advice that is within the scope of authority for such individual's practice with respect to matters under Title 26 (the Internal Revenue Code). The privilege of confidentiality may be asserted in any noncriminal tax proceeding before the IRS, as well as in noncriminal tax proceedings in the Federal Courts where the IRS is a party to the proceeding.

The provision allows taxpayers to consult with other qualified tax advisors in the same manner they currently may consult with tax advisors that are licensed to practice law. The provision does not modify the attorney-client privilege of confidentiality, other than to extend it to other authorized practitioners. The privilege established by the provision applies only to the extent that communications would be privileged if they were between a taxpayer and an attorney. Accordingly, the privilege does not apply to any communication between a certified public accountant, enrolled agent, or enrolled actuary and such individual's client (or prospective client) if the communication would not have been privileged between an attorney and the attorney's client or prospective client. For example, information disclosed to an attorney for the purpose of preparing a tax return is not privileged under present law. Such information would not be privileged under the provision whether it was disclosed to an attorney, certified public accountant, enrolled agent or enrolled actuary.

The privilege granted by the provision may only be asserted in noncriminal tax proceedings before the IRS and in the Federal Courts with regard to such noncriminal tax matters in proceedings where the IRS is a party. The privilege may not be asserted to prevent the disclosure of information to any regulatory body other than the IRS. The ability of any other regulatory body, including the Securities and Exchange Commission (SEC), to gain or compel information is unchanged by the provision. No privilege may be asserted under this provision by a taxpayer in dealings with such other regulatory bodies in an administrative or court proceeding.

Effective Date

The provision is effective with regard to communications made on or after the date of enactment.

ii. Limitation on financial status audit techniques (sec. 3412 of the bill and sec. 7602 of the Code)

Present Law

The Secretary is authorized and required to make the inquiries and determinations necessary to insure the assessment of Federal income taxes. For this purpose, any reasonable method may be used to determine the amount of Federal income tax owed. The courts have upheld the use of financial status and economic reality examination techniques to determine the existence of unreported income in appropriate circumstances.

Reasons for Change

The Committee believes that financial status audit techniques are intrusive, and that their use should be limited to situations where the IRS already has indications of unreported income.

Explanation of Provision

The provision prohibits the IRS from using financial status or economic reality examination techniques to determine the existence of unreported income of any taxpayer unless the IRS has a reasonable indication that there is a likelihood of unreported income.

Effective Date

The provision is effective on the date of enactment.

iii. Software trade secrets protection (sec. 3413 of the bill and new sec. 7612 of the Code)

Present Law

The Secretary of the Treasury is authorized to examine any books, papers, records, or other data that may be relevant or material to an inquiry into the correctness of any Federal tax return.

The Secretary may issue and serve summonses necessary to obtain such data, including summonses on certain third-party record keepers. There are no specific statutory restrictions on the ability of the Secretary to demand the production of computer records, programs, code or similar materials.

Reasons for Change

The Committee believes that the intellectual property rights of the developers and owners of computer programs should be respected. The Committee is concerned that the examination of computer programs and source code by the IRS could lead to the diminution of those rights through the inadvertent disclosure of trade secrets and believes that special protection against such inadvertent disclosure should be established.

The Committee also believes that the indiscriminate examination of computer source code by the IRS is inappropriate. Accordingly, the Committee believes that a summons for the production of certain computer source code should only be issued where the IRS is not otherwise able to ascertain through reasonable efforts the manner in which a taxpayer has arrived at an item on a return, identifies with specificity the portion of the computer source code it seeks to examine, and determines that the need to see the source code outweighs the risk of unauthorized disclosure of trade secrets.

Explanation of Provision

Discovery of computer source code

The provision generally prohibits the Secretary from issuing a summons in a Federal tax matter for any portion of computer source code. Exceptions to the general rule are provided for inquiries into any criminal offense connected with the administration or enforcement of the internal revenue laws and for computer software source code that was developed by the taxpayer or a related person for internal use by the taxpayer or related person. Computer software source code is considered to have been developed for internal use by the taxpayer or a related person if the software is primarily used in the taxpayer or related person's trade or business, as opposed to being held for sale or license to others. Software is considered to be used in a trade or business if it is used in the provision of services to others. It is anticipated that software that was originally developed for internal use by the taxpayer or a related person will continue to be subject to the exception, even if the software is later transferred to another. For example, software may have originally been developed by the taxpayer to administer the taxpayer's employee benefits system. If that function and the software necessary to perform it is later transferred to an unrelated third party, the software would continue to be subject to the exception.

In addition, the prohibition of the general rule would not apply, and the Secretary would be allowed to summons computer source code if the Secretary: (1) is unable to otherwise reasonably ascertain the correctness of an item on a return from the taxpayer's books and records, or the computer software program and any associated data; (2) identifies with reasonable specificity the portion of the computer source code to be used to verify the correctness of the item; and (3) determines that the need for the source code outweighs the risks of disclosure of the computer source code. No inference is intended as to whether software is included in the definition of a taxpayer's books and records.

It is expected that the Secretary will make a good faith and significant effort to ascertain the correctness of an item prior to seeking computer source code. The portion of the computer source code to be used would be considered identified with reasonable specificity where, for example, the Secretary requests the portion of the code that is used to determine a particular item on the return, that otherwise is necessary to the determination of an item on the return, or that implements an accounting or other method.

The Committee is aware that the refusal of the taxpayer or the owner of the software to cooperate could, in certain situations, prevent the Secretary from establishing the factors necessary to support the summons of computer source code. Accordingly, the requirement that the Secretary be unable to otherwise reasonably ascertain the correctness of an item on a return from the taxpayer's books and records, or from the computer software program and any associated data, and the requirement that the Secretary have identified with reasonable specificity the portion of the computer source code requested, will be deemed to be satisfied where (1) the Secretary makes a good faith determination that it is not feasible to determine the correctness of the return item in question without access to the computer software program and associated data, (2) the Secretary makes a formal request for such program and any data from the taxpayer and requests such program from the owner of the source code after reaching such determination, and (3) the Secretary has not received such program and data within 180 days of making the formal request. In the case of requests to the taxpayer, the Committee expects that a formal request will take the form of an Information Document Request (IDR), summons, or similar document. The Committee intends that the Secretary actively pursue the recovery of such program and any data from the taxpayer before seeking to have the normal requirements deemed satisfied under this rule.

Additional protections against disclosure of computer software and source code

The provision establishes a number of protections against the disclosure and improper use of trade secrets and confidential information incident to the examination by the Secretary of any computer software program or source code that comes into the possession or control of the Secretary in the course of any examination with respect to any taxpayer. These protections include the following:

(1) Such software or source code may be examined only in connection with the examination of the taxpayer's return with regard to which it was received. It is expected that the taxpayer will be informed of any alternative data or settings to be used in the examination of the software. However, the Committee does not intend to provide the taxpayer with the right to

monitor the examination of the software by the IRS on a key stroke by key stroke or similar basis.

(2) Such software or source code must be maintained in a secure area.

(3) Such source code may not be removed from the owner's place of business without the owner's consent unless such removal is pursuant to a court order. If the owner does not consent to the removal of source code from its place of business, the owner must make available the necessary equipment to review the source code. The owner shall have the right to require the use of equipment that is configured to prevent electronic communication outside the owner's place of business.

(4) Such software or source code may not be decompiled or disassembled.

(5) Such software or source code may only be copied as necessary to perform the specific examination. The owner of the software must be informed of any copies that are made, such copies must be numbered, and at the conclusion of the examination and any related court proceedings, all such copies must be accounted for and returned to the owner, permanently deleted, or destroyed. The Secretary must provide the owner of such software or source code with the names of any individuals who will have access to such software or source code. Source code may be copied (by the use of a scanner or otherwise) from written to machine readable form. However, any such machine readable copies shall be treated as separate copies and must be numbered, accounted for and returned or destroyed at the conclusion of the examination.

(6) If an individual who is not an officer or employee of the U.S. Government will examine the software or source code, such individual must enter into a written agreement with the Secretary that such individual will not disclose such software or source code to any person other than authorized employees or agents of the Secretary at any time, and that such individual will not participate in the development of software that is intended for a similar purpose as the summoned software for a period of two years.

Computer source code is the code written by a programmer using a programming language that is comprehensible to an appropriately trained person, is not machine readable, and is not capable of directly being used to give instructions to a computer. Computer source code also includes any related programmer's notes, design documents, memoranda and similar documentation and customer communications regarding the operation of the program (other than communications with the taxpayer or any person related to the taxpayer).

The Secretary's determination may be contested in any proceeding to enforce the summons, by any person to whom the summons is addressed. In any such proceeding, the court may issue any order that is necessary to prevent the disclosure of confidential information, including (but not limited to) the enforcement of the protections established by this provision.

Criminal penalties are provided where any person willfully divulges or makes known software that was obtained (whether or not by summons) for the purpose of examining a taxpayer's return in violation of this provision.

Effective Date

The provision is effective for summons issued and software acquired after the date of enactment. In addition, 90 days after the date of enactment, the protections against the disclosure and improper use of trade secrets and confidential information added by the provision (except for the requirement that the Secretary provide a written agreement from non-U.S. government officers and employees) apply to software and source code acquired on or before the date of enactment.

iv. Threat of audit prohibited to coerce tip reporting alternative commitment agreements (sec. 3414 of the bill)

Present Law

Restaurants may enter into Tip Reporting Alternative Commitment (TRAC) agreements. A restaurant entering into a TRAC agreement is obligated to educate its employees on their tip reporting obligations, to institute formal tip reporting procedures, to fulfill all filing and record keeping requirements, and to pay and deposit taxes. In return, the IRS agrees to base the restaurant's liability for employment taxes solely on reported tips and any unreported tips discovered during an IRS audit of an employee.

Reasons for Change

The Committee believes that it is inappropriate for the Secretary to use the threat of an IRS audit to induce participation in voluntary programs.

Explanation of Provision

The provision requires the IRS to instruct its employees that they may not threaten to audit any taxpayer in an attempt to coerce the taxpayer to enter into a TRAC agreement.

Effective Date

The provision is effective on the date of enactment.

v. Taxpayers allowed motion to quash all third-party summonses (sec. 3415 of the bill and sec. 7609(a) of the Code)

Present Law

When the IRS issues a summons to a "third-party recordkeeper" relating to the business transactions or affairs of a taxpayer, Code section 7609 requires that notice of the summons be given to the taxpayer within three days by certified or registered mail. The taxpayer is thereafter given up to 23 days to begin a court proceeding to quash the summons. If the taxpayer does so, third-party recordkeepers are prohibited from complying with the summons until the court rules on the taxpayer's petition or motion to quash, but the statute of limitations for assessment and collection with respect to the taxpayer is stayed during the pendency of such a proceeding. Third-party recordkeepers are generally persons who hold financial information about the taxpayer, such as banks, brokers, attorneys, and accountants.

Reasons for Change

The Committee believes that a taxpayer should have notice when the IRS uses its summons power to gather information in an effort to determine the taxpayer's liability. Expanding notice requirement to cover all third party summonses will ensure that taxpayer will receive notice and an opportunity to contest any summons issued to a third party in connection with the determination of their liability.

Explanation of Provision

The provision generally expands the current "third-party recordkeeper" procedures to apply to summonses issued to persons other than the taxpayer. Thus, the taxpayer whose liability is being investigated receives notice of the summons and is entitled to bring an action in the appropriate U.S. District Court to quash the summons. As under the current third-party recordkeeper provision, the statute of limitations on assessment and collection is stayed during the litigation, and certain kinds of summonses specified under current law are not subject to these requirements. No inference is intended with respect to the applicability of present law to summonses to the taxpayer or the scope of the authority to summons testimony, books, papers, or other records.

Effective Date

The provision is effective for summonses served after the date of enactment.

vi. Service of summonses to third-party recordkeepers permitted by mail (sec. 3416 of the bill and sec. 7603 of the Code)

Present Law

Code section 7603 requires that a summons shall be served "by an attested copy delivered in hand to the person to whom it is directed or left at his last and usual place of abode." By contrast, if a third-party recordkeeper summons is served, section 7609 permits the IRS to give the taxpayer notice of the summons via certified or registered mail. Moreover, Rule 4 of the Federal Rules of Civil Procedure permits service of process by mail even in summons enforcement proceedings.

Reasons for Change

The Committee is concerned that, in certain cases, the personal appearance of an IRS official at a place of business for the purpose of serving a summons may be unnecessarily disruptive. The Committee believes that it is appropriate to permit service of summons, as well as notice of summons, by mail.

Explanation of Provision

The provision allows the IRS the option of serving any summons either in person or by mail.

Effective Date

The provision is effective for summonses served after the date of enactment.

vii. Prohibition on IRS contact of third parties without taxpayer pre-notification (sec. 3417 of the bill and sec. 7602 of the Code)

Present Law

Third parties may be contacted by the IRS in connection with the examination of a taxpayer or the collection of the tax liability of the taxpayer. The IRS has the right to summon third-party record-keepers under Code section 7609. In general, the taxpayer must be notified of the service of summons on a third party within three days of the date of service (sec. 7609(a)). The IRS also has the right to seize property of the taxpayer that is held in the hands of third parties (sec. 6331(a)). Except in jeopardy situations, the Internal Revenue Manual provides that IRS will personally contact the taxpayer and inform the taxpayer that seizure of the asset is planned.

Reasons for Change

The Committee believes that taxpayers should be notified before the IRS contacts third parties regarding examination or collection activities with respect to the taxpayer. Such contacts may have a chilling effect on the taxpayer's business and could damage the taxpayer's reputation in the community. Accordingly, the Committee believes that taxpayers should have the opportunity to resolve issues and volunteer information before the IRS contacts third parties.

Explanation of Provision

The provision requires the IRS to notify the taxpayer before contacting third parties regarding examination or collection activities (including summonses) with respect to the taxpayer. Contacts with government officials relating to matters such as the location of assets or the taxpayer's current address are not restricted by this provision. The provision does not apply to criminal tax matters, if the collection of the tax liability is in jeopardy, or if the taxpayer authorized the contact.

Effective Date

The provision is effective for contacts made after 180 days after the date of enactment.

c. Collection Activities

i. Approval process for liens, levies, and seizures (sec. 3421 of the bill)

Present Law

Supervisory approval of liens, levies or seizures is only required under certain circumstances. For example, a levy on a taxpayer's principal residence is only permitted upon the written approval of the District Director or Assistant District Director (sec. 6334(e)).

Reasons for Change

The Committee believes that the imposition of liens, levies, and seizures may impose significant hardships on taxpayers. Accordingly, the Committee believes that extra protection in the form of an administrative approval process is appropriate.

Explanation of Provision

The provision requires the IRS to implement an approval process under which any lien, levy or seizure would be approved by a supervisor, who would review the taxpayer's information, verify that a balance is due, and affirm that a lien, levy or seizure is appropriate under the circumstances. Circumstances to be considered include the amount due and the value of the asset. Failure to follow such procedures should result in disciplinary action against the supervisor and/or revenue officer.

In addition, the Treasury Inspector General for Tax Administration is required to collect information on the approval process and annually report to the tax-writing committees.

Effective Date

The provision is effective for collection actions commenced after date of enactment.

ii. Modifications to certain levy exemption amounts (sec. 3431 of the bill and sec. 6334 of the Code)

Present Law

The Code authorizes the IRS to levy on all non-exempt property of the taxpayer. Property exempt from levy is described in section 6334. Section 6334(a)(2) exempts from levy up to $2,500 in value of fuel, provisions, furniture, and personal effects in the taxpayer's household. Section 6334(a)(3) exempts from levy up to $1,250 in value of books and tools necessary for the trade, business or profession of the taxpayer.

Reasons for Change

The Committee believes that a minimum amount of household items and equipment for taxpayer's business should be exempt from levy. To ensure that such exemption is meaningful, the amounts should be indexed for inflation.

Explanation of Provision

The provision increases the value of personal effects exempt from levy to $10,000 and the value of books and tools exempt from levy to $5,000. These amounts are indexed for inflation.

Effective Date

The provision is effective for collection actions taken after the date of enactment.

iii. Release of levy upon agreement that amount is uncollectible (sec. 3432 of the bill and sec. 6343 of the Code)

Present Law

Some have contended that the IRS does not release a wage levy immediately upon receipt of proof that the taxpayer is unable to pay the tax, but instead, the IRS levies on one period's wage payment before releasing the levy.

Reasons for Change

Congress believes that taxpayers should not have collection activity taken against them once the IRS has determined that the amounts are uncollectible.

Explanation of Provision

The IRS is required to immediately release a wage levy upon agreement with the taxpayer that the tax is not collectible.

Effective Date

The provision is effective for levies imposed after date of enactment.

iv. Levy prohibited during pendency of refund proceedings (sec. 3433 of the bill and sec. 6331 of the Code)

Present Law

The IRS is prohibited from making a tax assessment (and thus prohibited from collecting payment) with respect to a tax liability while it is being contested in Tax Court. However, the IRS is permitted to assess and collect tax liabilities during the pendency of a refund suit relating to such tax liabilities, under the circumstances described below.

Generally, full payment of the tax at issue is a prerequisite to a refund suit. However, if the tax is divisible (such as employment taxes or the trust fund penalty under Code section 6672), the taxpayer need only pay the tax for the applicable period before filing a refund claim. Most divisible taxes are not within the Tax Court's jurisdiction; accordingly, the taxpayer has no pre-payment forum for contesting such taxes. In the case of divisible taxes, it is possible that the taxpayer could be properly under the refund jurisdiction of the District Court or the U.S. Court of Federal Claims and still be subject to collection by levy with respect to the entire amount of the tax at issue. The IRS's policy is generally to exercise forbearance with respect to collection while the refund suit is pending, so long as the interests of the Government are adequately protected (e.g., by the filing of a notice of Federal tax lien) and collection is not in jeopardy. Any refunds due the taxpayer may be credited to the unpaid portion of the liability pending the outcome of the suit.

Reasons for Change

The Committee believes that taxpayers who are litigating a refund action over divisible taxes should be protected from collection of the full assessed amount, because the court considering the refund suit may ultimately determine that the taxpayer is not liable.

Explanation of Provision

The provision requires the IRS to withhold collection by levy of liabilities that are the subject of a refund suit during the pendency of the litigation. This will only apply when refund suits can be brought without the full payment of the tax, i.e., in the case of divisible taxes. Collection by levy would be withheld unless jeopardy exists or the taxpayer waives the suspension of collection in writing (because collection will stop the running of interest and penalties on the tax liability). This provision will not affect the IRS's ability to collect other assessments that are not the subject of the refund suit, to offset refunds, to counterclaim in a refund suit or related proceeding, or to file a notice of Federal tax lien. The statute of limitations on collection is stayed for the period during which the IRS is prohibited from collecting by levy.

Effective Date

The provision is effective for refund suits brought with respect to tax years beginning after December 31, 1998.

v. Approval required for jeopardy and termination assessments and jeopardy levies (sec. 3434 of the bill and sec. 7429(a) of the Code)

Present Law

In general, a 30-day waiting period is imposed after assessment of all types of taxes. In certain circumstances, the waiting period puts the collection of taxes at risk. The Code provides special procedures that allow the IRS to make jeopardy assessments or termination assessments in certain extraordinary circumstances, such as if the taxpayer is leaving or removing property from the United States (sec. 6851), or if assessment or collection would be jeopardized by delay (secs. 6861 and 6862). In jeopardy or termination situations, a levy may be made without the 30-days' notice of intent to levy that is ordinarily required by section 6331(d)(2). Jeopardy assessments apply when the tax year is over. Termination assessments apply to the current taxable year or the immediately preceding taxable year if the filing date has not yet passed. A termination assessment serves to terminate the taxable year for the purpose of computing the tax to be assessed and collected under the termination assessment procedure. Under both the jeopardy and termination assessment procedures, the IRS can assess the tax and immediately begin collection if any one of the following situations exists: (1) the taxpayer is or appears to be planning to depart the United States or to go into hiding; (2) the taxpayer is or appears to be planning to place property beyond the reach of the IRS by removing it from the country, hiding it, dissipating it, or by transferring it to other persons; or (3) the taxpayer's financial solvency is or appears to be imperiled. Because the same criteria apply to jeopardy and termination assessments, jeopardy and termination assessments are often entered at the same time against the same taxpayer.

The Code and regulations do not presently require Counsel to review jeopardy assessments, termination assessments, or jeopardy levies, although the Internal Revenue Manual does require Counsel review before such actions and it is current practice to make such a review. The IRS bears the burden of proof with respect to the reasonableness of a jeopardy or termination assessment or a jeopardy levy (sec. 7429(g)).

Reasons for Change

The Committee believes that it is appropriate to require Counsel review and approval of jeopardy and termination levies, because such actions often involve difficult legal issues.

Explanation of Provision

The provision requires IRS Counsel review and approval before the IRS could make a jeopardy assessment, a termination assessment, or a jeopardy levy. If Counsel's approval was not obtained, the taxpayer would be entitled to obtain abatement of the assessment or release of the levy, and, if the IRS failed to offer such relief, to appeal first to IRS Appeals under the new due process procedure for IRS collections (described in E. 1, above) and then to court.

Effective Date

The provision is effective with respect to taxes assessed and levies made after the date of enactment.

vi. Increase in amount of certain property on which lien not valid (sec. 3435 of the bill and sec. 6323 of the Code)

Present Law

The Federal tax lien attaches to all property and rights in property of the taxpayer, if the taxpayer fails to pay the assessed tax liability after notice and demand (sec. 6321). However, the Federal tax lien is not valid as to certain "superpriority" interests as defined in section 6323(b).

Two of these interests are limited by a specific dollar amount. Under section 6323(b)(4), purchasers of personal property at a casual sale are presently protected against a Federal tax lien attached to such property to the extent the sale is for less than $250. Section 6323(b)(7) provides protection to mechanic's lienors with respect to the repairs or improvements made to owner-occupied personal residences, but only to the extent that the contract for repair or improvement is for not more than $1,000.

In addition, a superpriority is granted under section 6323(b)(10) to banks and building and loan associations which make passbook loans to their customers, provided that those institutions retain the passbooks in their possession until the loan is completely paid off.

Reasons for Change

The Committee believes that it is appropriate to increase the dollar limits on the superpriority amounts because the dollar limits have not been increased for decades and do not reflect current prices or values.

Explanation of Provision

The provision increases the dollar limit in section 6323(b)(4) for purchasers at a casual sale from $250 to $1,000, and further increases the dollar limit in section 6323(b)(7) from $1,000 to $5,000 for mechanics lienors providing home improvement work for owner-occupied personal residences. The provision indexes these amounts for inflation. The provision also clarifies section 6323(b)(10) to reflect present banking practices, where a passbook-type loan may be made even though an actual passbook is not used.

Effective Date

The provision is effective on the date of enactment.

vii. Waiver of early withdrawal tax for IRS levies on employer-sponsored retirement plans or IRAs (sec. 3436 of the bill and sec. 72(t)(2)(A) of the Code)

Present Law

Under present law, a distribution of benefits from any employer-sponsored retirement plan or an individual retirement arrangement ("IRA") generally is includible in gross income in the year it is paid or distributed, except to the extent the amount distributed represents the employee's after-tax contributions or investment in the contract (i.e., basis). Special rules apply to certain lump-sum distributions from qualified retirement plans, distributions rolled over to an IRA or employer-sponsored retirement plan, and lump-sum distributions of employer securities.

Distributions from qualified plans and IRAs prior to attainment of age 59½ that are includible in income generally are subject to a 10-percent early withdrawal tax, unless an exception to the tax applies. An exception to the tax applies if the withdrawal is due to death or disability, is made in the form of certain periodic payments, or is used to pay medical expenses in excess of 7.5 percent of adjusted gross income ("AGI"). Certain additional exceptions to the tax apply separately to withdrawals from IRAs and qualified plans. Distributions from IRAs for education expenses, for up to $10,000 of first-time homebuyer expenses, or to unemployed individuals to purchase health insurance are not subject to the 10-percent early withdrawal tax. A distribution from a qualified plan made by an employee after separation from service after attainment of age 55 is not subject to the 10-percent early withdrawal tax.

Under present law, the IRS is authorized to levy on all non-exempt property of the taxpayer. Benefits under employer-sponsored retirement plans (including section 403(b) and 457 plans) and IRAs are not exempt from levy by the IRS.

Under present law, distributions from employer-sponsored retirement plans or IRAs made on account of an IRS levy are includible in the gross income of the individual, except to the extent the amount distributed represents after-tax contributions. In addition, the amount includible in income is subject to the 10-percent early withdrawal tax, unless an exception described above applies.

Reasons for Change

The Committee believes that the imposition of the 10-percent early withdrawal tax on amounts distributed from employer-sponsored retirement plans or IRAs on account of an IRS levy may impose significant hardships on taxpayers. Accordingly, the Committee believes such distributions should be exempt from the 10-percent early withdrawal tax.

Explanation of Provision

The provision provides an exception from the 10-percent early withdrawal tax for amounts withdrawn from any employer-sponsored retirement plan or an IRA that are subject to a levy by the IRS. The exception applies only if the plan or IRA is levied; it does not apply, for example, if the taxpayer withdraws funds to pay taxes in the absence of a levy, in order to release a levy on other interests, or in any other situation not addressed by the express statutory exceptions to the 10-percent early withdrawal tax.

Effective Date

The provision is effective for withdrawals after the date of enactment.

viii. Prohibition of sales of seized property at less than minimum bid (sec. 3441 of the bill and sec. 6335(e) of the Code)

Present Law

Section 6335(e) requires that a minimum bid price be established for seized property offered for sale. To conserve the taxpayer's equity, the minimum bid price should normally be computed at 80 percent or more of the forced sale value of the property less encumbrances having priority over the Federal tax lien. If the group manager concurs, the minimum sales price may be set at less than 80 percent. The taxpayer is to receive notice of the minimum bid price within 10 days of the sale. The taxpayer has the opportunity to challenge the minimum bid price, which cannot be more than the tax liability plus the expenses of sale. Accordingly, if the minimum bid price is set at the tax liability plus the expenses of sale, the taxpayer's concurrence is not required. IRM 56(13)5.1(4). Section 6335 does not contemplate a sale of the seized property at less than the minimum bid price. Rather, if no person offers the minimum bid price, the IRS may buy the property at the minimum bid price or the property may be released to the owner. Code section 7433 provides civil damages for certain unauthorized collection actions.

Reasons for Change

The Committee believes that strengthening provisions regarding the minimum bid price, including preventing the IRS from selling the taxpayer's property for less than the minimum bid price, are appropriate to preserve taxpayers" rights.

Explanation of Provision

The provision prohibits the IRS from selling seized property for less than the minimum bid price. The provision provides that the sale of property for less than the minimum bid price would constitute an unauthorized collection action, which would permit an affected person to sue for civil damages pursuant to section 7433.

Effective Date

The provision is effective for sales occurring after the date of enactment.

ix. Accounting of sales of seized property (sec. 3442 of the bill and sec. 6340 of the Code)

Present Law

The IRS is authorized to seize and sell a taxpayer's property to satisfy an unpaid tax liability (sec. 6331(b)). The IRS is required to give written notice to the taxpayer before seizure of the property (sec. 6331(d)). The IRS must also give written notice to the taxpayer at least 10 days before the sale of the seized property.

The IRS is required to keep records of all sales of real property (sec. 6340). The records must set forth all proceeds and expenses of the sale. The IRS is required to apply the proceeds first against the expenses of the sale, then against a specific tax liability on the seized property, if any, and finally against any unpaid tax liability of the taxpayer (sec. 6342(a)). Any surplus proceeds are credited to the taxpayer or persons legally entitled to the proceeds.

Reasons for Change

The Committee believes that taxpayers are entitled to know how proceeds from the sale of their property seized by the IRS are applied to their tax liability.

Explanation of Provision

The provision requires the IRS to provide a written accounting of all sales of seized property, whether real or personal, to the taxpayer. The accounting must include a receipt for the amount credited to the taxpayer's account.

Effective Date

The provision is effective for seizures occurring after the date of enactment.

x. Uniform asset disposal mechanism (sec. 3443 of the bill)

Present Law

The IRS must sell property seized by levy either by public auction or by public sale under sealed bids (sec. 6335(e)(2)(A)). These are often conducted by the revenue officer charged with collecting the tax liability.

Reasons for Change

The Committee believes that it is important for fairness and the appearance of propriety that revenue officers charged with collecting unpaid tax liability are not personally involved with the sale of seized property.

Explanation of Provision

The provision requires the IRS to implement a uniform asset disposal mechanism for sales of seized property. The disposal mechanism should be designed to remove any participation in the sale of seized assets by revenue officers. The provision authorizes the consideration of outsourcing of the disposal mechanism.

Effective Date

The provision requires a uniform asset disposal system to be implemented within two years from the date of enactment.

xi. Codification of IRS administrative procedures for seizure of taxpayer's property (sec. 3444 of the bill and sec. 6331 of the Code)

Present Law

The IRS provides guidelines for revenue officers engaged in the collection of unpaid tax liabilities. The Internal Revenue Manual (IRM) 56(12)5.1 provides general guidelines for seizure actions: (1) the revenue officer must first verify the taxpayer's liability; (2) no levy may be made if the estimated expenses of levy and sale will exceed the fair market value of the property to be sized (sec. 6331(f)); (3) no levy may be made on the date of an appearance in response to an administrative summons, unless jeopardy exists (sec. 6331(g)); (4) the taxpayer should have an opportunity to read the levy form; (5) the revenue officer must attach a sufficient number of warning notices on the property to clearly identify the property to be seized; (6) the revenue officer must inventory the property to be seized; and (7) a revenue officer may not use force in the seizure of property.

Prior to the levy action, the revenue officer must determine that there is sufficient equity in the property to be seized to yield net proceeds from the sale to apply to unpaid tax liabilities. If it is determined after seizure that the taxpayer's equity is insufficient to yield net proceeds from sale to apply to the unpaid tax, the revenue officer will immediately release the seized property. See IRM 56(12)2.1.

IRS Policy Statement P–5–34 states that the facts of a case and alternative collection methods must be thoroughly considered before deciding to seize the assets of a going business. IRS Policy Statement P–5–16 advises reasonable forbearance on collection activity when the taxpayer's business has been affected by a major disaster such as flood, hurricane, drought, fire, etc., and whose ability to pay has been impaired by such disaster.

Reasons for Change

The Committee believes that the IRS procedures on collections provide important protections to taxpayers. Accordingly, the Committee believes that it is appropriate to codify those procedures to ensure that they are uniformly followed by the IRS.

Explanation of Provision

The provision codifies the IRS administrative procedures which require the IRS to investigate the status of property prior to levy. The Treasury Inspector General for Tax Administration would be required to review IRS compliance with seizure procedures and report annually to Congress.

Effective Date

The provision is effective on the date of enactment.

xii. Procedures for seizure of residences and businesses (sec. 3445 of the bill and sec. 6334(a)(13) of the Code)

Present Law

Subject to certain procedural rules and limitations, the Secretary may seize the property of the taxpayer who neglects or refuses to pay any tax within 10 days after notice and demand. The IRS may not levy on the personal residence of the taxpayer unless the District Director (or the assistant District Director) personally approves in writing or in cases of jeopardy. There are no special rules for property that is used as a residence by parties other than the taxpayer.

IRS Policy Statement P–5–34 states that the facts of a case and alternative collection methods must be thoroughly considered before deciding to seize the assets of a going business.

Reasons for Change

The Committee is concerned that seizure of the taxpayer's principal residence is particularly disruptive for the taxpayer as well as the taxpayer's family. The seizure of any residence is disruptive to the occupants, and is not justified in the case of a small deficiency. In the case of seizure of a business, the seizure not only disrupts the taxpayer's life but also may adversely impact the taxpayer's ability to enter into an installment agreement or otherwise to continue to pay off the tax liability. Accordingly, the Committee believes that the taxpayer's principal residence or business should only be seized to satisfy tax liability as a last resort, and that any property used by any person as a residence should not be seized for a small deficiency.

Explanation of Provision

The provision prohibits the IRS from seizing real property that is used as a residence (by the taxpayer or another person) to satisfy an unpaid liability of $5,000 or less, including penalties and interest.

The provision requires the IRS to exhaust all other payment options before seizing the taxpayer's business or principal residence. The provision does not prohibit the seizure of a business or a principal residence, but would treat such seizure as a payment option of last resort. The provision does not apply in cases of jeopardy. It is anticipated that the IRS would consider installment agreements, offer-in-compromise, and seizure of other assets of the taxpayer before taking collection action against the taxpayer's business or principal residence.

Effective Date

The provision is effective on the date of enactment.

d. Provisions Relating to Examination and Collection Activities

i. Procedures relating to extensions of statute of limitations by agreement (sec. 3461 of the bill and sec. 6502(a) of the Code)

Present Law

The statute of limitations within which the IRS may assess additional taxes is generally three years from the date a return is filed (sec. 6501).[34] Prior to the expiration of the statute of limitations, both the taxpayer and the IRS may agree in writing to extend the statute, using Form 872 or 872–A. An extension may be for either a specified period or an indefinite period. The statute of limitations within which a tax may be collected after assessment is 10 years after assessment (sec. 6502). Prior to the expiration of the statute of limitations, both the taxpayer and the IRS may agree in writing to extend the statute, using Form 900.

Reasons for Change

The Committee believes that taxpayers should be fully informed of their rights with respect to the statute of limitations on assessment. The Committee is concerned that in some cases taxpayer have not been fully aware of their rights to refuse to extend the statute of limitations, and have felt that they had no choice but to agree to extend the statute of limitations upon the request of the IRS.

Moreover, the Committee believes that the IRS should collect all taxes within 10 years, and that such statute of limitation should not be extended.

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[34] For this purpose, a return filed before the due date is considered to be filed on the due date.

Explanation of Provision

The provision eliminates the provision of present law that allows the statute of limitations on collections to be extended by agreement between the taxpayer and the IRS.

The provision also requires that, on each occasion on which the taxpayer is requested by the IRS to extend the statute of limitations on assessment, the IRS must notify the taxpayer of the taxpayer's right to refuse to extend the statute of limitations or to limit the extension to particular issues.

Effective Date

The provision applies to requests to extend the statute of limitations made after the date of enactment and to all extensions of the statute of limitations on collection that are open 180 days after the date of enactment.

ii. Offers-in-compromise (sec. 3462 of the bill and sec. 7122 of the Code)

Present Law

Section 7122 of the Code permits the IRS to compromise a taxpayer's tax liability. An offer-in-compromise is a provision by the taxpayer to settle unpaid tax accounts for less than the full amount of the assessed balance due. An offer-in-compromise may be submitted for all types of taxes, as well as interest and penalties, arising under the Internal Revenue Code.

There are two bases on which an offer can be made: doubt as to liability for the amount owed and doubt as to ability to pay the amount owed.

A compromise agreement based on doubt as to ability to pay requires the taxpayer to file returns and pay taxes for five years from the date the IRS accepts the offer. Failure to do so permits the IRS to begin immediate collection actions for the original amount of the liability. The Internal Revenue Manual [35] provides guidelines for revenue officers to determine whether an offer-in-compromise is adequate. An offer is adequate if it reasonably reflects collection potential. Although the revenue officer is instructed to consider the taxpayer's assets and future and present income, the IRM advises that rejection of an offer solely based on narrow asset and income evaluations should be avoided.

Pursuant to the IRM, collection normally is withheld during the period an offer-in-compromise is pending, unless it is determined that the offer is a delaying tactic and collection is in jeopardy.

Reasons for Change

The Committee believes that the ability to compromise tax liability and to make payments of tax liability by installment enhances taxpayer compliance. In addition, the Committee believes that the IRS should be flexible in finding ways to work with taxpayers who are sincerely trying to meet their obligations and remain in the tax system. Accordingly, the Committee believes that the IRS should

[35] IRM 57(10)(10).1

make it easier for taxpayers to enter into offer-in-compromise agreements, and should do more to educate the taxpaying public about the availability of such agreements.

Explanation of Provision

Rights of taxpayers entering into offers-in-compromise

The provision requires the IRS to develop and publish schedules of national and local allowances that will provide taxpayers entering into an offer-in-compromise with adequate means to provide for basic living expenses. The IRS also will be required to consider the facts and circumstances of a particular taxpayer's case in determining whether the national and local schedules are adequate for that particular taxpayer. If the facts indicate that use of scheduled allowances would be inadequate under the circumstances, the taxpayer would not be limited by the national or local allowances.

The provision prohibits the IRS from rejecting an offer-in-compromise from a low-income taxpayer solely on the basis of the amount of the offer.[36] The provision provides that, in the case of an offer-in-compromise submitted solely on the basis of doubt as to liability, the IRS may not reject the offer merely because the IRS cannot locate the taxpayer's file. The provision prohibits the IRS from requesting a financial statement if the taxpayer makes an offer-in-compromise based solely on doubt as to liability.

Suspend collection by levy while offer-in-compromise is pending

The provision prohibits the IRS from collecting a tax liability by levy (1) during any period that a taxpayer's offer-in-compromise for that liability is being processed, (2) during the 30 days following rejection of an offer, and (3) during any period in which an appeal of the rejection of an offer is being considered. Taxpayers whose offers are rejected and who made good faith revisions of their offers and resubmitted them within 30 days of the rejection or return would be eligible for a continuous period of relief from collection by levy. This prohibition on collection by levy would not apply if the IRS determines that collection is in jeopardy or that the offer was submitted solely to delay collection. The provision provides that the statute of limitations on collection would be tolled for the period during which collection by levy is barred.

Procedures for reviews of rejections of offers-in-compromise and installment agreements

The provision requires that the IRS implement procedures to review all proposed IRS rejections of taxpayer offers-in-compromise and requests for installment agreements prior to the rejection being communicated to the taxpayer. The provision requires the IRS to allow the taxpayer to appeal any rejection of such offer or agreement to the IRS Office of Appeals. The IRS must notify taxpayers of their right to have an appeals officer review a rejected offer-in-compromise on the application form for an offer-in-compromise.

[36] This provision does not affect the ability of the IRS to reject an offer in compromise made by a taxpayer (other than a low-income taxpayer) because the amount offered is too low.

Publication of taxpayer's rights with respect to offers-in-compromise

The provision requires the IRS to publish guidance on the rights and obligations of taxpayers and the IRS relating to offers in compromise, including a compliant spouse's right to apply to reinstate an agreement that would otherwise be revoked due to the nonfiling or nonpayment of the other spouse, providing all payments required under the compromise agreement are current.

Liberal acceptance policy

It is anticipated that the IRS will adopt a liberal acceptance policy for offers-in-compromise to provide an incentive for taxpayers to continue to file tax returns and continue to pay their taxes.

Effective Date

The provision is generally effective for offers-in-compromise submitted after the date of enactment. The provision suspending levy is effective with respect to offers-in-compromise pending on or made after the 60th day after the date of enactment.

iii. Notice of deficiency to specify deadlines for filing Tax Court petition (sec. 3463 of the bill and sec. 6213(a) of the Code)

Present Law

Taxpayers must file a petition with the Tax Court within 90 days after the deficiency notice is mailed (150 days if the person is outside the United States) (sec. 6213). If the petition is not filed within that time period, the Tax Court does not have jurisdiction to consider the petition.

Reasons for Change

The Committee believes that taxpayers should receive assistance in determining the time period within which they must file a petition in the Tax Court and that taxpayers should be able to rely on the computation of that period by the IRS.

Explanation of Provision

The provision requires the IRS to include on each deficiency notice the date determined by the IRS as the last day on which the taxpayer may file a petition with the Tax Court. The provision provides that a petition filed with the Tax Court by this date is treated as timely filed.

Effective Date

The provision applies to notices mailed after December 31, 1998.

iv. Refund or credit of overpayments before final determination (sec. 3464 of the bill and sec. 6213(a) of the Code)

Present Law

Generally, the IRS may not take action to collect a deficiency during the period a taxpayer may petition the Tax Court, or if the taxpayer petitions the Tax Court, until the decision of the Tax Court becomes final. Actions to collect a deficiency attempted during this period may be enjoined, but there is no authority for ordering the refund of any amount collected by the IRS during the prohibited period.

If a taxpayer contests a deficiency in the Tax Court, no credit or refund of income tax for the contested taxable year generally may be made, except in accordance with a decision of the Tax Court that has become final. Where the Tax Court determines that an overpayment has been made and a refund is due the taxpayer, and a party appeals a portion of the decision of the Tax Court, no provision exists for the refund of any portion of any overpayment that is not contested in the appeal.

Reasons for Change

The Committee believes that the Secretary should be allowed to refund the uncontested portion of an overpayment of taxes, without regard to whether other portions of the overpayment are contested, as well as amounts that were collected during a period in which collection is prohibited.

Explanation of Provision

The provision provides that a proper court (including the Tax Court) may order a refund of any amount that was collected within the period during which the Secretary is prohibited from collecting the deficiency by levy or other proceeding.

The provision also allows the refund of that portion of any overpayment determined by the Tax Court to the extent the overpayment is not contested on appeal.

Effective Date

The provision is effective on the date of enactment.

v. IRS procedures relating to appeal of examinations and collections (sec. 3465 of the bill and new sec. 7123 of the Code)

Present Law

IRS Appeals operates through regional Appeals offices which are independent of the local District Director and Regional Commissioner's offices. The regional Directors of Appeals report to the National Director of Appeals of the IRS, who reports directly to the Commissioner and Deputy Commissioner. In general, IRS Appeals offices have jurisdiction over both pre-assessment and post-assessment cases. The taxpayer generally has an opportunity to seek Appeals jurisdiction after failing to reach agreement with the Examination function and before filing a petition in Tax Court, after filing a petition in Tax Court (but before litigation), after assessment of certain penalties, after a claim for refund has been rejected by the District Director's office, and after a proposed rejection of an offer-in-compromise in a collection case (Treas. Reg. sec. 601.106(a)(1)).

In certain cases under Coordinated Examination Program procedures, the taxpayer has an opportunity to seek early Appeals jurisdiction over some issues while an examination is still pending on other issues (Rev. Proc. 96–9, 1996–1 C.B. 575). The early referral procedures also apply to employment tax issues on a limited basis (Announcement 97–52).

A mediation or alternative dispute resolution (ADR) process is also available in certain cases. ADR is used at the end of the administrative process as a final attempt to resolve a dispute before litigation. ADR is currently only available for cases with more than $10 million in dispute. ADR processes are also available in bankruptcy cases and cases involving a competent authority determination.

In April 1996, the IRS implemented a Collections Appeals Program within the Appeals function, which allows taxpayers to appeal lien, levy, or seizure actions proposed by the IRS. In January 1997, appeals for installment agreements proposed for termination were added to the program.

The local IRS Offices of Appeals are generally located in the same area as the District Director's Offices. The IRS has videoconferencing capability. The IRS does not have any program to provide for Appeals conferences by videoconferencing techniques.

Reasons for Change

The Committee believes that the IRS should be statutorily bound to follow the procedures that the IRS has developed to facilitate settlement in the IRS Office of Appeals. The Committee also believes that mediation, binding arbitration, early referral to Appeals, and other procedures would foster more timely resolution of taxpayers' problems with the IRS.

In addition, the Committee believes that the ADR process is valuable to the IRS and taxpayers and should be extended to all taxpayers.

The Committee believes that all taxpayers should enjoy convenient access to Appeals, regardless of their locality.

Explanation of Provision

The provision codifies existing IRS procedures with respect to early referrals to Appeals and the Collections Appeals Process. The provision also codifies the existing ADR procedures, as modified by eliminating the dollar threshold.

In addition, the IRS is required to establish a pilot program of binding arbitration for disputes of all sizes. Under the pilot program, binding arbitration must be agreed to by both the taxpayer and the IRS.

The provision requires the IRS to make Appeals officers available on a regular basis in each State, and consider videoconferencing of

Appeals conferences for taxpayers seeking appeals in rural or remote areas.

Effective Date

The provision is effective as of the date of enactment.

vi. Application of certain fair debt collection practices (sec. 3466 of the bill and new sec. 6304 of the Code)

Present Law

The Fair Debt Collection Practices Act provides a number of rules relating to debt collection practices. Among these are restrictions on communication with the consumer, such as a general prohibition on telephone calls outside the hours of 8:00 a.m. to 9:00 p.m. local time, and prohibitions on harassing or abusing the consumer. In general, these provisions do not apply to the Federal Government.

Reasons for Change

The Committee believes that the IRS should be at least as considerate to taxpayers as private creditors are required to be with their customers. Accordingly, the Committee believes that it is appropriate to require the IRS to comply with applicable portions of the Fair Debt Collection Practices Act, so that both taxpayers and the IRS are fully aware of these requirements.

Explanation of Provision

The provision makes the restrictions relating to communication with the taxpayer/debtor and the prohibitions on harassing or abusing the debtor applicable to the IRS by incorporating these provisions into the Internal Revenue Code. The restrictions relating to communication with the taxpayer/debtor are not intended to hinder the ability of the IRS to respond to taxpayer inquiries (such as answering telephone calls from taxpayers).

Effective Date

The provision is effective on the date of enactment.

vii. Guaranteed availability of installment agreements (sec. 3467 of the bill and sec. 6159 of the Code)

Present Law

Section 6159 of the Code authorizes the IRS to enter into written agreements with any taxpayer under which the taxpayer is allowed to pay taxes owed, as well as interest and penalties, in installment payments if the IRS determines that doing so will facilitate collection of the amounts owed. An installment agreement does not reduce the amount of taxes, interest, or penalties owed. However, it does provide for a longer period during which payments may be made during which other IRS enforcement actions (such as levies or seizures) are held in abeyance. Many taxpayers can request an installment agreement by filing form 9465. This form is relatively simple and does not require the submission of detailed financial statements. The IRS in most instances readily approves these requests if the amounts involved are not large (in general, below $10,000) and if the taxpayer has filed tax returns on time in the past. Some taxpayers are required to submit background information to the IRS substantiating their application. If the request for an installment agreement is approved by the IRS, a user fee of $43 is charged. This user fee is in addition to the tax, interest, and penalties that are owed.

Reasons for Change

The Committee believes that the ability to make payments of tax liability by installment enhances taxpayer compliance. In addition, the Committee believes that the IRS should be flexible in finding ways to work with taxpayers who are sincerely trying to meet their obligations. Accordingly, the Committee believes that the IRS should make it easier for taxpayers to enter into installment agreements.

Explanation of Provision

The provision requires the Secretary to enter an installment agreement, at the taxpayer's option, if:

(1) the liability is $10,000, or less (excluding penalties and interest);

(2) within the previous 5 years, the taxpayer has not failed to file or to pay, nor entered an installment agreement under this provision;

(3) if requested by the Secretary, the taxpayer submits financial statements, and the Secretary determines that the taxpayer is unable to pay the tax due in full;

(4) the installment agreement provides for full payment of the liability within 3 years; and

(5) the taxpayer agrees to continue to comply with the tax laws and the terms of the agreement for the period (up to 3 years) that the agreement is in place.

Effective Date

The provision is effective on the date of enactment.

F. DISCLOSURES TO TAXPAYERS

1. Explanation of joint and several liability (sec. 3501 of the bill)

Present Law

In general, spouses who file a joint tax return are each fully responsible for the accuracy of the tax return and for the full liability. Spouses who wish to avoid such joint and several liability may file as married persons filing separately. Special rules apply in the case of innocent spouses pursuant to section 6013(e).

Reasons for Change

The Committee believes that married taxpayers need to clearly understand the legal implications of signing a joint return and that it is appropriate for the IRS to provide the information necessary for that understanding.

Explanation of Provision

The provision requires that, no later than 180 days after the date of enactment, the IRS must establish procedures clearly to alert married taxpayers of their joint and several liability on all appropriate tax publications and instructions and of the availability of electing separate liability. It is anticipated that the IRS will make an appropriate cross-reference to these statements near the signature line on appropriate tax forms.

Effective Date

The provision requires that the procedures be established as soon as practicable, but no later than 180 days after the date of enactment.

2. Explanation of taxpayers' rights in interviews with the IRS (sec. 3502 of the bill)

Present Law

Prior to or at initial in-person audit interviews, the IRS must explain to taxpayers the audit process and taxpayers' rights under that process (sec. 7521). In addition, prior to or at initial in-person collection interviews, the IRS must explain the collection process and taxpayers' rights under that process. If a taxpayer clearly states during an interview with the IRS that the taxpayer wishes to consult with the taxpayer's representative, the interview must be suspended to afford the taxpayer a reasonable opportunity to consult with the representative.

Reasons for Change

The Committee believes that taxpayers should be more fully informed of their rights to representation in dealings with the IRS, and that those rights should be respected.

Explanation of Provision

The provision requires that the IRS rewrite Publication 1 ("Your Rights as a Taxpayer") to more clearly inform taxpayers of their rights (1) to be represented by a representative and (2) if the taxpayer is so represented, that the interview may not proceed without the presence of the representative unless the taxpayer consents.

In addition, the provision requires the Treasury Inspector General for Tax Administration to report annually as to whether IRS employees are directly contacting taxpayers who have indicated that they prefer their representatives be contacted.

Effective Date

The addition to Publication 1 must be made not later than 180 days after the date of enactment. The annual reports would begin in 1999.

3. Disclosure of criteria for examination selection (sec. 3503 of the bill)

Present Law

The IRS examines Federal tax returns to determine the correct liability of taxpayers. The IRS selects returns to be audited in a number of ways, such as through a computerized classification system (the discriminant function ("DIF") system).

Reasons for Change

The Committee believes it is important that taxpayers understand the reasons they may be selected for examination.

Explanation of Provision

The provision requires that IRS add to Publication 1 ("Your Rights as a Taxpayer") a statement which sets forth in simple and nontechnical terms the criteria and procedures for selecting taxpayers for examination. The statement must not include any information the disclosure of which would be detrimental to law enforcement. The statement must specify the general procedures used by the IRS, including whether taxpayers are selected for examination on the basis of information in the media or from informants.

Effective Date

The addition to Publication 1 must be made not later than 180 days after the date of enactment.

4. Explanations of appeals and collection process (sec. 3504 of the bill)

Present Law

There is no statutory requirement that specific notices be given to taxpayers along with the first letter of proposed deficiency that allows the taxpayer an opportunity for administrative review in the IRS Office of Appeals.

Reasons for Change

The Committee believes it is important that taxpayers understand they have a right to have any assessment reviewed by the IRS Office of Appeals, as well as be informed of the steps they must take to obtain that review.

Explanation of Provision

The provision requires that, no later than 180 days after the date of enactment, a description of the entire process from examination through collections, including the assistance available to taxpayers from the Taxpayer Advocate at various points in the process, be provided with the first letter of proposed deficiency that allows the taxpayer an opportunity for administrative review in the IRS Office of Appeals.

Effective Date

The provision requires that the explanation be included as soon as practicable, but no later than 180 days after the date of enactment.

5. Explanation of reason for refund denial (sec. 3505 of the bill and new sec. 6402(j) of the Code)

Present Law

The Examination Division of the IRS examines claims for refund submitted by taxpayers. The Internal Revenue Manual requires examination or other audit action on refund claims within 30 days after receipt of the claims. The refund claim is preliminarily examined to determine if it should be disallowed because it (1) was untimely filed, (2) was based solely on alleged unconstitutionality of the Revenue Acts, (3) was already waived by the taxpayer as consideration for a settlement, (4) covers a taxable year and issues which were the subject of a final closing agreement or an offer in compromise, or (5) relates to a return closed on the basis of a final order of the Tax Court. In those cases, the taxpayer will receive a form from the IRS stating that the claim for refund cannot be considered. Other cases will be examined as quickly as possible and the disposition of the case, including the reasons for the disallowance or partial disallowance of the refund claim, must be stated in the portion of the revenue agent's report that is sent to the taxpayer.

Reasons for Change

The Committee believes that taxpayers are entitled to an explanation of the reason for the disallowance or partial disallowance of a refund claim so that the taxpayer may appropriately respond to the IRS.

Explanation of Provision

The provision requires the IRS to notify the taxpayer of the specific reasons for the disallowance (or partial disallowance) of the refund claim.

Effective Date

The provision is effective 180 days after the date of enactment.

6. Statements to taxpayers with installment agreements (sec. 3506 of the bill)

Present Law

A taxpayer entering into an installment agreement to pay tax liabilities due to the IRS must complete a Form 433–D which sets forth the installment amounts to be paid monthly and the total amount of tax due. The IRS does not provide the taxpayer with an annual statement reflecting the amounts paid and the amount due remaining.

Reasons for Change

The Committee believes that taxpayers who enter into an installment agreement should be kept informed of amounts applied towards the outstanding tax liability and amounts remaining due.

Explanation of Provision

The provision requires the IRS to send every taxpayer in an installment agreement an annual statement of the initial balance owed, the payments made during the year, and the remaining balance.

Effective Date

The provision is effective no later than 180 days after the date of an enactment.

7. Notification of change in tax matters partner (sec. 3507 of the bill and sec. 6231(a)(7) of the Code)

Present Law

In general, the tax treatment of items of partnership income, loss, deductions and credits are determined at the partnership level in a unified partnership proceeding rather than in separate proceedings with each partner. In providing notice to taxpayers with respect to partnership proceedings, the IRS relies on information furnished by a party designated as the tax matters partner (TMP) of the partnership. The TMP is required to keep each partner informed of all administrative and judicial proceedings with respect to the partnership (sec. 6233(g)). Under certain circumstances, the IRS may require the resignation of the incumbent TMP and designate another partner as the TMP of a partnership (sec. 6231(a)(7)).

Reasons for Change

The Committee is concerned that, in cases where the IRS designates the TMP, that the other partners may be unaware of such designation.

Explanation of Provision

The provision requires the IRS to notify all partners of any resignation of the tax matters partner that is required by the IRS, and to notify the partners of any successor tax matters partner.

Effective Date

The provision applies to selections of tax matters partners made by the Secretary after the date of enactment.

G. LOW-INCOME TAXPAYER CLINICS (SEC. 3601 OF THE BILL AND NEW SEC. 7526 OF THE CODE)

Present Law

There are no provisions in present law providing for assistance to clinics that assist low-income taxpayers.

Reasons for Change

The Committee believes that the provision of tax services by accredited nominal fee clinics to low-income individuals and those for whom English is a second language will improve compliance with the Federal tax laws and should be encouraged.

Explanation of Provision

The Secretary is authorized to provide up to $3,000,000 per year in matching grants to certain low-income taxpayer clinics. No clinic could receive more than $100,000 per year.

Eligible clinics would be those that charge no more than a nominal fee to either represent low-income taxpayers in controversies with the IRS or provide tax information to individuals for whom English is a second language.

A "clinic" would include (1) a clinical program at an accredited law school, an accredited business school, or an accredited accounting school, in which students represent low-income taxpayers, or (2) an organization exempt from tax under Code section 501(c) which either represents low-income taxpayers or provides referral to qualified representatives.

Effective Date

The provision is effective on the date of enactment.

H. OTHER PROVISIONS

1. Cataloging complaints (sec. 3701 of the bill)

Present Law

The IRS is required to make an annual report to the Congress, beginning in 1997, on all categories of instances involving allegations of misconduct by IRS employees, arising either from internally identified cases or from taxpayer or third-party initiated complaints. The report must identify the nature of the misconduct or complaint, the number of instances received by category, and the disposition of the complaints.

Reasons for Change

The Committee believes that all allegations of misconduct by IRS employees must be carefully investigated. The Committee also believes that the annual report to Congress will help develop a public perception that the IRS takes such allegations of misconduct seriously. The Committee is concerned that, in the absence of records detailing taxpayer complaints of misconduct on an individual employee basis, the IRS will not be able to adequately investigate such allegations or properly prepare the required report.

Explanation of Provision

The provision requires that, in collecting data for this report, records of taxpayer complaints of misconduct by IRS employees must be maintained on an individual employee basis. These individual records are not to be listed in the report.

Effective Date

The requirement is effective on the date of enactment.

2. Archive of records of Internal Revenue Service (sec. 3702 of the bill and sec. 6103 of the Code)

Present Law

The IRS is obligated to transfer agency records to the National Archives and Records Administration ("NARA") for retention or disposal. The IRS is also obligated to protect confidential taxpayer records from disclosure. These two obligations have created conflict between NARA and the IRS. Under present law, the IRS determines whether records contain taxpayer information. Once the IRS has made that determination, NARA is not permitted to examine those records. NARA has expressed concern that the IRS may be using the disclosure prohibition to improperly conceal agency records with historical significance.

IRS obligation to archive records

The IRS, like all other Federal agencies, must create, maintain, and preserve agency records in accordance with section 3101 of title 44 of the United States Code. NARA is the Government agency responsible for overseeing the management of the records of the Federal government.[37] Federal agencies are required to deposit significant and historical records with NARA.[38] The head of each Federal agency must also establish safeguards against the removal or loss of records.[39]

Authority of NARA

NARA is authorized, under the Federal Records Act, to establish standards for the selective retention of records of continuing value.[40] NARA has the statutory authority to inspect records management practices of Federal agencies and to make recommendations for improvement.[41] The head of each Federal agency must submit to NARA a list of records to be destroyed and a schedule for such destruction.[42] NARA examines the list to determine if any of the records on the list have sufficient administrative, legal research, or other value to warrant their continued preservation. In many cases, the description of the record on the list is sufficient for

[37] 44 U.S.C. sec. 2904.
[38] 5 U.S.C. sec. 552a(b)(6).
[39] 44 U.S.C. sec. 3105.
[40] 44 U.S.C. sec. 2905.
[41] 44 U.S.C. sec. 2904(c)(7).
[42] 44 U.S.C. sec. 3303.

NARA to make the determination. For example, NARA does not need to inspect Presidential tax returns to determine that they have historical value and should be retained. In some cases, NARA may find it helpful to examine a particular record. NARA has general authority to inspect records solely for the purpose of making recommendations for the improvement of records management practices.[43] However, tax returns and return information can only be disclosed under the authority provided in section 6103 of the Internal Revenue Code. There is no exception to the disclosure prohibition for records management inspection by NARA.[44]

In connection with its evaluation of the records management system of the IRS, NARA noted several instances where the disclosure prohibitions of Code section 6103 complicated their review of many IRS records.

NARA is also responsible for the custody, use and withdrawal of records transferred to it.[45] Statutory provisions that restrict public access to the records in the hands of the agency from which the records were transferred also apply to NARA. Thus, if a confidential record, such as a Presidential tax return, is transferred to NARA for archival storage, NARA is not permitted to disclose it. In general, the application of such restrictions to records in the hands of NARA expire after the records have been in existence for 30 years.[46] The issue of whether the specific disclosure prohibition of section 6103 takes precedence over the general 30–year expiration of restrictions generally applicable to records in the hands of NARA has not been addressed by a court, but an informal advisory opinion from the Office of Legal Counsel of the Attorney General concluded that the 30-year expiration provision would not reach records subject to section 6103.[47]

Confidentiality requirements

The IRS must preserve the confidentiality of taxpayer information contained in Federal income tax returns. Such information may not be disclosed except as authorized under Code section 6103. Section 6103 was substantially revised in 1976 to address Congress" concern that tax information was being used by Federal agencies in pursuit of objectives unrelated to administration and enforcement of the tax laws. Congress believed that the widespread use of tax information by agencies other than the IRS could adversely affect the willingness of taxpayers to comply voluntarily with the tax laws and could undermine the country's self- assessment tax system.[48] Section 6103 does not authorize the disclosure of confidential return information to NARA.

Section 6103 restricts the disclosure of returns and return information only. Return means any tax or information return, declaration of estimated tax, or claim for refund, including schedules and attachments thereto, filed with the IRS. Return information includes the taxpayer's name; nature and source or amount of in-

[43] 44 U.S.C. sec. 2906.
[44] *American Friends Service Committee* v. *Webster,* 720 F.2d 29 (D.C. Cir. 1983).
[45] 44 U.S.C. sec. 2108.
[46] 44 U.S.C. sec. 2108.
[47] Department of Justice, Office of Legal Counsel, Memorandum to Richard K. Willard, Assistant Attorney General (Civil Division) (February 27, 1986).
[48] S. Rept. 94–938, p. 317 (1976).

come; and whether the taxpayer's return is under investigation. Section 6103(b)(2) provides that "nothing in any other provision of law shall be construed to require the disclosure of standards used or to be used for the selection of returns for examination, or data used or to be used for determining such standards, if the Secretary determines that such disclosure will seriously impair assessment, collection, or enforcement under the internal revenue laws." Section 6103 does not restrict the disclosure of other records required to be maintained by the IRS, such as records documenting agency policy, programs and activities, and agency histories. Such records are required to be made available to the public under the Freedom of Information Act ("FOIA").[49]

The Internal Revenue Code prohibits disclosure of tax returns and return information, except to the extent specifically authorized by the Internal Revenue Code (sec. 6103). Unauthorized disclosure is a felony punishable by a fine not exceeding $5,000 or imprisonment of not more than five years, or both (sec. 7213). An action for civil damages also may be brought for unauthorized disclosure (sec. 7431).

Reasons for Change

The Committee believes that it is appropriate to permit disclosure to NARA for purposes of scheduling records for destruction or retention, while at the same time preserving the confidentiality of taxpayer information in those documents.

Explanation of Provision

The provision provides an exception to the disclosure rules to require IRS to disclose IRS records to officers or employees of NARA, upon written request from the U.S. Archivist, for purposes of the appraisal of such records for destruction or retention. The present-law prohibitions on and penalties for disclosure of tax information would generally apply to NARA.

Effective Date

The provision is effective for requests made by the Archivist after the date of enactment.

3. Payment of taxes (sec. 3703 of the bill)

Present Law

The Code provides that it is lawful for the Secretary to accept checks or money orders as payment for taxes, to the extent and under the conditions provided in regulations prescribed by the Secretary (sec. 6311). Those regulations state that checks or money orders should be made payable to the Internal Revenue Service.

Reasons for Change

The Committee believes that it more appropriate that checks be made payable to the United States Treasury.

[49] FOIA does not require disclosure of records or information that would frustrate law enforcement efforts. 5 U.S.C. sec. 552(b)(7).

Explanation of Provision

The provision requires the Secretary or his delegate to establish such rules, regulations, and procedures as are necessary to allow payment of taxes by check or money order to be made payable to the United States Treasury.

Effective Date

The provision is effective on the date of enactment.

4. Clarification of authority of Secretary relating to the making of elections (sec. 3704 of the bill and sec. 7805 of the Code)

Present Law

Except as otherwise provided, elections provided by the Code are to be made in such manner as the Secretary shall by regulations or forms prescribe.

Reasons for Change

The Committee wishes to eliminate any confusion over the type of guidance in which the Secretary may prescribe the manner of making any election.

Explanation of Provision

The provision clarifies that, except as otherwise provided, the Secretary may prescribe the manner of making of any election by any reasonable means.

Effective Date

The provision is effective as of the date of enactment.

5. IRS employee contacts (sec. 3705 of the bill)

Present Law

The IRS sends many different notices to taxpayers. Some (but not all) of these notices contain a name and telephone number of an IRS employee who the taxpayer may call if the taxpayer has any questions.

Reasons for Change

The Committee believes that it is important that taxpayers receive prompt answers to their questions about their tax liability. Many taxpayers report frustration because they cannot determine the appropriate IRS employee to contact for information.

Explanation of Provision

The provision requires that all IRS notices and correspondence contain a name and telephone number of an IRS employee whom the taxpayer may call. In addition, to the extent practicable and where it is advantageous to the taxpayer, the IRS should assign one employee to handle a matter with respect to a taxpayer until that matter is resolved.

Effective Date

The provision is effective 60 days after the date of enactment.

6. Use of pseudonyms by IRS employees (sec. 3706 of the bill)

Present Law

The Federal Service Impasses Panel has ruled that if an employee believes that use of the employee's last name only will identify the employee due to the unique nature of the employee's last name, and/or nature of the office locale, then the employee may "register" a pseudonym with the employee's supervisor.

Reasons for Change

The Committee is concerned that IRS employees may use pseudonyms in inappropriate circumstances.

Explanation of Provision

The provision provides that an IRS employee may use a pseudonym only if (1) adequate justification, such as protecting personal safety, for using the pseudonym was provided by the employee as part of the employee's request and (2) management has approved the request to use the pseudonym prior to its use.

Effective Date

The provision is effective with respect to requests made after the date of enactment.

7. Conferences of right in the National Office of IRS (sec. 3707 of the bill)

Present Law

In any matter involving the submission of a substantive legal matter involving a specific taxpayer to the National Office of the IRS, the taxpayer is entitled to at least one conference (the "conference of right") at which it can explain its position.

Reasons for Change

The Committee is concerned that the presence of the IRS employee with whom the taxpayer has previously dealt may hinder efficient resolution of the issue in the National Office.

Explanation of Provision

The provision gives a taxpayer the right to limit participation in its conference of right to IRS national office personnel.

Effective Date

The provision is effective with respect to requests made after the date of enactment.

8. Illegal tax protester designations (sec. 3708 of the bill)

Present Law

The IRS designates individuals who meet certain criteria as "illegal tax protesters" in the IRS Master File.

Reasons for Change

The Committee is concerned that taxpayers may be stigmatized by a designation as an "illegal tax protester."

Explanation of Provision

The provision prohibits the use by the IRS of the "illegal tax protester" designation. Any extant designation in the individual master file (the main computer file) must be removed and any other extant designation (such as on paper records that have been archived) must be disregarded. The IRS is, however, permitted to designate appropriate taxpayers as nonfilers. The IRS must remove the nonfiler designation once the taxpayer has filed valid tax returns for two consecutive years and paid all taxes shown on those returns.

Effective Date

The provision is effective on the date of enactment.

9. Provision of confidential information to Congress by whistleblowers (sec. 3709 of the bill and sec. 6103(f) of the Code)

Present Law

Tax return information generally may not be disclosed, except as specifically provided by statute. The Secretary of the Treasury may furnish tax return information to the Committee on Finance, the Committee on Ways and Means and the Joint Committee on Taxation upon a written request from the chairmen of such committees. If the information can be associated with, or otherwise identify, directly or indirectly, a particular taxpayer, the information may by furnished to the committee only while sitting in closed executive session unless such taxpayer otherwise consents in writing to such disclosure.

Reasons for Change

The Committee believes that it is appropriate to have the opportunity to receive tax return information directly from whistleblowers.

Explanation of Provision

The provision allows any person who is (or was) authorized to receive confidential tax return information to disclose tax return information directly to the Chairman of the Senate Committee on Finance, the Chairman of the House Committee on Ways and Means or the Chief of Staff of the Joint Committee on Taxation provided: (1) such disclosure is for the purpose of disclosing an incident of IRS employee or taxpayer abuse, and (2) the Chairman of the committee to which the information will be disclosed gives prior approval for the disclosure in writing.

Effective Date

The provision is effective on the date of enactment.

10. Listing of local IRS telephone numbers and addresses (sec. 3710 of the bill)

Present Law

The IRS is not statutorily required to publish the local telephone number or address of its local offices, and generally does not do so.

Reasons for Change

The Committee believes that every taxpayer should have convenient access to the IRS.

Explanation of Provision

The provision requires the IRS, as soon as is practicable but no later than 180 days after the date of enactment, to publish addresses and local telephone numbers of local IRS offices in appropriate local telephone directories.

Effective Date

The provision is effective on the date of enactment.

11. Identification of return preparers (sec. 3711 of the bill and sec. 6109(a) of the Code)

Present Law

Any return or claim for refund prepared by an income tax return preparer must bear the social security number of the return preparer, if such preparer is an individual (sec. 6109(a)).

Reasons for Change

The Committee is concerned that inappropriate use might be made of a preparer's social security number.

Explanation of Provision

The provision authorizes the IRS to approve alternatives to Social Security numbers to identify tax return preparers.

Effective Date

The provision is effective on the date of enactment.

12. Offset of past-due, legally enforceable State income tax obligations against overpayments (sec. 3712 of the bill and new sec. 6402(e) of the Code)

Present Law

Overpayments of Federal tax may be used to pay past-due child support and debts owed to Federal agencies (sec. 6402), without the consent of the taxpayer. Such amount for past-due child support may be paid directly to a State. Present law provides that offsets are made in the following priority: (1) child support; and (2) other Federal debts, in the order in which such debts accrued.

Reasons for Change

The Committee believes that it is appropriate to permit States to collect past-due, legally enforceable income tax debts that have been reduced to judgment from Federal tax overpayments.

Explanation of Provision

The provision permits States to participate in the IRS refund offset program for past-due, legally enforceable State income tax debts that have been reduced to judgment, providing the person making the Federal tax overpayment has shown on the return establishing the overpayment an address that is within the State seeking the tax offset. The offset applies after the offsets provided in present law for internal revenue tax liabilities, past-due support, and past-due, legally enforceable obligations owed a Federal agency. The offset occurs before the designation of any refund toward future Federal tax liability.

Effective Date

The provision applies to Federal income tax refunds payable after December 31, 1998.

13. Moratorium regarding regulations under Notice 98–11 (sec. 3713(a)(1) of the bill)

Present Law

Overview

U.S. citizens and residents and U.S. corporations are taxed currently by the United States on their worldwide income, subject to a credit against U.S. tax on foreign-source income for foreign income taxes paid with respect to such income. A foreign corporation generally is not subject to U.S. tax on its income from operations outside the United States.

Income of a foreign corporation generally is taxed by the United States when it is repatriated to the United States through payment to the corporation's U.S. shareholders, subject to a foreign tax credit. However, various regimes imposing current U.S. tax on income earned through a foreign corporation are reflected in the Code. One anti-deferral regime set forth in the Code is the controlled foreign corporation rules of subpart F (secs. 951–964).

A controlled foreign corporation ("CFC") is defined generally as any foreign corporation if U.S. persons own more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only) (sec. 957). Stock ownership includes not only stock owned directly, but also stock owned indirectly or constructively (sec. 958).

The United States generally taxes the U.S. 10–percent shareholders of a CFC currently on their pro rata shares of certain income of the CFC (so-called "subpart F income") (sec. 951). In effect, the Code treats those shareholders as having received a current distribution out of the CFC's subpart F income. Such shareholders also are subject to current U.S. tax on their pro rata shares of the CFC's earnings invested in U.S. property (sec. 951). The foreign tax credit may reduce the U.S. tax on these amounts.

Subpart F income includes, among other items, foreign base company income (sec. 952). Foreign base company income, in turn, includes foreign personal holding company income, foreign base company sales income, foreign base company services income, foreign base company shipping income and foreign base company oil related income (sec. 954). Foreign personal holding company income includes, among other items, dividends, interest, rents and royalties. An exception from foreign personal holding company income applies to certain dividends and interest received from a related person which is created or organized in the same country as the CFC and which has a substantial part of its assets in that country, and to certain rents and royalties received from a related person for the use of property in the same country in which the CFC was created or organized (the so-called "same-country exception").

Foreign base company sales income includes income derived by a CFC from certain related-party transactions, including the purchase of personal property from a related person and its sale to any person, the purchase of personal property from any person and its sale to a related person, and the purchase or sale of personal property on behalf of a related person, where the property which is purchased or sold is manufactured outside the country in which the CFC was created or organized and the property is purchased or sold for use or consumption outside such foreign country. A special branch rule applies for purposes of determining a CFC's foreign base company sales income. Under this rule, a branch of a CFC is treated as a separate corporation (only for purposes of determining the CFC's foreign base company sales income) where the activities of the CFC through the branch outside the CFC's country of incorporation have substantially the same effect as if such branch were a subsidiary.

Because of differences in U.S. and foreign laws, it is possible for a taxpayer to enter into transactions that are treated in one manner for U.S. tax purposes and in another manner for foreign tax purposes. These transactions are referred to as hybrid transactions. For example, a hybrid transaction may involve the use of an entity that is treated as a corporation for purposes of the tax law of one jurisdiction but is treated as a branch or partnership for purposes of the tax law of another jurisdiction.

Notice 98–11 and the regulations issued thereunder

Notice 98–11, issued on January 16, 1998, addresses the treatment of hybrid branches under the subpart F provisions of the Code. The Notice states that the Treasury Department and the Internal Revenue Service have concluded that the use of certain arrangements involving hybrid branches is contrary to the policy and rules of subpart F. The hybrid branch arrangements identified in Notice 98–11 involve structures that are characterized for U.S. tax purposes as part of a CFC but are characterized for purposes of the tax law of the country in which the CFC is incorporated as a separate entity. The Notice states that regulations will be issued to prevent the use of hybrid branch arrangements to reduce foreign tax while avoiding the corresponding creation of subpart F income. The Notice states that such regulations will provide that the branch and the CFC will be treated as separate corporations for purposes of subpart F. The Notice also states that similar issues raised under subpart F by certain partnership or trust arrangements will be addressed in separate regulation projects.

On March 23, 1998, temporary and proposed regulations were issued to address the issues raised in Notice 98–11 and to address certain partnership and other issues raised under subpart F. Under the regulations, certain payments between a CFC and its hybrid branch or between hybrid branches of the CFC (so-called "hybrid branch payments") are treated as giving rise to subpart F income. The regulations generally provide that non-subpart F income of the CFC, in the amount of the hybrid branch payment, is recharacterized as subpart F income of the CFC if: (1) the hybrid branch payment reduces the foreign tax of the payor, (2) the hybrid branch payment would have been foreign personal holding company income if made between separate CFCs, and (3) there is a disparity between the effective tax rate on the payment in the hands of the payee and the effective tax rate that would have applied if the income had been taxed in the hands of the payor. The regulations also apply to other hybrid branch arrangements involving a partnership, including a CFC's proportionate share of any hybrid branch payment made between a partnership in which the CFC is a partner and a hybrid branch of the partnership or between hybrid branches of such a partnership. Under the regulations, if a partnership is treated as fiscally transparent by the CFC's taxing jurisdiction, the recharacterization rules are applied by treating the hybrid branch payment as if it had been made directly between the CFC and the hybrid branch, or as if the hybrid branches of the partnership were hybrid branches of the CFC, as applicable. If the partnership is treated as a separate entity by the CFC's taxing jurisdiction, the recharacterization rules are applied to treat the partnership as if it were a CFC.

The regulations also address the application of the same-country exception to the foreign personal holding company income rules under subpart F in the case of certain hybrid branch arrangements. Under the regulations, the same-country exception applies to payments by a CFC to a hybrid branch of a related CFC only if the payment would have qualified for the exception if the hybrid branch had been a separate CFC incorporated in the jurisdiction in which the payment is subject to tax (other than a withholding tax).

The regulations provide additional rules regarding the application of the same-country exception in the case of certain hybrid arrangements involving a partnership.

The regulations generally apply to amounts paid or accrued pursuant to hybrid branch arrangements entered into or substantially modified on or after January 16, 1998. As a result, the regulations generally do not apply to amounts paid or accrued pursuant to hybrid branch arrangements entered into before January 16, 1998 and not substantially modified on or after that date.

In the case of certain hybrid arrangements involving partnerships, the regulations generally apply to amounts paid or accrued pursuant to such arrangements entered into or substantially modified on or after March 23, 1998. As a result, the regulations generally do not apply to amounts paid or accrued pursuant to such arrangements entered into before March 23, 1998 and not substantially modified on or after that date.

Reasons for Change

Notice 98–11 and the regulations issued thereunder address complex international tax issues relating to the treatment of hybrid transactions under the subpart F provisions of the Code. The impact of such administrative guidance on U.S. businesses operating abroad may be substantial. The Committee believes that it is appropriate to place a moratorium on the implementation of the regulations with respect to Notice 98–11 so that these important issues can be considered by the Congress.

Explanation of Provision

The bill provides that no temporary or final regulations with respect to Notice 98–11 may be implemented prior to six months after the date of enactment of this provision. This moratorium applies to the regulations with respect to hybrid branches and to the regulations with respect to hybrid arrangements involving partnerships. It is intended that the moratorium delaying implementation of the regulations would not require a modification to the effective dates of the regulations. No inference is intended regarding the authority of the Department of the Treasury or the Internal Revenue Service to issue the Notice or the regulations.

Effective Date

The provision is effective on the date of enactment.

14. Sense of the Senate regarding Notices 98–5 and 98–11 (secs. 3713 (a)(2) and (b) of the bill)

Present Law

Overview

U.S. citizens and residents and U.S. corporations are taxed currently by the United States on their worldwide income. U.S. persons may credit foreign taxes against U.S. tax on foreign-source income. The amount of foreign tax credits that can be claimed in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S.-source income. Separate limitations are applied to specific categories of income.

A foreign corporation generally is not subject to U.S. tax on its income from operations outside the United States. Income of a foreign corporation generally is taxed by the United States when it is repatriated to the United States through payment to the corporation's U.S. shareholders, subject to a foreign tax credit. However, various regimes imposing current U.S. tax on income earned through a foreign corporation are reflected in the Code. One antideferral regime set forth in the Code is the controlled foreign corporation rules of subpart F (secs. 951–964).

A controlled foreign corporation ("CFC") is defined generally as any foreign corporation if U.S. persons own more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only) (sec. 957). Stock ownership includes not only stock owned directly, but also stock owned indirectly or constructively (sec. 958).

The United States generally taxes the U.S. 10-percent shareholders of a CFC currently on their pro rata shares of certain income of the CFC (so-called "subpart F income") (sec. 951). In effect, the Code treats those shareholders as having received a current distribution out of the CFC's subpart F income. Such shareholders also are subject to current U.S. tax on their pro rata shares of the CFC's earnings invested in U.S. property (sec. 951). The foreign tax credit may reduce the U.S. tax on these amounts.

Subpart F income includes, among other items, foreign base company income (sec. 952). Foreign base company income, in turn, includes foreign personal holding company income, foreign base company sales income, foreign base company services income, foreign base company shipping income and foreign base company oil related income (sec. 954). Foreign personal holding company income includes, among other items, dividends, interest, rents and royalties. An exception from foreign personal holding company income applies to certain dividends and interest received from a related person which is created or organized in the same country as the CFC and which has a substantial part of its assets in that country, and to certain rents and royalties received from a related person for the use of property in the same country in which the CFC was created or organized (the so-called "same-country exception").

Foreign base company sales income includes income derived by a CFC from certain related-party transactions, including the purchase of personal property from a related person and its sale to any person, the purchase of personal property from any person and its sale to a related person, and the purchase or sale of personal property on behalf of a related person, where the property which is purchased or sold is manufactured outside the country in which the CFC was created or organized and the property is purchased or sold for use or consumption outside such foreign country. A special branch rule applies for purposes of determining a CFC's foreign base company sales income. Under this rule, a branch of a CFC is treated as a separate corporation (only for purposes of determining the CFC's foreign base company sales income) where the activities of the CFC through the branch outside the CFC's country of incorporation have substantially the same effect as if such branch were a subsidiary.

Because of differences in U.S. and foreign laws, it is possible for a taxpayer to enter into transactions that are treated in one manner for U.S. tax purposes and in another manner for foreign tax purposes. These transactions are referred to as hybrid transactions. For example, a hybrid transaction may involve the use of an entity that is treated as a corporation for purposes of the tax law of one jurisdiction but is treated as a branch or partnership for purposes of the tax law of another jurisdiction.

Notices 98–5 and 98–11

Notice 98–5, issued on December 23, 1997, addresses the treatment of certain types of transactions under the foreign tax credit provisions of the Code. The Notice states that the Treasury Department and the Internal Revenue Service have concluded that the use of certain transactions creates the potential for foreign tax credit abuse. The Notice states that such transactions typically involve either: (1) the acquisition of an asset that generates an income stream (e.g., royalties or interest) subject to a foreign withholding tax, or (2) the effective duplication of tax benefits through the use of certain structures designed to exploit inconsistencies between U.S. and foreign tax laws. The Notice includes five specific transactions as illustrations of arrangements creating the potential for foreign tax credit abuse. The Notice states that it is intended that regulations will be issued to disallow foreign tax credits for abusive transactions in cases where the reasonably expected economic profit from the transaction is insubstantial compared to the value of the foreign tax credits expected to be obtained as a result of the arrangement. The Notice further states that it is intended that regulations generally will apply with respect to such transactions for taxes paid or accrued on or after December 23, 1997. Regulations have not yet been issued under Notice 98–5.

Notice 98–11, issued on January 16, 1998, addresses the treatment of hybrid branches under the subpart F provisions of the Code. The Notice states that the Treasury Department and the Internal Revenue Service have concluded that the use of certain arrangements involving hybrid branches is contrary to the policy and rules of subpart F. The hybrid branch arrangements identified in Notice 98–11 involve structures that are characterized for U.S. tax purposes as part of a CFC but are characterized for purposes of the tax law of the country in which the CFC is incorporated as a separate entity. The Notice states that regulations will be issued to prevent the use of hybrid branch arrangements to reduce foreign tax while avoiding the corresponding creation of subpart F income. The Notice states that such regulations will provide that the branch and the CFC will be treated as separate corporations for purposes of subpart F. The Notice also states that similar issues raised under subpart F by certain partnership or trust arrangements will be addressed in separate regulation projects.

On March 23, 1998, temporary and proposed regulations were issued to address the issues raised in Notice 98–11 and to address certain partnership and other issues raised under subpart F. Under the regulations, certain payments between a CFC and its hybrid branch or between hybrid branches of the CFC (so-called "hybrid branch payments") are treated as giving rise to subpart F income. The regulations generally provide that non-subpart F income of the CFC, in the amount of the hybrid branch payment, is recharacterized as subpart F income of the CFC if: (1) the hybrid branch payment reduces the foreign tax of the payor, (2) the hybrid branch payment would have been foreign personal holding company income if made between separate CFCs, and (3) there is a disparity between the effective tax rate on the payment in the hands of the payee and the effective tax rate that would have applied if the income had been taxed in the hands of the payor. The regulations also apply to other hybrid branch arrangements involving a partnership, including a CFC's proportionate share of any hybrid branch payment made between a partnership in which the CFC is a partner and a hybrid branch of the partnership or between hybrid branches of such a partnership. Under the regulations, if a partnership is treated as fiscally transparent by the CFC's taxing jurisdiction, the recharacterization rules are applied by treating the hybrid branch payment as if it had been made directly between the CFC and the hybrid branch, or as if the hybrid branches of the partnership were hybrid branches of the CFC, as applicable. If the partnership is treated as a separate entity by the CFC's taxing jurisdiction, the recharacterization rules are applied to treat the partnership as if it were a CFC.

The regulations also address the application of the same-country exception to the foreign personal holding company income rules under subpart F in the case of certain hybrid branch arrangements. Under the regulations, the same-country exception applies to payments by a CFC to a hybrid branch of a related CFC only if the payment would have qualified for the exception if the hybrid branch had been a separate CFC incorporated in the jurisdiction in which the payment is subject to tax (other than a withholding tax). The regulations provide additional rules regarding the application of the same-country exception in the case of certain hybrid arrangements involving a partnership.

The regulations generally apply to amounts paid or accrued pursuant to hybrid branch arrangements entered into or substantially modified on or after January 16, 1998. As a result, the regulations generally do not apply to amounts paid or accrued pursuant to hybrid branch arrangements entered into before January 16, 1998 and not substantially modified on or after that date.

In the case of certain hybrid arrangements involving partnerships, the regulations generally apply to amounts paid or accrued pursuant to such arrangements entered into or substantially modified on or after March 23, 1998. As a result, the regulations generally do not apply to amounts paid or accrued pursuant to such arrangements entered into before March 23, 1998 and not substantially modified on or after that date.

Reasons for Change

The subpart F provisions of the Code reflect a balancing of various policy objectives. Any modification or refinement to that balance should be the subject of serious and thoughtful debate. It is the Committee's view that any significant policy developments with respect to the subpart F provisions, such as those addressed by Notice 98–11 and the regulations issued thereunder, should be considered by the Congress as part of the normal legislative process. The Committee also believes that any regulations issued under Notice 98–5 should be limited to the specific transactions described therein. Moreover, the Committee is concerned about the potential disruptive effect of the issuance of an administrative notice that describes general principles to be reflected in regulations that will be issued in the future, but provides that such future regulations will be effective as of the date of issuance of the notice.

Explanation of Provision

The bill provides that it is the sense of the Senate that the Department of the Treasury and the Internal Revenue Service should withdraw Notice 98–11 and the regulations issued thereunder, and that the Congress, and not the Department of the Treasury nor the Internal Revenue Service, should determine the international tax policy issues relating to the treatment of hybrid transactions under the subpart F provisions of the Code.

The bill further provides that it is the sense of the Senate that the Department of the Treasury and the Internal Revenue Service should limit any regulations issued under Notice 98–5 to the specific transactions described therein. In addition, such regulations should: (a) not affect transactions undertaken in the ordinary course of business, (b) not have an effective date any earlier than the date of issuance of proposed regulations, and (c) be issued in accordance with normal regulatory procedures which include an opportunity for comment. Nothing in this sense of the Senate should be construed to limit the ability of the Department of the Treasury or the Internal Revenue Service to address abusive transactions.

Effective Date

The provision is effective on the date of enactment.

I. STUDIES

1. Administration of penalties and interest (sec. 3801 of the bill)

Present Law

The last major comprehensive revision of the overall penalty structure in the Internal Revenue Code was the "Improved Penalty Administration and Compliance Tax Act," enacted as part of the Omnibus Budget Reconciliation Act of 1989.

Reasons for Change

The Committee believes that it is appropriate to undertake a study of penalty and interest administration, which will provide the Committee with legislative and administrative recommendations for improvement of the current penalty and interest structure.

Explanation of Provision

The provision requires the Joint Committee on Taxation and the Treasury to each conduct a separate study reviewing the interest and penalty provisions of the Code (including the administration and implementation of the penalty reform provisions of the Omnibus Budget Reconciliation Act of 1989), and making any legislative and administrative recommendations it deems appropriate to simplify penalty administration and reduce taxpayer burden. The studies must also include an analysis of the interest provisions in the Code, including legislative and administrative recommendations deemed appropriate to simplify the administration of the interest provisions and to reduce taxpayer burden.

Effective Date

The reports must be provided not later than nine months after the date of enactment.

2. Confidentiality of tax return information (sec. 3802 of the bill)

Present Law

The Internal Revenue Code prohibits disclosure of tax returns and return information, except to the extent specifically authorized by the Internal Revenue Code (sec. 6103). Unauthorized disclosure is a felony punishable by a fine not exceeding $5,000 or imprisonment of not more than five years, or both (sec. 7213). An action for civil damages also may be brought for unauthorized disclosure (sec. 7431). No tax information may be furnished by the IRS to another agency unless the other agency establishes procedures satisfactory to the IRS for safeguarding the tax information it receives (sec. 6103(p)).

Reasons for Change

The Committee believes that a study of the confidentiality provisions will be useful in assisting the Committee in determining whether improvements can be made to these provisions.

Explanation of Provision

The provision requires the Joint Committee on Taxation and Treasury to each conduct a separate study on provisions regarding taxpayer confidentiality. The studies are to examine present-law protections of taxpayer privacy, the need, if any, for third parties to use tax return information, whether greater levels of voluntary compliance can be achieved by allowing the public to know who is legally required to file tax returns but does not do so, and the interrelationship of the taxpayer confidentiality provisions in the Internal Revenue Code with those elsewhere in the United States Code (such as the Freedom of Information Act).

Effective Date

The findings of the studies, along with any recommendations, are required to be reported to the Congress no later than one year after the date of enactment.

TITLE IV. CONGRESSIONAL ACCOUNTABILITY FOR THE IRS

A. CENTURY DATE CHANGE (SEC. 4001 OF THE BILL)

Present Law

No specific provision.

Reasons for Change

Operations of the IRS computer systems are critical to the viability of the Federal tax system.

Explanation of Provision

The bill provides that it is the sense of the Congress that the IRS should place resolving the century date change computing problems as a high priority. The bill also provides that the Commissioner shall expeditiously submit a report to the Congress on the overall impact of the bill on the ability of the IRS to resolve the century date change computing problems and the provisions of the bill that will require significant amounts of computer programming changes prior to December 31, 1999, in order to carry out the provisions. It is expected that this report will be submitted within 14 days of the date of Committee action on the bill.

Effective Date

The provision is effective on the date of enactment.

B. TAX LAW COMPLEXITY ANALYSIS (SEC. 4002 OF THE BILL)

Present Law

Present law does not require a formal complexity analysis with respect to changes to the tax laws.

Reasons for Change

The National Commission on Restructuring the IRS found a clear connection between the complexity of the Internal Revenue Code and the difficulty of tax law administration and taxpayer frustration. The Committee shares the concern that complexity is a serious problem with the Federal tax system. Complexity and frequent changes in the tax laws create burdens for both the IRS and taxpayers. Failure to address complexity may ultimately reduce voluntary compliance.

The Committee is aware that it may not be possible or desirable to eliminate all complexity in the tax system. There are many objectives of a tax system and particular tax provisions, and simplicity is only one. In some cases other policies, such as fairness, may outweigh concerns about complexity. Nevertheless, the Committee believes complexity of the tax system should be reduced whenever possible. Accordingly, the Committee believes it appropriate to introduce new procedural rules that will focus attention on complexity. The Committee also believes that the tax-writing committees should receive periodic input from the IRS regarding areas of the law that cause problems for taxpayers. This input will be valuable in developing future legislation.

Explanation of Provision

IRS report on complexity

The IRS is to report to the House Ways and Means Committee and the Senate Finance Committee annually regarding sources of complexity in the administration of the Federal tax laws. Factors the IRS may take into account include: (1) frequently asked questions by taxpayers; (2) common errors made by taxpayers in filling out returns; (3) areas of the law that frequently result in disagreements between taxpayers and the IRS; (4) major areas in which there is no or incomplete published guidance or in which the law is uncertain; (5) areas in which revenue agents make frequent errors in interpreting or applying the law; (6) impact of recent legislation on complexity; (7) information regarding forms, including a listing of IRS forms, the time it takes for taxpayers to complete and review forms, the number of taxpayers who use each form, and how the time required changed as a result of recently enacted legislation; and (8) recommendations for reducing complexity in the administration of the Federal tax system.

Complexity analysis with respect to current legislation

The bill requires the Joint Committee on Taxation (in consultation with the IRS and Treasury) to provide an analysis of complexity or administrability concerns raised by tax provisions of widespread applicability to individuals or small businesses. The analysis is to be included in any Committee Report of the House Ways and Means Committee or Senate Finance Committee or Conference Report containing tax provisions, or provided to the Members of the relevant Committee or Committees as soon as practicable after the report is filed. The analysis is to include: (1) an estimate of the number and type of taxpayers affected; and (2) if applicable, the income level of affected individual taxpayers. In addition, such analysis should include, if determinable, the following: (1) the extent to which existing tax forms would require revision and whether a new form or forms would be required; (2) whether and to what extent taxpayers would be required to keep additional records; (3) the estimated cost to taxpayers to comply with the provision; (4) the extent to which enactment of the provision would require the IRS to develop or modify regulatory guidance; (5) whether and to what extent the provision can be expected to lead to disputes between taxpayers and the IRS; and (6) how the IRS can be expected to respond to the provision (including the impact on internal training, whether the Internal Revenue Manual would require revision, whether the change would require reprogramming of computers, and the extent to which the IRS would be required to divert or redirect resources in response to the provision).

Effective Date

The provision requiring the Joint Committee on Taxation to provide a complexity analysis is effective with respect to legislation considered on or after January 1, 1999. The provision requiring the

IRS to report on sources of complexity is effective on the date of enactment.

TITLE V. REVENUE OFFSETS

A. EMPLOYER DEDUCTION FOR VACATION AND SEVERANCE PAY (SEC. 5001 OF THE BILL AND SEC. 404 OF THE CODE)

Present Law

For deduction purposes, any method or arrangement that has the effect of a plan deferring the receipt of compensation or other benefits for employees is treated as a deferred compensation plan (sec. 404(b)). In general, contributions under a deferred compensation plan (other than certain pension, profit-sharing and similar plans) are deductible in the taxable year in which an amount attributable to the contribution is includible in income of the employee. However, vacation pay which is treated as deferred compensation is deductible for the taxable year of the employer in which the vacation pay is paid to the employee (sec. 404(a)(5)).

Temporary Treasury regulations provide that a plan, method, or arrangement defers the receipt of compensation or benefits to the extent it is one under which an employee receives compensation or benefits more than a brief period of time after the end of the employer's taxable year in which the services creating the right to such compensation or benefits are performed. A plan, method or arrangement is presumed to defer the receipt of compensation for more than a brief period of time after the end of an employer's taxable year to the extent that compensation is received after the 15th day of the 3rd calendar month after the end of the employer's taxable year in which the related services are rendered (the "2½ month" period). A plan, method or arrangement is not considered to defer the receipt of compensation or benefits for more than a brief period of time after the end of the employer's taxable year to the extent that compensation or benefits are received by the employee on or before the end of the applicable 2½ month period. (Temp. Treas. Reg. sec. 1.404(b)–1T A–2).

The Tax Court recently addressed the issue of when vacation pay and severance pay are considered deferred compensation in *Schmidt Baking Co., Inc.,* 107 T.C. 271 (1996). In *Schmidt Baking,* the taxpayer was an accrual basis taxpayer with a fiscal year that ended December 28, 1991. The taxpayer funded its accrued vacation and severance pay liabilities for 1991 by purchasing an irrevocable letter of credit on March 13, 1992. The parties stipulated that the letter of credit represented a transfer of substantially vested interest in property to employees for purposes of section 83, and that the fair market value of such interest was includible in the employees' gross incomes for 1992 as a result of the transfer.[50] The Tax Court held that the purchase of the letter of credit, and the resulting income inclusion, constituted payment of the vacation and severance pay within the 2½ month period. Thus, the vacation and severance pay were treated as received by the employees within the 2½ month period and were not treated as deferred compensa-

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[50] While the rules of section 83 may govern the income inclusion, section 404 governs the deduction if the amount involved is deferred compensation.

tion. The vacation pay and severance pay were deductible by the taxpayer for its 1991 fiscal year pursuant to its normal accrual method of accounting.

Reasons for Change

The Committee believes that the decision in *Schmidt Baking* reaches an inappropriate and unintended result. To permit methods such as that used in *Schmidt Baking* to be considered payment or receipt would allow taxpayers to avoid the 2½ month rule and inappropriately accelerate deductions. The Committee believes that the intent of the 2½ month rule was clearly to provide that a deduction for deferred compensation is not available for the current taxable year unless the compensation is actually paid to employees within 2½ months after the end of the year. Moreover, previous legislative histories reflect Congressional intent and understanding that compensation actually paid beyond the 2½ month period is deferred compensation.[51]

Further, the Committee is concerned that taxpayers may inappropriately extend the rationale of *Schmidt Baking* to other situations in which a deduction or other tax consequences are contingent upon an item being paid. The Committee does not believe that, as a general rule, letters of credit and similar mechanisms should be considered payment for any purposes of the Code.

Explanation of Provision

Under the bill, for purposes of determining whether an item of compensation is deferred compensation (under Code sec. 404), the compensation is not considered to be paid or received until actually received by the employee. In addition, an item of deferred compensation is not considered paid to an employee until actually received by the employee. The provision is intended to overrule the result in *Schmidt Baking*. For example, with respect to the determination of whether vacation pay is deferred compensation, the fact that the value of the vacation pay is includible in the income of employees within the applicable 2½ month period would not be relevant. Rather, the vacation pay must have been actually received by employees within the 2½ month period in order for the compensation not to be treated as deferred compensation.

It is intended that similar arrangements, in addition to the letter of credit approach used in Schmidt Baking, do not constitute actual receipt by the employee, even if there is an income inclusion. Thus, for example, actual receipt does not include the furnishing of a note or letter or other evidence of indebtedness of the taxpayer, whether or not the evidence is guaranteed by any other instrument or by any third party. As a further example, actual receipt does not include a promise of the taxpayer to provide service or property in the future (whether or not the promise is evidenced by a contract or other written agreement). In addition, actual receipt does not include an amount transferred as a loan, refundable deposit, or contingent payment. Amounts set aside in a trust for employees are not considered to be actually received by the employee.

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[51] See, e.g., the legislative history to the Omnibus Budget Reconciliation Act of 1987.

The provision does not change the rule under which deferred compensation (other than vacation pay and deferred compensation under qualified plans) is deductible in the year includible in the gross income of employees participating in the plan if separate accounts are maintained for each employee.

While *Schmidt Baking* involved only vacation pay and severance pay, there is concern that this type of arrangement may be tried to circumvent other provisions of the Code where payment is required in order for a deduction to occur. Thus, it is intended that the Secretary will prevent the use of similar arrangements. No inference is intended that the result in *Schmidt Baking* is present law beyond its immediate facts or that the use of similar arrangements is permitted under present law.

The provision does not affect the determination of whether an item is includible in income. Thus, for example, using the mechanism in *Schmidt Baking* for vacation pay could still result in income inclusion to the employees, but the employer would not be entitled to a deduction for the vacation pay until actually paid to and received by the employees.

Effective Date

The provision is effective for taxable years ending after the date of enactment. Any change in method of accounting required by the bill is treated as initiated by the taxpayer with the consent of the Secretary of the Treasury. Any adjustment required by section 481 as a result of the change will be taken into account in the year of the change.

B. MODIFY FOREIGN TAX CREDIT CARRYOVER RULES (SEC. 5002 OF THE BILL AND SEC. 904 OF THE CODE)

Present Law

U.S. persons may credit foreign taxes against U.S. tax on foreign source income. The amount of foreign tax credits that can be claimed in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S. source income. Separate foreign tax credit limitations are applied to specific categories of income.

The amount of creditable taxes paid or accrued (or deemed paid) in any taxable year which exceeds the foreign tax credit limitation is permitted to be carried back two years and forward five years. The amount carried over may be used as a credit in a carryover year to the extent the taxpayer otherwise has excess foreign tax credit limitation for such year. The separate foreign tax credit limitations apply for purposes of the carryover rules.

Reasons for Change

The Committee believes that reducing the carryback period for foreign tax credits to one year and increasing the carryforward period to seven years will reduce some of the complexity associated with carrybacks while continuing to address the timing differences between U.S. and foreign tax rules.

Explanation of Provision

The bill reduces the carryback period for excess foreign tax credits from two years to one year. The bill also extends the excess foreign tax credit carryforward period from five years to seven years.

Effective Date

The provision applies to foreign tax credits arising in taxable years ending after the date of enactment.

C. CLARIFY AND EXPAND MATHEMATICAL ERROR PROCEDURES (SEC. 5003 OF THE BILL AND SEC. 6213(g)(2) OF THE CODE)

Present Law

Taxpayer identification numbers ("TINs")

The IRS may deny a personal exemption for a taxpayer, the taxpayer's spouse or the taxpayer's dependents if the taxpayer fails to provide a correct TIN for each person for whom the taxpayer claims an exemption. This TIN requirement also indirectly effects other tax benefits currently conditioned on a taxpayer being able to claim a personal exemption for a dependent (e.g., head-of-household filing status and the dependent care credit). Other tax benefits, including the adoption credit, the child tax credit, the Hope Scholarship credit and Lifetime Learning credit, and the earned income credit also have TIN requirements. For most individuals, their TIN is their Social Security Number ("SSN"). The mathematical and clerical error procedure currently applies to the omission of a correct TIN for purposes of personal exemptions and all of the credits listed above except for the adoption credit.

Mathematical or clerical errors

The IRS may summarily assess additional tax due as a result of a mathematical or clerical error without sending the taxpayer a notice of deficiency and giving the taxpayer an opportunity to petition the Tax Court. Where the IRS uses the summary assessment procedure for mathematical or clerical errors, the taxpayer must be given an explanation of the asserted error and a period of 60 days to request that the IRS abate its assessment. The IRS may not proceed to collect the amount of the assessment until the taxpayer has agreed to it or has allowed the 60-day period for objecting to expire. If the taxpayer files a request for abatement of the assessment specified in the notice, the IRS must abate the assessment. Any reassessment of the abated amount is subject to the ordinary deficiency procedures. The request for abatement of the assessment is the only procedure a taxpayer may use prior to paying the assessed amount in order to contest an assessment arising out of a mathematical or clerical error. Once the assessment is satisfied, however, the taxpayer may file a claim for refund if he or she believes the assessment was made in error.

Reasons for Change

The Committee believes that it is appropriate to provide additional guidance to the Internal Revenue Service with respect to the application of the TIN requirement. It will also improve compliance to allow the IRS to use date of birth data, from the Social Security Administration, to determine ineligibility for the dependent care credit, the child tax credit and the earned income credit. Once this determination is made, the Committee believes that the IRS should use the mathematical and clerical error procedure to correctly assess the tax due with respect to affected tax returns.

Explanation of Provision

The bill provides in the application of the mathematical and clerical error procedure that a correct TIN is a TIN that was assigned by the Social Security Administration (or in certain limited cases, the IRS) to the individual identified on the return. For this purpose the IRS is authorized to determine that the individual identified on the tax return corresponds in every aspect (including, name, age, date of birth, and SSN) to the individual to whom the TIN is issued. The IRS also is authorized to use the mathematical and clerical error procedure to deny eligibility for the dependent care tax credit, the child tax credit, and the earned income credit even though a correct TIN has been supplied if the IRS determines that the statutory age restrictions for eligibility for any of the respective credits is not satisfied (e.g., the TIN issued for the child claimed as the basis of the child tax credit identifies the child as over the age of 17 at the end of the taxable year).

Effective Date

The provision is effective for taxable years ending after the date of enactment.

D. FREEZE GRANDFATHER STATUS OF STAPLED REITS (SEC. 5004 OF THE BILL)

Present Law

In general

A real estate investment trust ("REIT") is an entity that receives most of its income from passive real estate related investments and that essentially receives pass-through treatment for income that is distributed to shareholders. If an electing entity meets the qualifications for REIT status, the portion of its income that is distributed to the investors each year generally is taxed to the investors without being subjected to a tax at the REIT level. In general, a REIT must derive its income from passive sources and not engage in any active trade or business.

Requirements for REIT status

A REIT must satisfy a number of tests on a year-by-year basis that relate to the entity's (1) organizational structure, (2) source of income, (3) nature of assets, and (4) distribution of income. These tests are intended to allow pass-through treatment only if there is a pooling of investment arrangement, if the entity's investments are basically in real estate assets, and its income is passive income from real estate investment, as contrasted with income from the operation of a business involving real estate. In addition, substantially all of the entity's income must be passed through to its shareholders on a current basis.

Under the organizational structure tests, except for the first taxable year for which an entity elects to be a REIT, the beneficial ownership of the entity must be held by 100 or more persons. Generally, no more than 50 percent of the value of the REIT's stock can be owned by five or fewer individuals during the last half of the taxable year.

Under the source-of-income tests, at least 95 percent of its gross income generally must be derived from rents, dividends, interest and certain other passive sources (the "95-percent test"). In addition, at least 75 percent of its income generally must be from real estate sources, including rents from real property and interest on mortgages secured by real property (the "75-percent test").

For purposes of these tests, rents from real property generally include charges for services customarily rendered in connection with the rental of real property, whether or not such charges are separately stated. Where a REIT furnishes non-customary services to tenants, amounts received generally are not treated as qualifying rents unless the services are furnished through an independent contractor from whom the REIT does not derive any income. In general, an independent contractor is a person who does not own more than a 35-percent interest in the REIT, and in which no more than a 35-percent interest is held by persons with a 35-percent or greater interest in the REIT.

To satisfy the REIT asset requirements, at the close of each quarter of its taxable year, an entity must have at least 75 percent of the value of its assets invested in real estate assets, cash and cash items, and government securities. Not more than 25 percent of the value of the REIT's assets can be invested in securities (other than government securities and other securities described in the preceding sentence). The securities of any one issuer may not comprise more than five percent of the value of a REIT's assets. Moreover, the REIT may not own more than 10 percent of the outstanding securities of any one issuer, determined by voting power.

A REIT is permitted to have a wholly-owned subsidiary subject to certain restrictions. A REIT's subsidiary is treated as one with the REIT.

The income distribution requirement provides generally that at least 95 percent of a REIT's income (with certain minor exceptions) must be distributed to shareholders as dividends.

Stapled REITs

In a stapled REIT structure, both the shares of a REIT and a C corporation may be traded, but are subject to a provision that they may not be sold separately. Thus, the REIT and the C corporation have identical ownership at all times.

In the Deficit Reduction Act of 1984 (the "1984 Act"), Congress required that, in applying the tests for REIT status, all stapled entities are treated as one entity (sec. 269B(a)(3)). The 1984 Act included grandfather rules, one of which provided that certain then-existing stapled REITs were not subject to the new provision (sec. 136(c)(3) of the 1984 Act). That grandfather rule provided that the new provision did not apply to a REIT that was a part of a group of stapled entities if the group of entities was stapled on June 30, 1983, and included a REIT on that date.

Reasons for Change

In the 1984 Act, Congress eliminated the tax benefits of the stapled REIT structure out of concern that it could effectively result in one level of tax on active corporate business income that would otherwise be subject to two levels of tax. Congress also believed that allowing a corporate business to be stapled to a REIT was inconsistent with the policy that led Congress to create REITs.

As part of the 1984 Act provision, Congress provided grandfather relief to the small number of stapled REITs that were already in existence. Since 1984, however, many of the grandfathered stapled REITs have been acquired by new owners. Some have entered into new lines of businesses, and most of the grandfathered REITs have used the stapled structure to engage in large-scale acquisitions of assets. The Committee believes that such unlimited relief from a general tax provision by a handful of taxpayers raises new questions not only of fairness, but of unfair competition, because the stapled REITs are in direct competition with other companies that cannot use the benefits of the stapled structure.

The Committee believes that it would be unfair to remove the benefit of the stapled REIT structure with respect to real estate interests that have already been acquired. On the other hand, the Committee believes that future acquisitions of interests in real property by these grandfathered entities, or improvements of property that are tantamount to new acquisitions, should not be accorded the benefits of the stapled REIT structure. Accordingly, the rules of the Committee bill generally apply with respect to real property interests acquired by the REIT or a stapled entity after March 26, 1998, pursuant to transactions not in progress on that date. Further, the Committee is concerned that the some of the benefit of the stapled REIT structure can be derived through mortgages and interests in subsidiaries and partnerships. Accordingly, the Committee bill provides rules for mortgages acquired after March 26, 1998, and indirect acquisitions of real property interests through entities after such date (with transition relief similar to that for direct acquisitions).

Explanation of Provision

Overview

Under the provision, rules similar to the rules of present law treating a REIT and all stapled entities as a single entity for purposes of determining REIT status (sec. 269B) apply to real property interests acquired after March 26, 1998, by an existing stapled REIT, a stapled entity, or a subsidiary or partnership in which a 10-percent or greater interest is owned by an existing stapled REIT or stapled entity (together referred to as the “stapled REIT group”), unless the real property interest is grandfathered as described below. Special rules apply to certain mortgages acquired by the stapled REIT group after March 26, 1998, where a member of the stapled REIT group performs services with respect to the property secured by the mortgage.

Rules for real property interests

In general

The provision generally applies to real property interests acquired by a member of the stapled REIT group after March 26, 1998. Real property interests that are acquired by a member of the REIT group after such date, and which are not grandfathered under the rules described below, are referred to as "nonqualified real property interests".

The provision treats activities and gross income of a stapled REIT group with respect to nonqualified real property interests held by any member of the stapled REIT group as activities and income of the REIT for certain purposes in the same manner as if the stapled REIT group were a single entity. This treatment applies for purposes of the following provisions that depend on a REIT's gross income: (1) the 95-percent test (sec. 856(c)(2)); (2) the 75-percent test (sec. 856(c)(3)); (3) the "reasonable cause" exception for failure to meet either test (sec. 856(c)(6)); and (4) the special tax on excess gross income for REITs with net income from prohibited transactions (sec. 857(b)(5)).

Thus, for example, where a stapled entity leases nonqualified real property from the REIT and earns gross income from operating the property, such gross income will be subject to the provision. The REIT and the stapled entity will be treated as a single entity, with the result that the lease payments from the stapled entity to the REIT would be ignored. The gross income earned by the stapled entity from operating the property will be treated as gross income of the REIT, with the result that either the 75-percent or 95-percent test might not be met and REIT status might be lost. Similarly, where a stapled entity leases property from a third party after March 26, 1998, and uses that property in a business, the gross income it derives will be treated as income of the REIT because the lease would be a nonqualified real property interest.

Grandfathered real property interests

Under the provision, all real property interests acquired by a member of the stapled REIT group after March 26, 1998, are treated as nonqualified real property interests subject to the general rules described above, unless they qualify under one of the grandfather rules. An option to acquire real property is generally treated as a real property interest for purposes of the provision. However, a real property interest acquired by exercise of an option after March 26, 1998, is treated as a nonqualified real property interest, even though the option was acquired before such date.

Under the provision, grandfathered real property interests include properties acquired by a member of the stapled REIT group after March 26, 1998, pursuant to a written agreement which was binding on March 26, 1998, and all times thereafter. Grandfathered properties also include certain properties, the acquisition of which were described in a public announcement or in a filing with the Securities and Exchange Commission on or before March 26, 1998.

A real property interest does not generally lose its status as a grandfathered interest by reason of a repair to, an improvement of, or a lease of, the real property. Thus, if a REIT leases a grandfathered real property to a stapled entity, a renewal of the lease does not cause the property to lose its grandfathered status, whether the renewal is pursuant to the terms of the lease or otherwise. Similarly, if a REIT owns a grandfathered real property interest that is leased to a third party and, at the expiration of that lease, the REIT leases the property to a stapled entity, the interest would remain a grandfathered interest. Finally, if a stapled entity leases a grandfathered property interest from a third party and the property is repaired or improved, the interest would remain a grandfathered interest except as described below.

An improvement of a grandfathered real property interest will cause loss of grandfathered status and become a nonqualified real property interest in certain circumstances. Any expansion beyond the boundaries of the land of the otherwise grandfathered interest occurring after March 26, 1998, will be treated as a non-qualified real property interest to the extent of such expansion. Moreover, any improvement of an otherwise grandfathered real property interest (within its land boundaries) that is placed in service after December 31, 1999, is treated as a separate nonqualified real property interest in certain circumstances. Such treatment applies where (1) the improvement changes the use of the property and (2) its cost is greater than (a) 200 percent of the undepreciated cost of the property (prior to the improvement) or (b) in the case of property acquired where there is a substituted basis, the fair market value of the property on the date that the property was acquired by the stapled entity or the REIT. There is an exception for improvements placed in service before January 1, 2004, pursuant to a binding contract in effect on December 31, 1999, and at all times thereafter. The rule treating improvements as nonqualified real property interests could apply, for example, if a member of the stapled REIT group constructs a building after December 31, 1999, on previously undeveloped raw land that had been acquired on or before March 26, 1998.

Ownership through entities

If a REIT or stapled entity owns, directly or indirectly, a 10-percent-or-greater interest in a corporate subsidiary or partnership (or other entity described below) that owns a real property interest, the above rules apply with respect to a proportionate part of the entity's real property interest, activities and gross income. Thus, any real property interest acquired by such a subsidiary or partnership that is not grandfathered under the rules described above is treated as a nonqualified real property interest held by the REIT or stapled entity in the same proportion as its ownership interest in the entity. The same proportion of the subsidiary's or partnership's gross income from any nonqualified real property interest owned by it or another member of the stapled REIT group will be treated as income of the REIT under the rules described above. However, an interest in real property acquired by a grandfathered 10-percent-or-greater partnership or subsidiary is treated as grandfathered if such interest would be a grandfathered interest if held directly by the REIT or stapled entity. Thus, for example, if a REIT contributes a grandfathered real property interest to a partnership

10 percent or more of which is owned on March 26, 1998, the interest will not cease to be a grandfathered interest.[52]

Similar rules attributing the proportionate part of the subsidiary's or partnership's real property interests and gross income will apply when a REIT or stapled entity acquires a 10-percent-or-greater interest (or in the case of a previously-owned entity, acquires an additional interest) after March 26, 1998, with exceptions for interests acquired pursuant to binding written agreements or public announcements described above. Transition relief can apply to both an entity's assets and the interest in the entity under the above rules. Thus, if on March 26, 1998, and at all times thereafter, a stapled entity has a binding written contract to buy 10-percent or more of the stock of a corporation and the corporation also has a binding written contract to buy real property, no portion of the property will be treated as a nonqualified real property interest as a result of the transaction.

Under the above rules, gross income of a REIT or stapled entity with respect to a nonqualified real property interest held by a 10-percent-or-greater partnership or subsidiary is subject to the rules for nonqualified real property interests only in proportion to the interest held in the partnership or subsidiary. For example, assume that a stapled entity has a contract to manage a nonqualified real property interest held by a partnership in which the stapled entity owns an 85-percent interest. Under the above rules, for purposes of applying the gross income tests, 85 percent of the partnership's activities and gross income from the property are attributed to the REIT. As a result, 85 percent of the stapled entity's income from the management contract is ignored under the single-entity analysis described above. The remaining 15 percent of the management fee is not treated as gross income of the REIT because it is not income from a nonqualified real property interest held or deemed held by the REIT or a stapled entity.

Grandfathered real property interests that are deemed owned by a REIT or a stapled entity under the rules for 10-percent-or-greater interests will not be treated as acquired after March 26, 1998, if the REIT or a stapled entity subsequently becomes the actual owner. For example, assume a REIT has a 50-percent interest in a partnership that distributes a grandfathered real property interest to the REIT in complete liquidation of its interest. The 50-percent interest that was previously deemed owned by the REIT will continue to be grandfathered; the remaining 50-percent interest will be a nonqualified real property interest because it was acquired by the REIT after March 26, 1998.

Mortgage rules

Under the provision, special rules apply where a member of the stapled REIT group holds a mortgage (that is not an existing obligation under the rules described below) that is secured by an interest in real property, and a member of the stapled REIT group engages in certain activities with respect to that property. The activi-

[52] Nevertheless, under the rules below, if the REITs partnership interest increases as a result of the contribution, a portion of each of the partnership's real estate interests, reflecting the proportionate increase in the partnership interest, will be treated as a nonqualified real property interest.

ties that have this effect under the provision are activities that would result in impermissible tenant service income (as defined in sec. 856(d)(7)) if performed by the REIT with respect to property it held. In such a case, all interest on the mortgage that is allocable to that property and all gross income received by a member of the stapled REIT group from the activity will be treated as impermissible tenant service income of the REIT, which is not qualifying income under either the 75-percent or 95-percent tests. For example, assume that the REIT makes a mortgage loan on a hotel owned by a third party which is operated by a stapled entity under a management contract. Unless an exception applies, both the management fees earned by the stapled entity and the interest earned by the REIT will be treated as impermissible tenant services income of the REIT.

An exception to the above rules is provided for mortgages the interest on which does not exceed an arm's-length rate and which would be treated as interest for purposes of the REIT rules. An exception also is available for mortgages that are held by a member of the stapled REIT group on March 26, 1998, and at all times thereafter, and which are secured by an interest in real property on that date, and at all times thereafter (the "existing mortgage exception"). The existing mortgage exception ceases to apply if the mortgage is refinanced and the principal amount is increased in such refinancing.

In the case of a partnership or subsidiary in which the REIT or a stapled entity owns a 10-percent-or-greater interest, a proportionate part of the entity's mortgages, interest and gross income from activities would be attributed to the REIT or the stapled entity, subject to rules similar to those for nonqualified real property interests. Thus, if a REIT or a stapled entity acquires a 10-percent-or-greater interest in a partnership or corporation after March 26, 1998, no mortgage held by the partnership or subsidiary at such time would qualify for the existing mortgage exception. Similarly, if a REIT or stapled entity owns a 10-percent-or-greater interest in a partnership or subsidiary on March 26, 1998, and the REIT or the stapled entity subsequently acquires a greater interest, a portion of each of the partnership's or subsidiary's mortgages that is the same as the proportionate increase in the ownership interest would fail to qualify for the existing mortgage exception.

Under the provision's priority rules, the mortgage rules do not apply to any part of a real property interest that is owned or deemed owned by the REIT or a stapled entity under the rules for real property interests described above. Thus, for example, if the REIT makes a mortgage loan on real property owned by a stapled entity, the mortgage rules would not apply. If the property is a nonqualified real property interest, the interest on the mortgage would be ignored under the single-entity analysis described above, and the gross income of the stapled entity from the property would be treated as income of the REIT. Similarly, assume that a stapled entity owns 75 percent of the stock of a subsidiary and has a management contract to operate a hotel owned by the subsidiary. Assume also that the REIT makes a mortgage loan for the hotel. Under the real property interest rules, 75 percent of the hotel is treated as owned by the stapled entity. Thus, if the hotel is a nonqualified real property interest, 75 percent of the subsidiary's gross income from the hotel is treated as income of the REIT and 75 percent of the income on the management contract is ignored under the single-entity analysis. With respect to the remaining 25-percent interest in the subsidiary, the real property interest rules do not apply, but the mortgage rules would treat 25 percent of the mortgage interest and 25 percent of management contract income as impermissible tenant services income of the REIT.

Other rules

For purposes of both the real property interest and mortgage rules, if a stapled REIT is not stapled as of March 26, 1998, and at all times thereafter, or if it fails to qualify as a REIT as of such date or any time thereafter, no assets of any member of the stapled REIT group would qualify under the grandfather rules. Thus, all of the real property interests held by the group would be non-qualified real property interests and none of the mortgages held by the group would qualify for the existing mortgage exception.

For a corporate subsidiary owned by a stapled entity, the 10-percent ownership test would be met if a stapled entity owns, directly or indirectly, 10 percent or more of the corporation's stock, by either vote or value.[53] For this purpose, any change in proportionate ownership that is attributable solely to fluctuations in the relative fair market values of different classes of stock is not taken into account. For interests in partnerships, the ownership test would be met if either the REIT or a stapled entity owns, directly or indirectly, a 10-percent or greater interest in the partnership's assets or net profits. Interests in other entities, such as trusts, are treated in the same manner as 10-percent-or-greater interests in partnerships or corporations if the REIT or a stapled entity owns, directly or indirectly, 10 percent or more of the beneficial interests in the entity.

Under the provision, terms used that are also used in the stapled stock rules (sec. 269B) or the REIT rules (sec. 856) have the same meanings as under those rules.

The Secretary of the Treasury is given authority to prescribe such guidance as may be necessary or appropriate to carry out the purposes of the provision, including guidance to prevent the double counting of income and to prevent transactions that would avoid the purposes of the provision.

Effective Date

The provision is effective for taxable years ending after March 26, 1998.

[53] The provision does not apply to a stapled REIT's ownership of a corporate subsidiary, although the REIT would be subject to the normal restrictions on a REIT's ownership of stock in a corporation.

E. MAKE CERTAIN TRADE RECEIVABLES INELIGIBLE FOR MARK-TO-MARKET TREATMENT (SEC. 5005 OF THE BILL AND SEC. 475 OF THE CODE)

Present Law

In general, dealers in securities are required to use a mark-to-market method of accounting for securities (sec. 475). Exceptions to the mark-to-market rule are provided for securities held for investment, certain debt instruments and obligations to acquire debt instruments and certain securities that hedge securities. A dealer in securities is a taxpayer who regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business, or who regularly offers to enter into, assume, offset, assign, or otherwise terminate positions in certain types of securities with customers in the ordinary course of a trade or business. A security includes (1) a share of stock, (2) an interest in a widely held or publicly traded partnership or trust, (3) an evidence of indebtedness, (4) an interest rate, currency, or equity notional principal contract, (5) an evidence of an interest in, or derivative financial instrument in, any of the foregoing securities, or any currency, including any option, forward contract, short position, or similar financial instrument in such a security or currency, or (6) a position that is an identified hedge with respect to any of the foregoing securities.

Treasury regulations provide that if a taxpayer would be a dealer in securities only because of its purchases and sales of debt instruments that, at the time of purchase or sale, are customer paper with respect to either the taxpayer or a corporation that is a member of the same consolidated group, the taxpayer will not normally be treated as a dealer in securities. However, the regulations allow such a taxpayer to elect out of this exception to dealer status.[54] For this purpose, a debt instrument is customer paper with respect to a person if: (1) the person's principal activity is selling nonfinancial goods or providing nonfinancial services; (2) the debt instrument was issued by the purchaser of the goods or services at the time of the purchase of those goods and services in order to finance the purchase; and (3) at all times since the debt instrument was issued, it has been held either by the person selling those goods or services or by a corporation that is a member of the same consolidated group as that person.

Reasons for Change

Congress enacted the mark-to-market rules of section 475 to provide a more accurate reflection of the income of securities dealers. The Committee does not believe that these provisions were intended to be used by taxpayers whose principal activity is selling goods and services to obtain a deduction for loss in value of their receivables at a time earlier than otherwise would be permitted.

Explanation of Provision

The provision provides that certain trade receivables are not eligible for mark-to-market treatment. A trade receivable is covered

[54] Treas. reg. sec. 1.475(c)–1(b), issued December 23, 1996; the "customer paper election."

by the provision if it is a note, bond or debenture arising out of the sale of goods by a person the principal activity of which is selling or providing nonfinancial goods and services and it is held by such person or a related person at all times since it was issued.

Under the provision, a receivable meeting the above definition is not treated as a security for purposes of the mark-to-market rules (sec. 475). Thus, such receivables are not marked-to-market, even if the taxpayer qualifies as a dealer in other securities. Because trade receivables cease to meet the above definition when they are disposed of (other than to a related person), a taxpayer who regularly sells trade receivables is treated as a dealer in securities as under present law, with the result that the taxpayer's other securities would be subject to mark-to-market treatment unless an exception to section 475 applies (such as that for securities identified as held for investment).

Effective Date

The provision generally is effective for taxable years ending after the date of enactment. Adjustments required under section 481 as a result of the change in method of accounting generally are required to be taken into account ratably over the four-year period beginning in the first taxable year for which the provision is in effect. However, where the taxpayer terminates its existence or ceases to engage in the trade or business that generated the receivables (except as a result of a tax-free transfer), any remaining balance of the section 481 adjustment is taken into account entirely in the year of such cessation or termination (see sec. 5.04(c) of Rev. Proc. 97–37, 1997–33 I.R.B. 18).

F. ADD VACCINES AGAINST ROTAVIRUS GASTROENTERITIS TO THE LIST OF TAXABLE VACCINES (SEC. 5006 OF THE BILL AND SEC. 4132 OF THE CODE)

Present Law

A manufacturer's excise tax is imposed at the rate of 75 cents per dose (sec. 4131) on the following vaccines routinely recommended for administration to children: diphtheria, pertussis, tetanus, measles, mumps, rubella, polio, HIB (haemophilus influenza type B), hepatitis B, and varicella (chicken pox). The tax applied to any vaccine that is a combination of vaccine components equals 75 cents times the number of components in the combined vaccine.

Amounts equal to net revenues from this excise tax are deposited in the Vaccine Injury Compensation Trust Fund to finance compensation awards under the Federal Vaccine Injury Compensation Program for individuals who suffer certain injuries following administration of the taxable vaccines. This program provides a substitute Federal, "no fault" insurance system for the State-law tort and private liability insurance systems otherwise applicable to vaccine manufacturers. All persons immunized after September 30, 1988, with covered vaccines must pursue compensation under this Federal program before bringing civil tort actions under State law.

Reasons for Change

Rotavirus gastroenteritis is a highly contagious disease among young children that can lead to life-threatening diarrhea, cramps, vomiting, and can result in death. In the United States, more than 50,000 children are hospitalized and more than 100 die annually from rotavirus gastroenteritis. The Food and Drug Administration's ("FDA") advisory committee has favorably reviewed a vaccine against the disease and the Centers for Disease Control have voted to recommend the vaccine for inoculation of children, subject to final FDA approval. The Committee believes American children will benefit from wide use of this new vaccine. The Committee believes that, by including the new vaccine with those presently covered by the Vaccine Injury Compensation Trust Fund, greater application of the vaccine will be promoted. The Committee, therefore, believes it is appropriate to add the vaccine against rotavirus gastroenteritis to the list of taxable vaccines.

Explanation of Provision

The bill adds any vaccine against rotavirus gastroenteritis to the list of taxable vaccines.

Effective Date

The provision is effective for vaccines sold by a manufacturer or importer after the date of enactment. For sales on or before the date of enactment for which delivery is made after the date of enactment, the delivery date is deemed to be the sale date.

TITLE VI. TAX TECHNICAL CORRECTIONS

TECHNICAL CORRECTIONS TO THE TAXPAYER RELIEF ACT OF 1997

A. AMENDMENTS TO TITLE I OF THE 1997 ACT RELATING TO THE CHILD CREDIT

1. Stacking rules for the child credit under the limitations based on tax liability (sec. 6003(a) of the bill, sec. 101(a) of the 1997 Act, and sec. 24 of the Code)

Present Law

Present law provides a $500 ($400 for taxable year 1998) tax credit for each qualifying child under the age of 17. A qualifying child is defined as an individual for whom the taxpayer can claim a dependency exemption and who is a son or daughter of the taxpayer (or a descendent of either), a stepson or stepdaughter of the taxpayer or an eligible foster child of the taxpayer. For taxpayers with modified adjusted gross income in excess of certain thresholds, the allowable child credit is phased out. The length of the phase-out range is affected by the number of the taxpayer's qualifying children.

Generally, the maximum amount of a taxpayer's child credit for each taxable year is limited to the excess of the taxpayer's regular tax liability over the taxpayer's tentative minimum tax liability (determined without regard to the alternative minimum foreign tax credit). In the case of a taxpayer with three or more qualifying children, the maximum amount of the taxpayer's child credit for each taxable year is limited to the greater of: (1) the amount computed under the rule described above, or (2) an amount equal to the excess of the sum of the taxpayer's regular income tax liability and the employee share of FICA taxes (and one-half of the taxpayer's SECA tax liability, if applicable) reduced by the earned income credit. In the case of a taxpayer with three or more qualifying children, the excess of the amount allowed in (2) over the amount computed in (1) is a refundable credit.

Nonrefundable credits may not be used to reduce tax liability below a taxpayer's tentative minimum tax. Certain credits not used as result of this rule may be carried over to other taxable years, while others may not. Special stacking rules apply in determining which nonrefundable credits are used in the current year. Generally, the stacking rules require that nonrefundable personal credits be considered first,[55] followed by other credits, business credits, and the investment tax credit. Refundable credits, which are not limited by the minimum tax, are not stacked until after the nonrefundable credits.

Explanation of Provision

The bill clarifies the application of the income tax liability limitation to the refundable portion of the child credit by treating the refundable portion of the child credit in the same way as the other refundable credits. Specifically, after all the other credits are applied according to the stacking rules of the income tax limitation then the refundable credits are applied first to reduce the taxpayer's tax liability for the year and then to provide a credit in excess of income tax liability for the year.

Effective Date

The provision is effective for taxable years beginning after December 31,

2. Treatment of a portion of the child credit as a supplemental child credit (sec. 6003(b) of the bill, sec. 101(b) of the 1997 Act, and sec. 32(n) of the Code)

Present Law

A portion of the child credit may be treated as a supplemental child credit. The supplemental child credit is treated as provided under the earned income credit and the child credit amount is reduced by the amount of the supplemental child credit.

[55] It is understood that there is also a stacking rule under which the income tax liability limitation applies between the nonrefundable personal credits, including the nonrefundable portion of the child credit. Generally, the nonrefundable portion of the child credit and the other nonrefundable personal credits which do not provide a carryforward are grouped together and stacked first followed by the nonrefundable personal credits which provide a carryforward for purposes of applying the income tax liability limitation. Therefore, if the sum of the taxpayer's nonrefundable credits exceeds the difference between the taxpayer's regular income tax liability and the taxpayer's tentative minimum tax (determined without regard to the alternative minimum foreign tax credit) then the nonrefundable personal credits which do not provide a carryforward would be applied to reduce the income tax liability for that year first and any excess credits which allow a carryforward would be available to reduce the taxpayer's income tax liability in future years.

Explanation of Provision

The bill clarifies that the treatment of a portion of the child credit as a supplemental child credit under the earned income credit (sec. 32) and the offsetting reduction of the child credit (sec. 24) does not affect the total tax credits allowed to the taxpayer or any other tax credit available to the taxpayer. Rather, it simply reduces the otherwise allowable nonrefundable child credit dollar-for-dollar by the amount treated as a supplemental child credit. The bill also clarifies that the amount of the supplemental child credit under section 32(n) is the lesser of (1) the amount by which the taxpayer's total nonrefundable personal credits (as limited by the tax liability limitation of section 26(a)) are increased by reason of the child credit, or (2) the "negative" tax liability of the taxpayer, defined as the excess of taxpayer's total tax credits, including the earned income credit over the sum of the taxpayer's regular income taxes and social security taxes. For purposes of this calculation, subsection 32(n) is not taken into account. The bill also clarifies that the earned income credit rules (e.g., the phaseout of the earned income credit) generally do not apply to the supplemental child credit.

Effective Date

The provision is effective for taxable years beginning after December 31, 1997.

B. AMENDMENTS TO TITLE II OF THE 1997 ACT RELATING TO EDUCATION INCENTIVES

1. Clarifications to HOPE and Lifetime Learning tax credits (sec. 6004(a) of the bill, sec. 201 of the 1997 Act, and secs. 25A and 6050S of the Code)

Present Law

Individual taxpayers are allowed to claim a nonrefundable HOPE credit against Federal income taxes up to $1,500 per student for qualified tuition and fees paid during the year on behalf of a student (i.e., the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer) who is enrolled in a post-secondary degree or certificate program at an eligible post-secondary institution on at least a half-time basis. The HOPE credit is available only for the first two years of a student's post-secondary education. The credit rate is 100 percent of the first $1,000 of qualified tuition and fees and 50 percent on the next $1,000 of qualified tuition and fees. The HOPE credit amount that a taxpayer may otherwise claim is phased out for taxpayers with modified adjusted gross income (AGI) between $40,000 and $50,000 ($80,000 and $100,000 for joint returns). For taxable years beginning after 2001, the $1,500 maximum HOPE credit amount and the AGI phase-out range will be indexed for inflation. The HOPE credit is available for expenses paid after December 31, 1997, for education furnished in academic periods beginning after such date.

If a student is not eligible for the HOPE credit (or in lieu of claiming a HOPE credit with respect to a student), individual taxpayers are allowed to claim a nonrefundable Lifetime Learning credit against Federal income taxes equal to 20 percent of qualified tuition and fees paid during the taxable year on behalf of the taxpayer, the taxpayer's spouse, or a dependent. In contrast to the HOPE credit, the student need not be enrolled on at least a half-time basis in order to be eligible for the Lifetime Learning credit, which is available for an unlimited number of years of post-secondary training. For expenses paid before January 1, 2003, up to $5,000 of qualified tuition and fees per taxpayer return will be eligible for the Lifetime Learning credit (i.e., the maximum credit per taxpayer return will be $1,000). For expenses paid after December 31, 2002, up to $10,000 of qualified tuition and fees per taxpayer return will be eligible for the Lifetime Learning credit (i.e., the maximum credit per taxpayer return will be $2,000). The Lifetime Learning credit amount that a taxpayer may otherwise claim is phased out over the same modified AGI phase-out range as applies for purposes of the HOPE credit. The Lifetime Learning credit is available for expenses paid after June 30, 1998, for education furnished in academic periods beginning after such date.

Section 6050S provides that certain educational institutions and other taxpayers engaged in a trade or business must file information returns with the IRS and certain individual taxpayers, as required by regulations prescribed by the Secretary of the Treasury, containing information on individuals who made payments for qualified tuition and related expenses or to whom reimbursements or refunds were made of such expenses.

Explanation of Provision

The bill clarifies that, under section 6050S, information returns containing information with respect to qualified tuition and fees must be filed by a person that is not an eligible educational institution only if such person is engaged in a trade or business of making payments to any individual under an insurance arrangement as reimbursements or refunds (or similar payments) of qualified tuition and related expenses. As under present law, section 6050S will continue to require the filing of information returns by persons engaged in a trade or business if, in the course of such trade or business, the person receives from any individual interest aggregating $600 or more for any calendar year on one or more qualified education loans.

Effective Date

The provision is effective as if included in the 1997 Act—i.e., for expenses paid after December 31, 1997, for education furnished in academic periods beginning after such date.

2. Education IRAs (sec. 6004(d) of the bill, sec. 213 of the 1997 Act, and sec. 530 of the Code)

Present Law

Section 530 provides that taxpayers may establish "education IRAs," meaning certain trusts or custodial accounts created exclusively for the purpose of paying qualified higher education expenses of a named beneficiary. Annual contributions to education IRAs may not exceed $500 per designated beneficiary, and may not be made after the designated beneficiary reaches age 18. Contributions to an education IRA may not be made by certain high-income taxpayers—i.e., the contribution limit is phased out for taxpayers with modified adjusted gross income between $95,000 and $110,000 ($150,000 and $160,000 for taxpayers filing joint returns). No contribution may be made to an education IRA during any year in which any contributions are made by anyone to a qualified State tuition program on behalf of the same beneficiary.

Until a distribution is made from an education IRA, earnings on contributions to the account generally are not subject to tax.[56] In addition, distributions from an education IRA are excludable from gross income to the extent that the distribution does not exceed qualified higher education expenses incurred by the beneficiary during the year the distribution is made (provided that a HOPE credit or Lifetime Learning credit is not claimed with respect to the beneficiary for the same taxable year). The earnings portion of an education IRA distribution not used to pay qualified higher education expenses is includible in the gross income of the distributee and generally is subject to an additional 10-percent tax.[57] However, the additional 10-percent tax does not apply if a distribution is made of excess contributions above the $500 limit (and any earnings attributable to such excess contributions) if the distribution is made on or before the date that a return is required to be filed (including extensions of time) by the contributor for the year in which the excess contribution was made. In addition, section 530 allows tax-free rollovers of account balances from an education IRA benefiting one family member to an education IRA benefiting another family member. Section 530 is effective for taxable years beginning after December 31, 1997.

Explanation of Provision

Consistent with the legislative history to the 1997 Act, the bill provides that any balance remaining in an education IRA will be deemed to be distributed within 30 days after the date that the designated beneficiary reaches age 30 (or, if earlier, within 30 days of the date that the beneficiary dies). The bill further clarifies that, in the event of the death of the designated beneficiary, the balance remaining in an education IRA may be distributed (without imposition of the additional 10-percent tax) to any other (i.e., contingent) beneficiary or to the estate of the deceased designated beneficiary. If any member of the family of the deceased beneficiary becomes the new designated beneficiary of an education IRA, then no tax will be imposed on such redesignation and the account will continue to be treated as an education IRA.

Under the bill, the additional 10-percent tax provided for by section 530(d)(4) will not apply to a distribution from an education IRA, which (although used to pay for qualified higher education expenses) is includible in the beneficiary's gross income solely be-

[56] However, education IRAs are subject to the unrelated business income tax ("UBIT") imposed by section 511.

[57] This 10-percent additional tax does not apply if a distribution from an education IRA is made on account of the death, disability, or scholarship received by the designated beneficiary.

cause the taxpayer elects to claim a HOPE or Lifetime Learning credit with respect to the beneficiary. The bill further provides that the additional 10-percent tax will not apply to the distribution of any contribution to an education IRA made during a taxable year if such distribution is made on or before the date that a return is required to be filed (including extensions of time) by the *beneficiary* for the taxable year during which the contribution was made (or, if the beneficiary is not required to file such a return, April 15th of the year following the taxable year during which the contribution was made). In addition, the bill amends section 4973(e) to provide that the excise tax penalty applies under that section for each year that an excess contribution remains in an education IRA (and not merely the year that the excess contribution is made).

The bill clarifies that, in order for taxpayers to establish an education IRA, the designated beneficiary must be a life-in-being. The bill also clarifies that, under rules contained in present-law section 72, distributions from education IRAs are treated as representing a pro-rata share of the principal (i.e., contributions) and accumulated earnings in the account.[58]

The bill also provides that, if any qualified higher education expenses are taken into account in determining the amount of the exclusion under section 530 for a distribution from an education IRA, then no deduction (under section 162 or any other section), or exclusion (under section 135) or credit will be allowed under the Internal Revenue Code with respect to such qualified higher education expenses.

In addition, because the 1997 Act allows taxpayers to redeem U.S. Savings Bonds and be eligible for the exclusion under present-law section 135 (as if the proceeds were used to pay qualified higher education expenses) provided the proceeds from the redemption are contributed to an education IRA (or to a qualified State tuition program defined under section 529) on behalf of the taxpayer, the taxpayer's spouse, or a dependent, the bill conforms the definition of "eligible educational institution" under section 135 to the broader definition of that term under present-law section 530 (and section 529). Thus, for purposes of section 135, as under present-law sections 529 and 530, the term "eligible educational institution" is defined as an institution which (1) is described in section 481 of the Higher Education Act of 1965 (20 U.S.C. 1088) and (2) is eligible to participate in Department of Education student aid programs.

[58] For example, if an education IRA has a total balance of $10,000, of which $4,000 represents principal (i.e., contributions) and $6,000 represents earnings, and if a distribution of $2,000 is made from such an account, then $800 of that distribution will be treated as a return of principal (which under no event is includible in the gross income of the distributee) and $1,200 of the distribution will be treated as accumulated earnings. In such a case, if qualified higher education expenses of the beneficiary during the year of the distribution are at least equal to the $2,000 total amount of the distribution (i.e., principal plus earnings), then the entire earnings portion of the distribution will be excludible under section 530, provided that a Hope credit or Lifetime Learning credit is not claimed for that same taxable year on behalf of the beneficiary. If, however, the qualified higher education expenses of the beneficiary for the taxable year are less than the total amount of the distribution, then only a portion of the earnings will be excludable from gross income under section 530. Thus, in the example discussed above, if the beneficiary incurs only $1,500 of qualified higher education expenses in the year that a $2,000 distribution is made, then only $900 of the earnings will be excludable from gross income under section 530 (i.e., an exclusion will be provided for the pro-rata portion of the earnings, based on the ratio that the $1,500 of qualified higher education expenses bears to the $2,000 distribution) and the remaining $300 of the earnings portion of the distribution will be includible in the distributee's gross income.

Effective Date

The provisions are effective as if included in the 1997 Act—i.e., for taxable years beginning after December 31, 1997.

3. Treatment of cancellation of certain student loans (6004(f) of the bill, sec. 225 of the 1997 Act, and sec. 108(f) of the Code)

Present Law

Under present law, an individual's gross income does not include forgiveness of loans made by tax-exempt educational organizations if the proceeds of such loans are used to pay costs of attendance at an educational institution or to refinance outstanding student loans and the student is not employed by the lender organization. The exclusion applies only if the forgiveness is contingent on the student's working for a certain period of time in certain professions for any of a broad class of employers. In addition, the student's work must fulfill a public service requirement.

Explanation of Provision

The bill clarifies that gross income does not include amounts from the forgiveness of loans made by educational organizations and certain tax-exempt organizations to refinance *any* existing student loan (and not just loans made by educational organizations). In addition, the bill clarifies that refinancing loans made by educational organizations and certain tax-exempt organizations must be made pursuant to a program of the refinancing organization (e.g., school or private foundation) that requires the student to fulfill a public service work requirement.

Effective Date

The provision is effective as of August 5, 1997, the date of enactment of the 1997 Act.

4. Deduction for student loan interest (sec. 6004(b) of the bill, sec. 202 of the 1997 Act, and sec. 221 of the Code)

Present Law

Certain individuals who have paid interest on qualified education loans may claim an above-the-line deduction for such interest expenses, up to a maximum deduction of $2,500 per year. The deduction is allowed only with respect to interest paid on a qualified education loan during the first 60 months in which interest payments are required. In this regard, required payments of interest do not include nonmandatory payments, such as interest payments made during a period of loan forbearance. Months during which the qualified education loan is in deferral or forbearance do not count against the 60-month period. No deduction is allowed to an individual if that individual is claimed as a dependent on another taxpayer's return for the taxable year.

A qualified education loan generally is defined as any indebtedness incurred to pay for the qualified higher education expenses of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred in attending (1) post-secondary educational institutions and certain vocational schools defined by reference to section 481 of the Higher Education Act of 1965, or (2) institutions conducting internship or residency programs leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training.

Explanation of Provision

The bill clarifies that the student loan interest deduction may be claimed only by a taxpayer who is legally obligated to make the interest payments pursuant to the terms of the loan.

Effective Date

The provision is effective for interest payments due and paid after December 31, 1997, on any qualified education loan.

5. Enhanced deduction for corporate contributions of computer technology and equipment (sec. 6004(e) of the bill, sec. 224 of the 1997 Act, and sec. 170(e)(6) of the Code)

Present Law

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the fair market value of property contributed to a charitable organization. However, in the case of a charitable contribution of inventory or other ordinary-income property, short-term capital gain property, or certain gifts to private foundations, the amount of the deduction is limited to the taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, a taxpayer's deduction is limited to the adjusted basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose.

The Taxpayer Relief Act of 1997 provided that certain contributions of computer and other equipment to eligible donees to be used for the benefit of elementary and secondary school children qualify for an augmented deduction. Under this special rule, the amount of the augmented deduction available to a corporation making a qualified contribution generally is equal to its basis in the donated property plus one-half of the amount of ordinary income that would have been realized if the property had been sold. However, the augmented deduction cannot exceed twice the basis of the donated property. To qualify for the augmented deduction, the contribution must satisfy various requirements.

The legislative history of the provision states that the special tax treatment for contributions of computer and other equipment was to be effective for contributions made during a three-year period in taxable years beginning after December 31, 1997, and before January 1, 2001.[59] However, as a result of a drafting error, the statutory provision does not apply to contributions made during taxable years beginning after December 31, 1999.

[59] H. Rept. 105–220, p. 374.

Explanation of Provision

The bill corrects the termination date of the provision to provide that the special rule applies to contributions made during taxable years beginning after December 31, 1997, and before December 31, 2000.

In addition, the bill clarifies that the requirements set forth in section 170(e)(6)(B)(ii)–(vii) apply regardless of whether the donee is an educational organization or a tax-exempt charitable entity. Similarly, the rule in section 170(e)(6)(ii)(I) regarding subsequent contributions by private foundations is clarified to permit contributions to either educational organizations or tax-exempt charitable entities described in section 170(e)(6)(B)(i).

Effective Date

The provision is effective as of August 5, 1997, the date of enactment of the 1997 Act.

6. Qualified State tuition programs (sec. 6004(c) of the bill, sec. 211 of the 1997 Act, and sec. 529 of the Code)

Present Law

Section 529 provides tax-exempt status to "qualified State tuition programs," meaning certain programs established and maintained by a State (or agency or instrumentality thereof) under which persons may (1) purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of qualified higher education expenses of the beneficiary, or (2) make contributions to an account that is established for the purpose of meeting qualified higher education expenses of the designated beneficiary of the account. The term "qualified higher education expenses" means expenses for tuition, fees, books, supplies, and equipment required for the enrollment or attendance at an eligible postsecondary educational institution, as well as room and board expenses (meaning the minimum room and board allowance applicable to the student as determined by the institution in calculating costs of attendance for Federal financial aid programs under sec. 472 of the Higher Education Act of 1965) for any period during which the student is at least a half-time student.

Section 529 also provides that no amount shall be included in the gross income of a contributor to, or beneficiary of, a qualified State tuition program with respect to any distribution from, or earnings under, such program, except that (1) amounts distributed or educational benefits provided to a beneficiary (e.g., when the beneficiary attends college) will be included in the beneficiary's gross income (unless excludable under another Code section) to the extent such amounts or the value of the educational benefits exceed contributions made on behalf of the beneficiary, and (2) amounts distributed to a contributor or another distributee (e.g., when a parent receives a refund) will be included in the contributor's/distributee's gross income to the extent such amounts exceed contributions made on behalf of the beneficiary. Earnings on an account may be refunded to a contributor or beneficiary, but the State or instrumentality must impose a more than de minimis monetary penalty unless the refund is (1) used for qualified higher education expenses of the beneficiary, (2) made on account of the death or disability of the beneficiary, or (3) made on account of a scholarship received by the designated beneficiary to the extent the amount refunded does not exceed the amount of the scholarship used for higher education expenses.

A transfer of credits (or other amounts) from one account benefiting one designated beneficiary to another account benefiting a different beneficiary will be considered a distribution (as will a change in the designated beneficiary of an interest in a qualified State tuition program), unless the beneficiaries are members of the same family. For this purpose, the term "member of the family" means persons described in paragraphs (1) through (8) of section 152(a)—e.g., sons, daughters, brothers, sisters, nephews and nieces, certain in-laws, etc—and any spouse of such persons.

Explanation of Provision

The bill clarifies that, under rules contained in present-law section 72, distributions from qualified State tuition programs are treated as representing a pro-rata share of the principal (i.e., contributions) and accumulated earnings in the account.

In addition, the bill modifies section 529(e)(2) to clarify that—for purposes of tax-free rollovers and changes of designated beneficiaries—a "member of the family" includes the spouse of the original beneficiary.

Effective Date

The provisions are effective for distributions made after December 31, 1997.

7. Qualified zone academy bonds (sec. 6004(g) of the bill, sec. 226 of the 1997 Act, and sec. 1397E of the Code)

Present Law

Certain financial institutions (i.e., banks, insurance companies, and corporations actively engaged in the business of lending money) that hold "qualified zone academy bonds" are entitled to a nonrefundable tax credit in an amount equal to a credit rate (set monthly by the Treasury Department[60]) multiplied by the face amount of the bond (sec. 1397E). The credit rate applies to all such bonds issued in each month. A taxpayer holding a qualified zone academy bond on the credit allowance date (i.e., each one-year anniversary of the issuance of the bond) is entitled to a credit. The credit is includible in gross income (as if it were an interest payment on the bond), and may be claimed against regular income tax and AMT liability.

"Qualified zone academy bonds" are defined as any bond issued by a State or local government, provided that (1) at least 95 percent of the proceeds are used for the purpose of renovating, providing equipment to, developing course materials for use at, or train-

[60] The Treasury Department will set the credit rate each month at a rate estimated to allow issuance of qualified zone academy bonds without discount and without interest cost to the issuer.

ing teachers and other school personnel in a "qualified zone academy"—meaning certain public schools located in empowerment zones or enterprise communities or with a certain percentage of students from low-income families—and (2) private entities have promised to make contributions to the qualified zone academy with a value equal to at least 10 percent of the bond proceeds.

A total of $400 million of "qualified zone academy bonds" may be issued in each of 1998 and 1999. The $400 million aggregate bond cap will be allocated each year to the States according to their respective populations of individuals below the poverty line.[61] Each State, in turn, will allocate the credit to qualified zone academies within such State. A State may carry over any unused allocation into subsequent years.

Explanation of Provision

The bill clarifies that, for purposes of section 6655(g)(1)(B), the credit for certain holders of qualified zone academy bonds may be claimed for estimated tax purposes. Similarly, the bill clarifies for purposes of section 6401(b)(1) the manner in which the credit is taken into account when determining whether a taxpayer has made an overpayment of tax.

Effective Date

The provisions are effective for obligations issued after December 31, 1997.

C. AMENDMENTS TO TITLE III OF THE 1997 ACT RELATING TO SAVINGS INCENTIVES

1. Conversions of IRAs into Roth IRAs (sec. 6005(b) of the bill, sec. 302 of the 1997 Act, and secs. 408A and 72(t) of the Code)

Present Law

A taxpayer with adjusted gross income of less than $100,000 may convert a present-law deductible or nondeductible IRA into a Roth IRA at any time. The amount converted is includible in income in the year of the conversion, except that if the conversion occurs in 1998, the amount converted is includible in income ratably over the 4-year period beginning with the year in which the conversion occurs.[62] Amounts includible in income as a result of the conversion are not taken into account in determining whether the $100,000 threshold is exceeded. The 10-percent tax on early withdrawals does not apply to conversions of IRAs into Roth IRAs.

In general, distributions of earnings from a Roth IRA are excludable from income if the individual has had a Roth IRA for at least 5 years and certain other requirements are satisfied. The 5-year holding period with respect to conversion Roth IRAs begins from

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[61] See Rev. Proc. 98–9, which sets forth the maximum face amount of qualified zone academy bonds that may be issued for each State during 1998; IRS Proposed Rules (REG–119449–97), which provides guidance to holders and issuers of qualified zone academy bonds.

[62] If the conversion is accomplished by means of a withdrawal and a rollover into a Roth IRA, the 4-year rule applies if the withdrawal is made during 1998 and the rollover occurs within 60 days of the withdrawal. In such a case, the 4-year period begins with the year in which the withdrawal was made. For purposes of this discussion, such conversions are treated as occurring in 1998.

the year of the conversion. (Distributions that are excludable from income are referred to as qualified distributions.)

Present law does not contain a specific rule addressing what happens if an individual dies during the 4-year spread period for 1998 conversions.

Explanation of Provision

Distributions of converted amounts

Distributions before the end of the 4-year spread

The bill modifies the rules relating to conversions of IRAs into Roth IRAs in order to prevent taxpayers from receiving premature distributions from a Roth conversion IRA while retaining the benefits of 4-year income averaging. In the case of conversions to which the 4-year income inclusion rule applies, income inclusion will be accelerated with respect to any amounts withdrawn before the final year of inclusion. Under this rule, a taxpayer that withdraws converted amounts prior to the last year of the 4-year spread will be required to include in income the amount otherwise includible under the 4-year rule, plus the lesser of (1) the taxable amount of the withdrawal, or (2) the remaining taxable amount of the conversion (i.e., the taxable amount of the conversion not included in income under the 4-year rule in the current or a prior taxable year). In subsequent years (assuming no such further withdrawals), the amount includible in income under the 4-year will be the lesser of (1) the amount otherwise required under the 4-year rule (determined without regard to the withdrawal) or (2) the remaining taxable amount of the conversion.

Under the bill, application of the 4-year spread will be elective. The election will be made in the time and manner prescribed by the Secretary. If no election is made, the 4-year rule will be deemed to be elected. An election, or deemed election, with respect to the 4-year spread cannot be changed after the due date for the return for the first year of the income inclusion (including extensions).

The following example illustrates the application of these rules.

> *Example:* Taxpayer A has a nondeductible IRA with a value of $100 (and no other IRAs). The $100 consists of $75 of contributions and $25 of earnings. A converts the IRA into a Roth IRA in 1998 and elects the 4-year spread. As a result of the conversion, $25 is includible in income ratably over 4 years ($6.25 per year). The 10-percent early withdrawal tax does not apply to the conversion. At the beginning of 1999, the value of the account is $110, and A makes a withdrawal of $10. Under the proposal, the withdrawal would be treated as attributable entirely to amounts that were includible in income due to the conversion. In the year of withdrawal, $16.25 would be includible in income (the $6.25 includible in the year of withdrawal under the 4-year rule, plus $10 ($10 is less than the remaining taxable amount of $12.50 ($25–$12.50)). In the next year, $2.50 would be includible in income under the 4-year rule. No amount would be includible in income in year 4 due to the conversion.

Application of early withdrawal tax to converted amounts

The bill modifies the rules relating to conversions to prevent taxpayers from receiving premature distributions (i.e., within 5 years) while retaining the benefit of the nonpayment of the early withdrawal tax. Under the bill, if converted amounts are withdrawn within the 5-year period beginning with the year of the conversion, then, to the extent attributable to amounts that were includible in income due to the conversion, the amount withdrawn will be subject to the 10- percent early withdrawal tax.[63]

Applying this rule to the example above, the $10 withdrawal would be subject to the 10-percent early withdrawal tax (unless as exception applies).

Application of 5-year holding period

The bill will also eliminate the special rule under which a separate 5-year holding period begins for purposes of determining whether a distribution of amounts attributable to a conversion is a qualified distribution; thus, the 5-year holding rule for Roth IRAs will begin with the year for which a contribution is first made to a Roth IRA. A subsequent conversion will not start the running of a new 5-year period.

Ordering rules

Ordering rules will apply to determine what amounts are withdrawn in the event a Roth IRA contains both conversion amounts (possibly from different years) and other contributions. Under these rules, regular Roth IRA contributions will be deemed to be withdrawn first, then converted amounts (starting with the amounts first converted). Withdrawals of converted amounts will be treated as coming first from converted amounts that were includible in income. As under present law, earnings will be treated as withdrawn after contributions. For purposes of these rules, all Roth IRAs, whether or not maintained in separate accounts, will be considered a single Roth IRA.

Corrections

In order to assist individuals who erroneously convert IRAs into Roth IRAs or otherwise wish to change the nature of an IRA contribution, contributions to an IRA (and earnings thereon) may be transferred in a trustee-to-trustee transfer from any IRA to another IRA by the due date for the taxpayer's return for the year of the contribution (including extensions). Any such transferred contributions will be treated as if contributed to the transferee IRA (and not to the transferor IRA). Trustee-to-trustee transfers include transfers between IRA trustees as well as IRA custodians, apply to transfers from and to IRA accounts and annuities, and apply to transfers between IRA accounts and annuities with the same trustee or custodian.

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[63] The otherwise available exceptions to the early withdrawal tax, e.g., for distributions after age 59½, would apply.

Effect of death on 4-year spread

Under the bill, in general, any amounts remaining to be included in income as a result of a 1998 conversion will be includible in income on the final return of the taxpayer. If the surviving spouse is the sole beneficiary of the Roth IRA, the spouse may continue the deferral by including the remaining amounts in his or her income over the remainder of the 4-year period.

Calculation of AGI limit for conversions

The bill clarifies the determination of AGI for purposes of applying the $100,000 AGI limit on IRA conversions into Roth IRAs. Under the bill, the conversion amount (to the extent otherwise includible in AGI) is subtracted from AGI as determined under the rules relating to IRAs (sec. 219) for the year of distribution. Thus, for example, the AGI-based phase out of the exemption from the disallowance for passive activity losses from rental real estate activities (sec. 469(i)(3)) would be applied taking into account the amount of the conversion that is includible in AGI, and then the amount of the conversion would be subtracted from AGI in determining whether a taxpayer is eligible to convert an IRA into a Roth IRA.

Effective Date

The provision is effective as if included in the 1997 Act, i.e., for taxable years beginning after December 31, 1997.

2. Penalty-free distributions for education expenses and purchase of first homes (sec. 6005(c) of the bill, secs. 203 and 303 of the 1997 Act, and sec. 402 of the Code)

Present Law

The 10-percent early withdrawal tax does not apply to distributions from an IRA if the distribution is for first-time homebuyer expenses, subject to a $10,000 life-time cap, or for higher education expenses. These exceptions do not apply to distributions from employer-sponsored retirement plans. A distribution from an employer-sponsored retirement plan that is an "eligible rollover distribution" may be rolled over to an IRA. The term "eligible rollover distribution" means any distribution to an employee of all or a portion or the balance to the credit of the employee in a qualified trust, except the term does not include certain periodic distributions, distributions based on life or joint life expectancies and distributions required under the minimum distribution rules. Generally, distributions from cash or deferred arrangements made on account of hardship are eligible rollover distributions. An eligible rollover distribution which is not transferred directly to another retirement plan or an IRA is subject to 20–percent withholding on the distribution.

Explanation of Provision

Under present law, participants in employer-sponsored retirement plans can avoid the early withdrawal tax applicable to such plans by rolling over hardship distributions to an IRA and withdrawing the funds from the IRA. The bill modifies the rules relating to the ability to roll over hardship distributions from employer-sponsored retirement plans (including section 403(b) plans) in order to prevent such avoidance of the 10-percent early withdrawal tax. The bill provides that distributions from cash or deferred arrangements and similar arrangements made on account of hardship of the employee are not eligible rollover distributions. Such distributions will not be subject to the 20-percent withholding applicable to eligible rollover distributions.

Effective Date

The provision is effective for distributions after December 31, 1998.

3. Limits based on modified adjusted gross income (sec. 6005(b) of the bill, sec. 302(a) of the 1997 Act, and sec. 72(t) of the Code)

Present Law

The $2,000 Roth IRA maximum contribution limit is phased out for individual taxpayers with adjusted gross income ("AGI") between $95,000 and $110,000 and for married taxpayers filing a joint return with AGI between $150,000 and $160,000. The maximum deductible IRA contribution is phased out between $0 and $10,000 of AGI in the case of married couples filing a separate return.

Explanation of Provision

The bill clarifies the phase-out range for the Roth IRA maximum contribution limit for a married individual filing a separate return and conforms it to the range for deductible IRA contributions. Under the bill, the phase-out range for married individuals filing a separate return will be $0 to $10,000 of AGI.

Effective Date

The provision is effective as if included in the 1997 Act, i.e., for taxable years beginning after December 31, 1997.

4. Contribution limit to Roth IRAs (sec. 6005(b) of the bill, sec. 302 of the 1997 Act, and sec. 408A(c) of the Code)

Present Law

An individual who is an active participant in an employer-sponsored plan may deduct annual IRA contributions up to the lesser of $2,000 or 100 percent of compensation if the individual's adjusted gross income ("AGI") does not exceed certain limits. For 1998, the limit is phased-out over the following ranges of AGI: $30,000 to $40,000 in the case of a single taxpayer and $50,000 to $60,000 in the case of married taxpayers. An individual who is not an active participant in an employer-sponsored retirement plan (and whose spouse is not an active participant) may deduct IRA contributions up to the limits described above without limitation based on income. An individual who is not an active participant in an employer-sponsored retirement plan (and whose spouse is such an active participant) may deduct IRA contributions up to the limits described above if the AGI of the such individuals filing a joint return does not exceed certain limits. The limit is phased for out for such individuals with AGI between $150,000 and $160,000.

An individual may make nondeductible contributions up to the lesser of $2,000 or 100 percent of compensation to a Roth IRA if the individual's AGI does not exceed certain limits. An individual may make nondeductible contributions to an IRA to the extent the individual does not or cannot make deductible contributions to an IRA or contributions to a Roth IRA. Contributions to all an individual's IRAs for a taxable year may not exceed $2,000.

Explanation of Provision

The bill clarifies the intent of the Act that an individual may contribute up to $2,000 a year to all the individual's IRAs. Thus, for example, suppose an individual is not eligible to make deductible IRA contributions because of the phase-out limits, and is eligible to make a $1,000 Roth IRA contribution. The individual could contribute $1,000 to the Roth IRA and $1,000 to a nondeductible IRA.

Effective Date

The provision is effective as if included in the 1997 Act, i.e., for taxable years beginning after December 31, 1997.

5. Contribution limitations for active participants in an IRA (sec. 6005(a) of the bill, sec. 301(b) of the 1997 Act, and sec. 219(g) of the Code)

Present Law

Under present law, if a married individual (filing a joint return) is an active participant in an employer-sponsored retirement plan, the $2,000 IRA deduction limit is phased out over the following levels of adjusted gross income ("AGI"):

Taxable years beginning in:	*Phase-out range*
1997	$40,000–50,000
1998	50,000–60,000
1999	51,000–61,000
2000	52,000–62,000
2001	53,000–63,000
2002	54,000–64,000
2003	60,000–70,000
2004	65,000–75,000
2005	70,000–80,000
2006	75,000–85,000
2007	80,000–100,000

An individual is not considered an active participant in an employer-sponsored retirement plan merely because the individual's spouse is an active participant. The $2,000 maximum deductible IRA contribution for an individual who is not an active participant, but whose spouse is, is phased out for taxpayers with AGI between $150,000 and $160,000.

Explanation of Provision

The bill clarifies the intent of the Act relating to the AGI phase-out ranges for married individuals who are active participants in employer-sponsored plans and the AGI phase-out range for spouses of such active participants as described above.

Effective Date

The provision is effective as if included in the 1997 Act, i.e., for taxable years beginning after December 31, 1997.

D. AMENDMENTS TO TITLE III OF THE 1997 ACT RELATING TO CAPITAL GAINS

1. Individual capital gains rate reductions (sec. 6005(d) of the bill, sec. 311 of the 1997 Act, and sec. 1(h) of the Code)

Present Law

The 1997 Act provided lower capital gains rates for individuals. Generally, the 1997 Act reduced the maximum rate on the adjusted net capital gain of an individual from 28 percent to 20 percent and provided a 10-percent rate for the adjusted net capital gain otherwise taxed at a 15-percent rate. The "adjusted net capital gain" means the net capital gain determined without regard to certain gain for which the 1997 Act provided a higher maximum rate of tax. The 1997 Act generally retained a 28-percent maximum rate for the long-term capital gain from collectibles, certain long-term capital gain included in income from the sale of small business stock, and the net capital gain determined by including all capital gains and losses properly taken into account after July 28, 1997, from property held more than one year but not more than 18 months and all capital gains and losses properly taken into account for the portion of the taxable year before May 7, 1997. In addition, the 1997 Act provided a maximum rate of 25 percent for the long-term capital gain attributable to real estate depreciation ("unrecaptured section 1250 gain"). Beginning in 2001 and 2006, lower rates of 8 and 18 percent will apply to certain property held more than five years.

The amounts taxed at the 28 and 25-percent rates may not exceed the individual's net capital gain and also are reduced by amounts otherwise taxed at a 15-percent rate.

Under the provisions of the 1997 Act, net short-term capital losses and long-term capital loss carryovers reduce the amount of adjusted net capital gain before reducing amounts taxed at the maximum 25 and 28-percent rates.

The 1997 Act failed to coordinate the new multiple holding periods with certain provisions of the Code.

Explanation of Provision

Under the bill, the "adjusted net capital gain" of an individual is the net capital gain reduced (but not below zero) by the sum of the 28-percent rate gain and the unrecaptured section 1250 gain.

"28-percent rate gain" means the amount of net gain attributable to collectibles gains and losses, an amount of gain equal to the gain excluded from gross income on the sale of certain small business stock under section 1202,[64] long-term capital gains and losses properly taken into account after July 28, 1997, from property held more than one year but not more than 18 months, the net short-term capital loss for the taxable year and the long-term capital loss carryover to the taxable year. Long-term capital gains and losses properly taken into account before May 7, 1997, also are included in computing 28-percent rate gain.

"Unrecaptured section 1250 gain" means the amount of long-term capital gain (not otherwise treated as ordinary income) which would be treated as ordinary income if section 1250 recapture applied to all depreciation (rather than only to depreciation in excess of straight-line depreciation) from property held more than 18 months (one year for amounts properly taken into account after May 6, 1997, and before July 29, 1997).[65] The unrecaptured section 1250 depreciation is reduced (but not below zero) by the excess (if any) of amount of losses taken into account in computing 28-percent gain over the amount of gains taken into account in computing 28-percent rate gain.

The bill contains several conforming amendments to coordinate the multiple holding periods with other provisions of the Code. Inherited property (sec. 1223 (11) and (12)) and certain patents (sec. 1235) are deemed to have a holding period of more than 18 months, allowing the 10 and 20-percent rates to apply. Amounts treated as ordinary income by reason of section 1231(c) will be allocated among categories of net section 1231 gain in accordance with IRS forms or regulations. The bill clarifies that the amount treated as long-term capital gain or loss on a section 1256 contract is treated as attributable to property held for more than 18 months.

Under the bill, in applying section 1233(b) where the substantially identical property has been held more than one year but not more than 18 months, any gain on the closing of the short sale will be considered gain from property held not more than 18 months, and the substantially identical property will have be treated as held for one year on the day before the earlier of the date of the closing of the short sale or the date the property is disposed of. In applying section 1233(d) where, on the date of the short sale, the substantially identical property has been held more than 18 months, any loss on the closing of the short sale will be treated as a loss from the sale or exchange of a capital asset held more than 18 months. Finally, in applying section 1092(f), any loss with respect to the option shall be treated as a loss from the sale or exchange of a capital asset held more than 18 months, if at the time the loss is realized, gain on the sale or exchange of the stock would

[64] For example, assume an individual has $300,000 gain from the sale of qualified stock in a small business corporation and assume that section 1202(b) limits the gain that may be taken into account under section 1202(a) to $240,000. $120,000 of the gain (50 percent of $240,000) is excluded from gross income under section 1202(a). The $180,000 of gain that is included in gross income is included in the computation of net capital gain, and $120,000 of that gain is taken into account under section 1(h)(5)(i)(III), as added by the bill, in computing 28-percent rate gain. The maximum effective regular tax rate on the $240,000 of gain to which the 50-percent section 1202 exclusion applies is 14 percent and the maximum rate on the remaining $60,000 of gain is 20 percent.

[65] In the case of a disposition of a partnership interest held more than 18 months, the amount of the individual's long-term capital gain which would be treated as ordinary income under section 751(a) if section 1250 applied to all depreciation, will be taken into account in computing unrecaptured section 1250 gain.

be treated as gain from the sale or exchange of a capital asset held more than 18 months.[66]

The bill reorders the rate structure under sections 1(h)(1) and 55(b)(3) without any substantive change.

The bill makes minor technical changes, including a provision to reduce the minimum tax preference on certain small business stock to 28 percent, beginning in 2006.[67]

Effective Date

The provision applies to taxable years ending after May 6, 1997.

2. Rollover of gain from sale of qualified stock (sec. 6005(f) of the bill, sec. 313 of the 1997 Act, and sec. 1045 of the Code)

Present Law

The 1997 Act provided that gain from the sale of qualified small business stock held by an individual for more than six months can be "rolled over" tax-free to other qualified small business stock.

Explanation of Provision

Under the bill, a partnership or an S corporation can roll over gain from qualified small business stock held more than six months if (and only if) at all times during the taxable year all the interests in the partnership or S corporation are held by individuals, estates,[68] and trusts with no corporate beneficiaries.

Effective Date

The provision applies to sales on or after August 5, 1997, the date of enactment of the 1997 Act.

3. Exclusion of gain on the sale of a principal residence owned and used less than two years (sec. 6005(e)(1) and (2) of the bill, sec. 312(a) of the 1997 Act, and sec. 121 of the Code)

Present Law

Under present law, a taxpayer generally is able to exclude up to $250,000 ($500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. To be eligible for the exclusion, the taxpayer must have owned the residence and used it as a principal residence for at least two of the five years prior to the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or unforeseen circumstances is able to exclude a fraction of the taxpayer's realized gain equal to the fraction of the two years that the requirements are met.

[66] Any loss treated as a long-term capital loss by reason of section 1233(d) or 1092(f) will be taken into account in computing 28–percent rate gain where the property causing such loss to be treated as a long-term capital loss was held not more than 18 months on the applicable date.

[67] Thus, the maximum rate under the minimum tax will be 17.92% (.64 times 28%).

[68] The term "estate" is intended to include both the estate of a decedent and the estate of an individual in bankruptcy.

Explanation of Provision

The bill clarifies that an otherwise qualifying taxpayer who fails to satisfy the two-year ownership and use requirements is able to exclude an amount equal to the fraction of the $250,000 ($500,000 if married filing a joint return), not the fraction of the realized gain which is equal to the fraction of the two years that the ownership and use requirements are met. For example, an unmarried taxpayer who owns and uses a principal residence for one year then sells at realized gain of $500,000 may exclude $125,000 of gain (one-half of $250,000) not $250,000 of gain (one-half of the realized gain). Similarly, an unmarried taxpayer who owns and uses a principal residence for one year then sells at a realized gain of $50,000 may exclude the entire $50,000 of gain since it is less than one half of $250,000. The exclusion is not limited to $25,000 (one-half of the $50,000 realized gain).

In addition, the bill provides that if a married couple filing a joint return does not qualify for the $500,000 maximum exclusion, the amount of the maximum exclusion that may be claimed by the couple is the sum of each spouse's maximum exclusion determined on a separate basis.

Effective Date

The provision is effective as if included in section 312 of the 1997 Act.

4. Effective date of the exclusion of gain on the sale of a principal residence (sec. 6005(e)(3) of the bill, sec. 312(d)(2) of the 1997 Act, and sec. 121 of the Code)

Present law

The exclusion for gain on sale of a principal residence under the 1997 Act generally applies to sales or exchanges occurring after May 6, 1997. A taxpayer may elect, however, to apply prior law to a sale or exchange (1) made before the date of enactment of the Act, (2) made after the date of enactment pursuant to a binding contract in effect on such date, or (3) where a replacement residence was acquired on or before the date of enactment (or pursuant to a binding contract in effect on the date of enactment) and the prior-law rollover provision would apply.

Explanation of Provision

The bill clarifies that a taxpayer may elect to apply prior law with respect to a sale or exchange on the date of enactment of section 312 of the 1997 Act.

Effective Date

The provision is effective as if included in section 312 of the 1997 Act.

E. AMENDMENTS TO TITLE IV OF THE 1997 ACT RELATING TO ALTERNATIVE MINIMUM TAX

1. Election to use AMT depreciation for regular tax purposes (sec. 6006(b) of the bill, sec. 402 of the 1997 Act, and sec. 168 of the Code)

Present Law

For regular tax purposes, depreciation deductions for certain shorter-lived tangible property may be determined using the 200-percent declining balance method over 3-, 5-, 7-, or 10-year recovery periods (depending on the type of property). For alternative minimum tax ("AMT") purposes, depreciation on such property placed in service after 1986 and before 1999 is computed by using the 150–percent declining balance method over the longer class lives prescribed by the alternative depreciation system of section 168(g). A taxpayer may elect to use the methods and lives applicable to AMT depreciation for regular tax purposes.

The 1997 Act conformed the recovery periods (but not the methods) used for purposes of the AMT depreciation to the recovery periods used for purposes of the regular tax, for property placed in service after 1998. The 1997 Act did not make a conforming change to the election to use the pre-1998 AMT recovery methods and recovery periods for regular tax purposes.

Explanation of Provision

For property placed in service after 1998, a taxpayer would be allowed to elect, for regular tax purposes, to compute depreciation on tangible personal property otherwise qualified for the 200-percent declining balance method by using the 150-percent declining balance method over the recovery periods applicable to the regular tax (rather than the longer class lives of the alternative depreciation system of sec. 168(g)).

Effective Date

The provision is effective for property placed in service after December 31, 1998.

2. Clarification of the small business exemption (sec. 6006(a) of the bill, sec. 401 of the 1997 Act, and sec. 55 of the Code)

Present Law

The corporate alternative minimum tax is repealed for small corporations for taxable years beginning after December 31, 1997. A small corporation is one that had average gross receipts of $5 million or less for a prior three-year period. A corporation that meets the $5 million gross receipts test will continue to be treated as a small corporation exempt from the alternative minimum tax so long as its average gross receipts do not exceed $7.5 million.

Explanation of Provision

The provision clarifies the application of the $5 million and $7.5 million gross receipts tests that a corporation must meet to be a small corporation exempt from the AMT. Under the provision, in order for a corporation to qualify as a small corporation exempt from the AMT for a taxable year, the corporation's average gross receipts for all 3-taxable-year periods beginning after December 31, 1993 and ending before such taxable year must be $7.5 million or less. The $7.5 million amount is reduced to $5 million for the corporation's first 3-taxable-year period (or portion thereof) beginning after December 31, 1993, and ending before the taxable year for which the exemption is claimed.

If a corporation's first taxable year beginning after December 31, 1997 (the first year the exemption is available) is its first taxable year (and the corporation does not lose its status as a small corporation because it is aggregated with one or more corporations under section 448(c)(2) or treated as having a predecessor corporation under section 448(c)(3)(D)), the corporation will be treated as an exempt small corporation for such year regardless of its gross receipts for such year.

The operation of the gross receipts tests for the small corporation AMT exemption is demonstrated by the following examples.

Example 1.—Assume a calendar-year corporation was in existence on January 1, 1994. In order to qualify as a small corporation for 1998 (the first year the exemption is available), (1) the corporation's average gross receipts for the 3-taxable-year period 1994 through 1996 must be $5 million or less and (2) the corporation's average gross receipts for the 1995 through 1997 period must be $7.5 million or less. If the corporation qualifies for 1998, the corporation will qualify for 1999 if its average gross receipts for the 3-taxable-year period 1996 through 1998 also is $7.5 million or less. If the corporation does not qualify for 1998, the corporation cannot qualify for 1999 or any subsequent year.

Example 2.—Assume a calendar-year corporation is first incorporated in 1999 and is neither aggregated with a related, existing corporation under section 448(c)(2) nor treated as having a predecessor corporation under section 448(c)(3)(D). The corporation will qualify as a small corporation for 1999 regardless of its gross receipts for such year. In order to qualify as a small corporation for 2000, the corporation's gross receipts for 1999 must be $5 million or less.[69] If the corporation qualifies for 2000, the corporation also will qualify for 2001 if its average gross receipts for the 2-taxable-year period 1999 through 2000 is $7.5 million or less. If the corporation does not qualify for 2000, the corporation cannot qualify for 2001 or any subsequent year. If the corporation qualifies for 2001, the corporation will qualify for 2002 if its average gross receipts for the 3-taxable-year period 1999 through 2001 is $7.5 million or less.

Effective Date

The provision is effective for taxable years beginning after December 31, 1997.

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[69] The gross receipts for 1999 must be annualized under section 448(c)(3)(B) if the 1999 taxable year is less than 12 months.

F. AMENDMENTS TO TITLE V OF THE 1997 ACT RELATING TO ESTATE AND GIFT TAXES

1. Clarification of phaseout range for 5-percent surtax to phase out the benefits of the unified credit and graduated rates (sec. 6007(a)(1) of the bill, sec. 501 of the 1997 Act, and sec. 2001(c)(2) of the Code)

Present Law

Prior to the 1997 Act, a 5-percent surtax was imposed upon cumulative taxable transfers between $10 million and $21,040,000 to phase out the benefits of the graduated rates and the unified credit. The 1997 Act increased the unified credit beginning in 1998, from an effective exemption of $600,000 to an effective exemption of $1,000,000 in 2006. A conforming amendment was made to the 5-percent surtax provision in section 2001(c)(2) that was intended to reflect the increased unified credit. However, the conforming amendment was drafted in a manner that had the effect of phasing out the benefits of the graduated rates but not the unified credit.

Explanation of Provision

The provision clarifies section 2001(c)(2) to properly phase out the benefits of both the graduated rates and the unified credit.

Effective Date

The provision is effective for decedents dying, and gifts made, after December 31, 1997.

2. Clarification of effective date for indexing of generation-skipping exemption (sec. 6007(a)(2) of the bill, secs. 501 (d) and (f) of the 1997 Act, and sec. 2631(c) of the Code)

Present Law

The 1997 Act provided for the indexation of the $1 million exemption from generation-skipping transfers effective for decedents dying after December 31, 1998.

Explanation of Provision

The provision clarifies that the indexing of the exemption from generation-skipping transfers is effective with respect to all generation-skipping transfers (i.e., direct skips, taxable terminations, and taxable distributions) made after 1998.

With respect to existing trusts, transferors are permitted to make a late allocation of any additional GST exemption amount attributable to indexing adjustments in accordance with the present-law rules applicable to late allocations as set forth in sections 2632 and 2642, and the regulations promulgated thereunder. For example, assume an individual transferred $2 million to a trust in 1995, and allocated his entire $1 million GST exemption to the trust at that time (resulting in an inclusion ratio of .50). Assume further that in 2001, the GST exemption has increased to $1,100,000 as the result of indexing, and that the value of the trust assets is now $3 million. If the individual is still alive in 2001, he is permitted to make a late allocation of $100,000 of GST exemption to the trust, resulting in a new inclusion ratio of 1−(($1,500,000+100,000)/$3,000,000), or .467.

Effective Date

The provision is effective for generation-skipping transfers (i.e., direct skips, taxable terminations, and taxable distributions) made after December 31, 1998.

3. Conversion of qualified family-owned business exclusion into a deduction (sec. 6007(b)(1)(A) of the bill, sec. 502 of the 1997 Act, and redesignated sec. 2057 of the Code)

Present Law

The qualified family-owned business provision in the 1997 Act provides an exclusion from estate taxes for certain qualified family-owned business interests. It is unclear whether the provision provides an exclusion of value or an exclusion of property from the estate, and thus it is unclear how the new provision interacts with other provisions in the Internal Revenue Code (e.g., secs. 1014, 2032A, 2056, 2612, and 6166).

Explanation of Provision

The provision converts the qualified family-owned business exclusion into a deduction, and redesignates section 2033A as section 2057. Except as provided below, the requirements of the qualified family-owned business provision otherwise remain unchanged. The qualified family-owned business deduction is not available for generation-skipping transfer tax purposes.

Effective Date

The provision is effective with respect to estates of decedents dying after December 31, 1997.

4. Coordination between unified credit and family-owned business provision (sec. 6007(b)(1)(B) and 6007(b)(4) of the bill, sec. 502 of the 1997 Act, and redesignated sec. 2057(a) of the Code)

Present Law

The 1997 Act effectively increased the amount of lifetime gifts and transfers at death that are exempt from unified estate and gift tax from $600,000 to $1,000,000 over the period 1997 to 2006, through increases in an individual's unified credit. In addition, the 1997 Act provided a limited exclusion for certain family-owned business interests. The exclusion for family-owned business interests may be taken only to the extent that the exclusion for family-owned business interests, plus the amount effectively exempted by the unified credit, does not exceed $1.3 million. As a result, for years after 1998, the maximum amount of exclusion for family-owned business interests is reduced by increases in the dollar amount of transfers effectively exempted through the unified credit.

Because the structure of the 1997 Act increases the unified credit over time (until 2006) while decreasing over the same period the benefit of the closely-held business exclusion, the estate tax on estates with family-owned businesses increases over time until 2006. This increase in estate tax results from the fact that increases in the unified credit provide a benefit at the decedent's lowest estate tax brackets, while the exclusion for family-owned businesses provides a benefit at the decedent's highest estate tax brackets.

Explanation of Provision

Under the provision, if an executor elects to utilize the qualified family-owned business deduction, the estate tax liability is calculated as if the estate were allowed a maximum qualified family-owned business deduction of $675,000 and an applicable exclusion amount under section 2010 (i.e., the amount exempted by the unified credit) of $625,000, regardless of the year in which the decedent dies. If the estate includes less than $675,000 of qualified family-owned business interests, the applicable exclusion amount is increased on a dollar-for-dollar basis, but only up to the applicable exclusion amount generally available for the year of death.

For example, assume the decedent dies in 2005, when the applicable exclusion amount under section 2010 is $800,000. If the estate includes qualified family-owned business interests valued at $675,000 or more, the estate tax liability is calculated as if the estate were allowed a qualified family-owned business deduction of $675,000, and the applicable exclusion amount under section 2010 is limited to $625,000. If the estate includes qualified family-owned business interests of $500,000 or less, all of the qualified family-owned business interests could be deducted from the estate, and the applicable exclusion amount under section 2010 is $800,000. If the estate includes qualified family-owned business interests valued between $500,000 and $675,000, all of the qualified family-owned business interests could be deducted from the estate, and the applicable exclusion amount under section 2010 is calculated as the excess of $1.3 million over the amount of qualified family-owned business interests. (For example, if the qualified family-owned business interests were valued at $600,000, the applicable exclusion amount under section 2010 is $700,000.)

If a recapture event occurs with respect to any qualified family-owned business interest, the total amount of estate taxes potentially subject to recapture is calculated as the difference between the actual amount of estate tax liability for the estate, and the amount of estate taxes that would have been owed had the qualified family-owned business election not been made.

Effective Date

The provision is effective for decedents dying after December 31, 1997.

5. Clarification of businesses eligible for family-owned business provision (sec. 6007(b)(2) of the bill, sec. 502 of the 1997 Act, and redesignated sec. 2057(b)(3) of the Code)

Present Law

In order to be eligible to exclude from the gross estate a portion of the value of a family-owned business, the sum of (1) the adjusted value of family-owned business interests includible in the decedent's estate, and (2) the amount of gifts of family-owned business interests to family members of the decedent that are not included in the decedent's gross estate, must exceed 50 percent of the decedent's adjusted gross estate.

Explanation of Provision

The provision clarifies the formula for determining the amount of gifts of family-owned business interests made to members of the decedent's family that are not otherwise includible in the decedent's gross estate.

Effective Date

The provision is effective with respect to decedents dying after December 31, 1997.

6. Clarification of "trade or business" requirement for family-owned business provision (sec. 6007(b)(5) of the bill, sec. 502 of the Act, and redesignated secs. 2057(e)(1) and 2057(f) of the Code)

Present Law

A qualified family-owned business interest is defined as any interest in a trade or business that meets certain requirements—e.g., the decedent and members of his family must own certain percentages of the trade or business, the decedent or members of his family must have materially participated in the trade or business for five of the eight years preceding the decedent's death, and the qualified heir or members of his family must materially participate in the trade or business for at least five years of any eight-year period within 10 years following the decedent's death.

Explanation of Provision

The provision clarifies that an individual's interest in property used in a trade or business may qualify for the qualified family-owned business provision as long as such property is used in a trade or business by the individual or a member of the individual's family. Thus, for example, if a brother and sister inherit farmland upon their father's death, and the sister cash-leases her portion to her brother, who is engaged in the trade or business of farming, the "trade or business" requirement is satisfied with respect to both the brother and the sister. Similarly, if a father cash-leases farmland to his son, and the son materially participates in the trade or business of farming the land for at least five of the eight years preceding his father's death, the pre-death material participation and "trade or business" requirements are satisfied with respect to the father's interest in the farm.

Effective Date

The provision is effective with respect to estates of decedents dying after December 31, 1997.

7. Clarification that interests eligible for family-owned business provision must be passed to a qualified heir (secs. 6007(b)(1)(B) of the bill, sec. 502 of the Act, and redesignated sec. 2057(a)(1) of the Code)

Present Law

The 1997 Act provided a new exclusion for qualified family-owned business interests. One of the requirements for the exclusion is that such interests must pass to a "qualified heir," which includes members of the decedent's family and any individual who has been actively employed by the trade or business for at least 10 years prior to the date of the decedent's death.

Explanation of Provision

The provision clarifies that qualified family-owned business interests must pass to a qualified heir in order to qualify for the deduction. For this purpose, if all beneficiaries of a trust are qualified heirs (and in such other circumstances as the Secretary of the Treasury may provide), property passing to the trust may be treated as having passed to a qualified heir.

Effective Date

The provision is effective with respect to estates of decedents dying after December 31, 1997.

8. Other modifications to the qualified family-owned business provision (secs. 6007(b)(3), 6007(b)(6), and 6007(b)(7) of the bill, sec. 502 of the 1997 Act, and redesignated sec. 2057 of the Code)

Present Law

The qualified family-owned business provision incorporates by cross-reference several other provisions of the Code, including a number of provisions in section 2032A and the personal holding company rules of section 543(a).

Explanation of Provision

The provision modifies section 2033A(g) (relating to the security requirements for noncitizen qualified heirs) by deleting the cross-reference to section 2033A(i)(3)(M), which does not appear to be appropriate. The provision also makes rules similar to those set forth in section 2032A(h) and (i) (relating to conversions and exchanges of property under sections 1031 and 1033) applicable for purposes of section 2033A. Finally, the provision clarifies that, in identifying assets that produce (or are held for the production of) income of a type described in section 543(a), section 543(a) is applied without regard to section 543(a)(2)(B) (the dividend requirement for corporate entities).

Effective Date

The provision is effective with respect to estates of decedents dying after December 31, 1997.

9. Clarification of interest on installment payment of estate tax on holding companies (sec. 6007(c) of the bill, sec. 503 of the 1997 Act, and secs. 6166(b)(7)(A) and 6166(b)(8)(A) of the Code)

Present Law

If certain conditions are met, a decedent's estate may elect to pay the estate tax attributable to certain closely-held businesses over a 14-year period. The 1997 Act provided for a 2-percent interest rate on the estate tax on first $1 million in value of interests in qualified closely-held businesses, and a rate equal to 45 percent of the regular deficiency rate on the amount in excess of the portion eligible for the 2-percent rate, but also provided that none of interest on the deferred payment of estate taxes is deductible for income or estate tax purposes. Interests in holding companies and non-readily-tradeable business interests are not eligible for the 2-percent rate.

Explanation of Provision

The provision clarifies that deferred payments of estate tax on holding companies and non-readily-tradable business interests do not qualify for the 2-percent interest rate, but instead are subject to a rate of 45 percent of the regular deficiency rate. Such interest payments are not deductible for income or estate tax purposes.

Effective Date

The provision generally is effective for decedents dying after December 31, 1997.

10. Clarification on declaratory judgment jurisdiction of U.S. Tax Court regarding installment payment of estate tax (sec. 6007(d) of the bill, sec. 505 of the 1997 Act, and sec. 7479(a) of the Code)

Present Law

If certain conditions are met, a decedent's estate may elect to pay estate tax attributable to certain closely-held business over a 14-year period. The 1997 Act provided that the U.S. Tax Court would have jurisdiction to determine whether the estate of a decedent qualifies for the 14-year installment payment of estate tax.

Explanation of Provision

The provision clarifies that the jurisdiction of the U.S. Tax Court to determine whether an estate qualifies for installment payment of estate tax on closely-held businesses extends to determining which businesses in an estate are eligible for the deferral.

Effective Date

The provision is effective for decedents dying after the date of enactment of the 1997 Act.

11. Clarification of rules governing revaluation of gifts (sec. 6007(e) of the bill, sec. 506 of the 1997 Act, and sec. 2504(c) of the Code)

Present Law

The valuation of a gift becomes final for gift tax purposes after the statute of limitations on any gift tax assessed or paid has expired. The 1997 Act extended that rule to apply for estate tax purposes, provided for a lengthened statute of limitations for gift tax purposes if certain information is not disclosed with the gift tax return, and provided jurisdiction to the U.S. Tax Court to determine the value of any gift.

Explanation of Provision

The provision clarifies that in determining the amount of taxable gifts made in preceding calendar periods, the value of prior gifts is the value of such gifts as finally determined, even if no gift tax was assessed or paid on that gift. For this purpose, final determinations include, e.g., the value reported on the gift tax return (if not challenged by the IRS prior to the expiration of the statute of limitations), the value determined by the IRS (if not challenged in court by the taxpayer), the value determined by the courts, or the value agreed to by the IRS and the taxpayer in a settlement agreement.

Effective Date

The provision is effective with respect to gifts made after the date of enactment of the 1997 Act.

12. Clarification with respect to post-mortem conservation easements (sec. 6007(g) of the bill, sec. 506 of the 1997 Act, and sec. 2031(c) of the Code)

Present Law

A deduction is allowed for estate tax purposes for a contribution of a qualified real property interest to a charity (or other qualified organization) exclusively for conservation purposes (sec. 2055(f)). The 1997 Act also provided an election to exclude from the taxable estate 40 percent of the value of any land subject to a qualified conservation easement that meets certain requirements. The 1997 Act provided that the executor of the decedent's estate, or the trustee of a trust holding the land, could grant a qualifying easement after the decedent's death, as long as the easement is granted prior to the date of the election (generally, within nine months after the date of the decedent's death).

Explanation of Provision

The provision clarifies that, in the case of a qualified conservation contribution made after the date of the decedent's death, an estate tax deduction is allowed under section 2055(f). However, no income tax deduction is allowed to the estate or the qualified heirs with respect to such post-mortem conservation easements.

Effective Date

The provision is effective with respect to estates of decedents dying after December 31, 1997.

G. AMENDMENTS TO TITLE VII OF THE 1997 ACT RELATING TO INCENTIVES FOR THE DISTRICT OF COLUMBIA (SEC. 6008 OF THE BILL, SEC. 701 OF THE 1997 ACT, AND SECS. 1400, 1400B AND 1400C OF THE CODE)

Present Law

Designation of D.C. Enterprise Zone

Certain economically depressed census tracts within the District of Columbia are designated as the "D.C. Enterprise Zone," within which businesses and individual residents are eligible for special tax incentives. The census tracts that compose the D.C. Enterprise Zone for purposes of the wage credit, expensing, and tax-exempt financing incentives include all census tracts that presently are part of the D.C. enterprise community and census tracts within the District of Columbia where the poverty rate is not less than 20 percent. The D.C. Enterprise Zone designation generally will remain in effect for five years for the period from January 1, 1998, through December 31, 2002.

Empowerment zone wage credit, expensing, and tax-exempt financing

The following tax incentives generally are available in the D.C. Enterprise Zone: (1) a 20-percent wage credit for the first $15,000 of wages paid to D.C. residents who work in the D.C. Enterprise Zone; (2) an additional $20,000 of expensing under Code section 179 for qualified zone property placed in service by a "qualified D.C. Zone business"; and (3) special tax-exempt financing for certain zone facilities.

Qualified D.C. Zone business

For purposes of the increased expensing under section 179, as well as for purposes of the zero percent capital gains rate (described below), a corporation or partnership is a qualified D.C. Zone business if: (1) the sole trade or business of the corporation or partnership is the active conduct of a "qualified business" (defined below) within the D.C. Zone; (2) at least 50 percent (80 percent for purposes of the zero percent capital gains rate) of the total gross income of such entity is derived from the active conduct of a qualified business within the D.C. Zone; (3) a substantial portion of the use of the entity's tangible property (whether owned or leased) is within the D.C. Zone; (4) a substantial portion of the entity's intangible property is used in the active conduct of such business; (5) a substantial portion of the services performed for such entity by its employees are performed within the D.C. Zone; and (6) less than 5 percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to (a) certain financial property, or (b) collectibles not held primarily for sale to customers in the ordinary course of an active trade or business. Similar rules apply to a qualified business carried on by an individual as a proprietorship.

In general, a "qualified business" means any trade or business. However, a "qualified business" does not include any trade or business that consists predominantly of the development or holding of intangibles for sale or license. In addition, a qualified business does not include any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, liquor store, or certain large farms (so-called "excluded businesses"). The rental of residential real estate is not a qualified business. The rental of commercial real estate is a qualified business only if at least 50 percent of the gross rental income from the real property is from qualified D.C. Zone businesses. The rental of tangible personal property to others also is not a qualified business unless at least 50 percent of the rental of such property is by qualified D.C. Zone businesses or by residents of the D.C. Zone.

For purposes of the tax-exempt financing provisions, the term "D.C. Zone business" generally is defined as for purposes of the increased expensing under section 179. However, a qualified D.C. Zone business for purposes of the tax-exempt financing provisions includes a business located in the D.C. Zone that would qualify as a D.C. Zone business if it were separately incorporated. In addition, under a special rule applicable only for purposes of the tax- exempt financing rules, a business is not required to satisfy the requirements applicable to a D.C. Zone business until the end of a startup period if, at the beginning of the startup period, there is a reasonable expectation that the business will be a qualified D.C. Zone business at the end of the startup period and the business makes bona fide efforts to be such a business. With respect to each property financed by a bond issue, the startup period ends at the beginning of the first taxable year beginning more than two years after the later of (1) the date of the bond issue financing such property, or (2) the date the property was placed in service (but in no event more than three years after the date of bond issuance). In addition, if a business satisfies certain requirements applicable to a qualified D.C. Zone business for a three-year testing period following the end of the start-up period and thereafter continues to satisfy certain business requirements, then it will be treated as a qualified D.C. Zone business for all years after the testing period irrespective of whether it satisfies all of the requirements of a qualified D.C. Zone business.

Zero-percent capital gains rate

A zero-percent capital gains rate applies to capital gains from the sale of certain qualified D.C. Zone assets held for more than five years. For purposes of the zero-percent capital gains rate, the D.C. Enterprise Zone is defined to include all census tracts within the District of Columbia where the poverty rate is not less than 10 percent. Only capital gain that is attributable to the 10-year period beginning January 1, 1998, and ending December 31, 2007, is eligible for the zero-percent rate.

In general, qualified "D.C. Zone assets" mean stock or partnership interests held in, or tangible property held by, a D.C. Zone business. Such assets must generally be acquired after December 31, 1997, and before January 1, 2003. However, under a special rule, qualified D.C. Zone assets include property that was a qualified D.C. Zone asset in the hands of a prior owner, provided that at the time of acquisition, and during substantially all of the subsequent purchaser's holding period, either (1) substantially all of the use of the property is in a qualified D.C. Zone business, or (2) the property is an ownership interest in a qualified D.C. Zone business.

First-time homebuyer tax credit

First-time homebuyers of a principal residence in the District are eligible for a tax credit of up to $5,000 of the amount of the purchase price, except that the credit phases out for individual taxpayers with adjusted gross income ("AGI") between $70,000 and $90,000 ($110,000–$130,000 for joint filers). The credit is available with respect to property purchased after the date of enactment and before January 1, 2001. Any excess credit may be carried forward indefinitely to succeeding taxable years.

Explanation of Provisions

Eligible census tracts

The bill clarifies that the determination of whether a census tract in the District of Columbia satisfies the applicable poverty criteria for inclusion in the D.C. Enterprise Zone for purposes of the wage credit, expensing, and special tax-exempt financing incentives (poverty rate of not less than 20 percent) or for purposes of the zero-percent capital gains rate (poverty rate of not less than 10 percent) is based on 1990 decennial census data. Thus, data from the 2000 decennial census would not result in the expansion or other reconfiguration of the D.C. Enterprise Zone.

Qualified D.C. Zone business

The bill modifies section 1400B(c) to clarify that a proprietorship can constitute a D.C. Zone business for purposes of the zero-percent capital gains rate.

The bill also clarifies that qualified D.C. Zone businesses that take advantage of the special tax-exempt financing incentives do not become subject to a 35-percent zone resident requirement after the close of the testing period.

Zero-percent capital gains rate

The bill clarifies that there is no requirement that D.C. Zone business property be acquired by a subsequent purchaser prior to January 1, 2003, to be eligible for the special rule applicable to subsequent purchasers.

In addition, the bill clarifies that the termination of the D.C. Enterprise Zone designation at the end of 2002 will not, by itself, result in property failing to be treated as a qualified D.C. Zone asset for purposes of the zero-percent capital gains rate, provided that the property otherwise continues to qualify were the D.C. Zone designation in effect.

First-time homebuyer credit

The bill clarifies that, for purposes of the first-time homebuyer credit, a "first-time homebuyer" means any individual if such individual (and, if married, such individual's spouse) did not have a present ownership interest in a principal residence in the District of Columbia during the one-year period ending on the date of the purchase of the principal residence to which the credit applies.

The bill also clarifies that the phaseout of the credit for individual taxpayers with adjusted gross income between $70,000 and $90,000 ($110,000–$130,000 for joint filers) applies only in the year the credit is generated, and does not apply in subsequent years to which the credit may be carried over.

In addition, the bill clarifies that the term "purchase price" means the adjusted basis of the principal residence on the date the residence is purchased. Newly constructed residences are treated as purchased by the taxpayer on the date the taxpayer first occupies such residence.

The bill clarifies that the first-time homebuyer credit is a nonrefundable personal credit and would provide that the first-time homebuyer credit is claimed after the credits described in Code sections 25 (credit for interest on certain home mortgages) and 23 (adoption credit).

Finally, the bill clarifies that the first-time homebuyer credit would be available only for property purchased after August 4, 1997, and before January 1, 2001. Thus, the credit is available to first-time home purchasers who acquire title to a qualifying principal residence on or after August 5, 1997, and on or before December 31, 2000, irrespective of the date the purchase contract was entered into.

EFFECTIVE DATE

The provisions are effective as of August 5, 1997, the date of enactment of the 1997 Act.

H. AMENDMENTS TO TITLE IX OF THE 1997 ACT RELATING TO MISCELLANEOUS PROVISIONS

1. Clarification of effect of certain transfers to Highway Trust Fund (sec. 6009(a) of the bill, sec. 901 of the 1997 Act, and sec. 9503 of the Code) [70]

Present Law

The 1997 Act provided for the transfer of an additional 4.3 cents per gallon of the highway motor fuels tax revenues from the General Fund to the Highway Trust Fund, and provided that revenues transferred to the Trust Fund under this provision could not be used in a manner resulting in changes in direct spending. The 1997

[70] S. 1173, as passed by the Senate, and H.R. 2400, as passed by the House, would repeal the underlying provision of the 1997 Act to which this correction relates.

Act further changed the dates by which certain taxes would be required to be deposited with the Treasury in fiscal year 1998.

Explanation of Provision

The bill clarifies that the tax deposit delays included in the provisions affecting transfers to the Highway Trust Fund, like the revenue transfers themselves, do not affect direct spending from the Trust Fund.

Effective Date

The provision is effective as if included in the 1997 Act.

2. Clarification of Mass Transit Account portions of highway motor fuels taxes (sec. 6009(b) of the bill, sec. 907 of the 1997 Act, and sec. 9503 of the Code) [71]

Present Law

The 1997 Act provided for the transfer to the Highway Trust Fund of revenues attributable to a General Fund fuels tax rate of 4.3 cents per gallon. That Act further enacted reduced rates, based on energy content, for propane, liquefied natural tax, compressed natural gas, and methanol produced from natural gas. When deposited in the Highway Trust Fund, revenues from the taxes on each of these products are divided between the Trust Fund's Highway Account and the Mass Transit Account.

Explanation of Provision

The bill clarifies that the Mass Transit Account portion of the highway motor fuels taxes generally is 2.86 cents per gallon and that taxes on the four fuels eligible for reduced rates are divided between the Highway Account and the Mass Transit Account in the same proportion as is the tax on gasoline.

Effective Date

The provision is effective as if included in the 1997 Act.

3. Clarification of qualification for reduced rate of excise tax on certain hard ciders (sec. 6009(c) of the bill, sec. 908 of the 1997 Act, and sec. 5041 of the Code)

Present Law

Distilled spirits are taxed at a rate of $13.50 per proof gallon; beer is taxed at a rate of $18 per barrel (approximately 58 cents per gallon); and still wines of 14 percent alcohol or less are taxed at a rate of 1.07 per wine gallon. The Code defines still wines as wines containing not more than 0.392 gram of carbon dioxide per hundred milliliters of wine. Higher rates of tax are applied to wines with greater alcohol content, to sparkling wines (e.g., champagne), and to artificially carbonated wines.

[71] S. 1173, as passed by the Senate, and H.R. 2400, as passed by the House, include an identical technical correction.

Certain small wineries may claim a credit against the excise tax on wine of 90 cents per wine gallon on the first 100,000 gallons of still wine produced annually (i.e., net tax rate of 17 cents per wine gallon on wines with an alcohol content of 14 percent or less). No credit is allowed on sparkling wines. Certain small breweries pay a reduced tax of $7.00 per barrel (approximately 22.6 cents per gallon) on the first 50,000 barrels of beer produced annually.

Hard cider is a wine fermented solely from apples or apple concentrate and water, containing no other fruit product and containing at least one-half of one percent and less than 7 percent alcohol by volume. Once fermented, eligible hard cider may not be altered by the addition of other fruit juices, flavor, or other ingredients that alter the flavor that results from the fermentation process. The 1997 Act provided a lower excise tax rate of 22.6 cents per gallon on hard cider. Qualifying small producers that produce 250,000 gallons or less of hard cider and other wines in a calendar year may claim a credit of 5.6 cents per wine gallon on the first 100,000 gallons of hard cider produced. This credit produces an effective tax rate of 17 cents per gallon, the same effective rate as that applied to small producers of still wines having an alcohol content of 14 percent or less. This credit is phased out for production in excess of 100,000 gallons but less than 250,000 gallons annually.

Explanation of Provision

The bill clarifies that the 22.6-cents-per-gallon tax rate applies only to apple cider that otherwise would be a still wine subject to a tax rate of $1.07 per wine gallon, i.e., still wines having an alcohol content of 14 percent or less.

Effective Date

The provision is effective as if included in the 1997 Act.

4. Combined employment tax reporting demonstration project (sec. 6009(f) of the bill, sec. 976 of the 1997 Act, and sec. 6103 of the Code)

Present Law

Traditionally, Federal tax forms are filed with the Federal Government and State tax forms are filed with individual states. This necessitates duplication of items common to both returns. Some States have recently been working with the IRS to implement combined State and Federal reporting of certain types of items on one form as a way of reducing the burdens on taxpayers. The State of Montana and the IRS have cooperatively developed a system to combine State and Federal employment tax reporting on one form. The one form would contain exclusively Federal data, exclusively State data, and information common to both: the taxpayer's name, address, TIN, and signature.

The Internal Revenue Code prohibits disclosure of tax returns and return information, except to the extent specifically authorized by the Internal Revenue Code (sec. 6103). Unauthorized disclosure is a felony punishable by a fine not exceeding $5,000 or imprisonment of not more than five years, or both (sec. 7213). An action for civil damages also may be brought for unauthorized disclosure (sec. 7431). No tax information may be furnished by the Internal Revenue Service ("IRS") to another agency unless the other agency establishes procedures satisfactory to the IRS for safeguarding the tax information it receives (sec. 6103(p)).

Implementation of the combined Montana-Federal employment tax reporting project had been hindered because the IRS interprets section 6103 to apply that provision's restrictions on disclosure to information common to both the State and Federal portions of the combined form, although these restrictions would not apply to the State with respect to the State's use of State-requested information if that information were supplied separately to both the State and the IRS.

The 1997 Act permits implementation of a demonstration project to assess the feasibility and desirability of expanding combined reporting in the future. There are several limitations on the demonstration project. First, it is limited to the State of Montana and the IRS. Second, it is limited to employment tax reporting. Third, it is limited to disclosure of the name, address, TIN, and signature of the taxpayer, which is information common to both the Montana and Federal portions of the combined form. Fourth, it is limited to a period of five years.

Explanation of Provision

The provision permits Montana to use this information as if it had collected it separately by eliminating Federal penalties for disclosure of this information. The provision also corrects a cross-reference to the provision.

Effective Date

The provision is effective as of the date of enactment of the 1997 Act (August 5, 1997), and will expire on the date five years after the date of enactment of the 1997 Act.

5. Election for 1987 partnerships to continue exception from treatment of publicly traded partnerships as corporations (sec. 6009(d) of the bill, sec. 964 of the 1997 Act, and sec. 7704 of the Code)

Present Law

In general

In the case of an electing 1987 partnership that elects to be subject to a 3.5-percent tax on gross income from the active conduct of a trade or business, the general rule treating a publicly traded partnership as a corporation does not apply. The 3.5-percent tax was intended to approximate the corporate tax the partnership would pay if it were treated as a corporation for Federal tax purposes.

Tax on partnership

The 3.5-percent tax is imposed on the electing 1987 partnership under the provision (sec. 7704(g)(3)). The provision does not specifically make inapplicable, however, the general rule that a partnership as such is not subject to income tax, but rather, the partners are liable for the tax in their separate or individual capacities (sec. 701).

Estimated tax payments

The provision does not specifically make applicable the requirements for payment of estimated tax that apply generally to payments of corporate tax.

Explanation of Provisions

Tax on partnership

The technical correction clarifies that the 3.5-percent tax is paid by the partnership. The general rule of section 701(a) that a partnership as such is not subject to income tax, but rather, the partners are liable for the tax in their separate or individual capacities does not apply to the payment of the 3.5-percent tax by the partnership.

Estimated tax payments

The technical correction provides that the corporate estimated tax payment rules of section 6655 are applied to the 3.5-percent tax payable by an electing 1987 partnership in the same manner as if the partnership were a corporation and the tax were imposed under section 11 (relating to corporate tax rates). References in section 11 to taxable income are to be applied for this purpose as if they were references to gross income of the partnership for the taxable year from the active conduct of trades and businesses by the partnership.

Effective Date

Tax on partnership

The provision is effective as if enacted with the 1997 Act.

Estimated tax payments

The provision is effective for taxable years beginning after the date of enactment.

6. Depreciation limitations for electric vehicles (sec. 6009(e) of the bill, sec. 971 of the 1997 Act, and sec. 280F of the Code)

Present Law

Annual depreciation deductions with respect to passenger automobiles are limited to specified dollar amounts, indexed for inflation. Any cost not recovered during the 6-year recovery period of such vehicles may be recovered during the years succeeding the recovery period, subject to similar limitations. The recovery-period limitations are trebled for vehicles that are propelled primarily by electricity.

Explanation of Provision

The depreciation limitations applicable to post-recovery periods under section 280F are trebled for vehicles that are propelled primarily by electricity.

Effective Date

The provision is effective for property placed in service after August 5, 1997 and before January 1, 2005.

7. Modification of operation of elective carryback of existing net operating losses of the National Railroad Passenger Corporation ("Amtrak") (sec. 6009(g) of the bill and sec. 977 of the 1997 Act)

Present Law

The 1997 Act provides elective procedures that allow Amtrak to consider the tax attributes of its predecessors (i.e., those railroads that were relieved of their responsibility to provide intercity rail passenger service as a result of the Rail Passenger Service Act of 1970) in the use of Amtrak's net operating losses. The benefit allowable under these procedures is limited to the least of: (1) 35 percent of Amtrak's existing qualified carryovers, (2) the net tax liability for the carryback period, or (3) $2,323,000,000. One half of the amount so calculated will be treated as a payment of the tax imposed by chapter 1 of the Internal Revenue Code of 1986 for Amtrak's taxable year ending December 31, 1997, and a similar amount for Amtrak's taxable year ending December 31, 1998.

The availability of the elective procedures is conditioned on Amtrak (1) agreeing to make payments of one percent of the amount it receives to each of the non-Amtrak States to offset certain transportation related expenditures and (2) using the balance for certain qualified expenses. Non-Amtrak States are those States that are not receiving Amtrak service at any time during the period beginning on the date of enactment and ending on the date of payment.

Explanation of Provision

The provision provides that the term "non-Amtrak State" means any State that is not receiving intercity passenger rail service from Amtrak as of the date of enactment of the 1997 Act (August 5, 1997). Thus, a State will not lose its status as a non-Amtrak State with respect to any payment by reason of acquiring Amtrak service with any payment from Amtrak under the 1997 Act provision.

Effective Date

The provision is effective as if included in section 977 of the 1997 Act.

I. AMENDMENTS TO TITLE X OF THE 1997 ACT RELATING TO REVENUE-RAISING PROVISIONS

1. Exception from constructive sales rules for certain debt positions (sec. 6010(a)(1) of the bill, sec. 1001(a) of the 1997 Act, and sec. 1259(b)(2) of the Code)

Present Law

A taxpayer is required to recognize gain (but not loss) upon entering into a constructive sale of an "appreciated financial position," which generally includes an appreciated position with respect to any stock, debt instrument or partnership interest. An exception is provided for positions with respect to debt instruments that have an unconditionally payable principal amount, that are not convertible into the stock of the issuer or a related person, and the interest on which is either fixed, payable at certain variable rates or based on certain interest payments on a pool of mortgages.

Explanation of Provision

The provision clarifies that, to qualify for the exception for positions with respect to debt instruments, the position would either have to meet the requirements as to unconditional principal amount, non-convertibility and interest terms or, alternatively, be a hedge of a position meeting these requirements. A hedge for purposes of the provision includes any position that reduces the taxpayer's risk of interest rate or price changes or currency fluctuations with respect to another position.

Effective Date

The provision is generally effective for constructive sales entered into after June 8, 1997.

2. Definition of forward contract under constructive sales rules (sec. 6010(a)(2) of the bill, sec. 1001(a) of the 1997 Act, and sec. 1259(d)(1) of the Code)

Present Law

A constructive sale of an appreciated financial position generally results when the taxpayer enters into a forward contact to deliver the same or substantially identical property. A forward contract for this purpose is defined as a contract that provides for delivery of a substantially fixed amount of property at a substantially fixed price.

Explanation of Provision

The provision clarifies that the definition of a forward contract includes a contract that provides for cash settlement with respect to a substantially fixed amount of property at a substantially fixed price.

Effective Date

The provision is generally effective for constructive sales entered into after June 8, 1997.

3. Treatment of mark-to-market gains of electing traders (sec. 6010(a)(3) of the bill, sec. 1001(b) of the 1997 Act, and sec. 475(f)(1)(D) of the Code)

Present Law

Securities and commodities traders may elect application of the mark-to-market accounting rules. Gain or loss recognized by an electing taxpayer under these rules is treated as ordinary gain or loss.

Under the Self-Employment Contributions Act ("SECA"), a tax is imposed on an individual's net earnings from self-employment ("NESE"). Gain or loss from the sale or exchange of a capital asset is excluded from NESE.

A publicly-traded partnership generally is treated as a corporation for Federal tax purposes. An exception to this rule applies if 90 percent or more of the partnership's gross income consists of passive-type income, which includes gain from the sale or disposition of a capital asset.

Explanation of Provision

The provision clarifies that gain or loss of a securities or commodities trader that is treated as ordinary solely by reason of election of mark-to-market treatment is not treated as other than gain or loss from a capital asset for purposes of determining NESE for SECA tax purposes, determining whether the passive-type income exception to the publicly-traded partnership rules is met or for purposes of any other Code provision specified by the Treasury Department in regulations.

Effective Date

The provision applies to taxable years of electing securities and commodities traders ending after the date of enactment of the 1997 Act.

4. Special effective date for constructive sale rules (sec. 6010(a)(4) of the bill, sec. 1001(d) of the 1997 Act, and sec. 1259 of the Code)

Present Law

The constructive sales rules contain a special effective date provision for decedents dying after June 8, 1997, if (1) a constructive sale of an appreciated financial position occurred before such date, (2) the transaction remains open for not less than two years, (3) the transaction remains open at any time during the three years prior to the decedent's death, and (4) the transaction is not closed within the 30-day period beginning on the date of enactment of the 1997 Act. If the requirements of the special effective date provision are met, both the appreciated financial position and the transaction resulting in the constructive sale are generally treated as property constituting rights to receive income in respect of a decedent under section 691. However, gain with respect to a position in a constructive sale transaction that accrues after the transaction is closed is not included in income in respect of a decedent.

Explanation of Provision

The provision clarifies the special effective date rule to provide that the rule does not apply if the constructive sale transaction is closed at any time prior to the end of the 30th day after the date of enactment of the 1997 Act.

Effective Date

The provision is effective for decedents dying after June 8, 1997.

5. Gain recognition for certain extraordinary dividends (sec. 6010(b) of the bill, sec. 1011 of the 1997 Act, and sec. 1059 of the Code)

Present Law

A corporate shareholder generally can deduct at least 70 percent of a dividend received from another corporation. This dividends received deduction is 80 percent if the corporate shareholder owns at least 20 percent of the distributing corporation and generally 100 percent if the shareholder owns at least 80 percent of the distributing corporation.

Section 1059 of the Code requires a corporate shareholder that receives an "extraordinary dividend" to reduce the basis of the stock with respect to which the dividend was received by the nontaxed portion of the dividend. Whether a dividend is "extraordinary" is determined, among other things, by reference to the size of the dividend in relation to the adjusted basis of the shareholder's stock. In addition, dividends resulting from non pro rata redemptions, partial liquidations, and certain other redemptions are extraordinary dividends. Pursuant to a provision of the 1997 Act, gain is recognized to the extent the reduction in basis of stock exceeds the basis in the stock with respect to which an extraordinary dividend is received. Prior to the 1997 Act, the recognition of such gain generally was deferred until the stock to which the adjustment related was sold or disposed of.

The consolidated return regulations provide basis adjustment rules with respect to dividends paid within a consolidated group of corporations. These rules provide that a dividend paid from one member of a group to its parent reduces the parent's basis in the stock of the payor and if such reduction exceeds the parent's basis, an "excess loss account" is created or increased. Excess loss accounts generally are not restored to income until the occurrence of certain specified events (e.g., when the corporation to which the excess loss account relates leaves the consolidated group). Legislative history indicates that, except as provided in regulations, the extraordinary dividend provisions do not apply to result in a double reduction in basis in the case of distributions between members of an affiliated group filing consolidated returns or in the double inclusion of earnings and profits.

Explanation of Provision

The provision provides the Treasury Department regulatory authority to coordinate the basis adjustment rules of section 1059 and the consolidated return regulations. It is expected that these rules generally would provide that, except as provided in regulations to be issued,[72] section 1059 will not cause current gain recognition to the extent that the consolidated return regulations require the creation or increase of an excess loss account with respect to a distribution.

Effective Date

The provision generally is effective for distributions after May 3, 1995.

6. Treatment of certain corporate distributions (sec. 6010(c) of the bill, sec. 1012 of the 1997 Act, and secs. 355(e)(3)(A)(iv) and 358(c) of the Code)

Present Law

The 1997 Act (sec. 1012(a)) requires a distributing corporation ("distributing") to recognize corporate level gain on the distribution of stock of a controlled corporation ("controlled") under section 355 of the Code if, pursuant to a plan or series of related transactions, one or more persons acquire a 50-percent or greater interest (defined as 50 percent or more of the voting power or value of the stock) of either the distributing or controlled corporation (Code sec. 355(e)). Certain transactions are excepted from the definition of acquisition for this purpose, including, under section 355(e)(3)(A)(iv), the acquisition by a person of stock in a corporation if shareholders owning directly or indirectly stock possessing more than 50 percent of the voting power and more than 50 percent of the value of the stock in distributing or any controlled corporation before such acquisition own directly or indirectly stock possessing such vote and value in such distributing or controlled corporation after such acquisition.[73]

In the case of a 50-percent or more acquisition of either the distributing corporation or the controlled corporation, the amount of gain recognized is the amount that the distributing corporation would have recognized had the stock of the controlled corporation been sold for fair market value on the date of the distribution. The Conference Report to the 1997 Act states that no adjustment to the basis of the stock or assets of either corporation is allowed by reason of the recognition of the gain.[74]

The 1997 Act (sec. 1012(b)(1)) also provides that, except as provided in regulations, section 355 shall not apply to the distribution

[72] Thus, current Treas. reg. sec. 1.1059(e)–1(a) will not result in gain recognition with respect to distributions within a consolidated group to the extent such distribution results in the creation or increase of an excess loss account under the consolidated return regulations.

[73] This exception (as certain other exceptions) does not apply if the stock held before the acquisition was acquired pursuant to a plan (or series of related transactions) to acquire a 50-percent or greater interest in the distributing or a controlled corporation.

[74] The 1997 Act does not limit the otherwise applicable Treasury regulatory authority under section 336(e) of the Code. Nor does it limit the otherwise applicable provisions of section 1367 with respect to the effect on shareholder stock basis of gain recognized by an S corporation under this provision.

of stock from one member of an affiliated group of corporations (as defined in section 1504(a)) to another member of such group (an intragroup spin-off) if such distribution is part of such a plan or series of related transactions pursuant to which one or more persons acquire stock representing a 50-percent or greater interest in a distributing or controlled corporation, determined after the application of the rules of section 355(e).

In addition, the 1997 Act (sec. 1012(b)(2)) provides that in the case of any distribution of stock of one member of an affiliated group of corporations to another member under section 355, the Treasury Department has regulatory authority under section 358(g) to provide adjustments to the basis of any stock in a corporation which is a member of such group, to reflect appropriately the proper treatment of such distribution.

The 1997 Act (sec. 1012(c)) also modified certain rules for determining control immediately after a distribution in the case of certain divisive transactions in which a controlled corporation is distributed and the transaction meets the requirements of section 355. In such cases, under section 351 and modified section 368(a)(2)(H) with respect to reorganizations under section 368(a)(1)(D), those shareholders receiving stock in the distributed corporation are treated as in control of the distributed corporation immediately after the distribution if they hold stock representing a greater than 50 percent interest in the vote and value of stock of the distributed corporation.

The effective date (Act section 1012(d)(1)) states that the forgoing provisions of the 1997 Act apply to distributions after April 16, 1997, pursuant to a plan (or series of related transactions) which involves an acquisition occurring after such date (unless certain transition provisions apply).

Explanation of Provision

Acquisition of a 50-percent or greater interest

The bill clarifies that the acquisitions described in Code section 355(e)(3)(A) are disregarded in determining whether there has been an acquisition of a 50-percent or greater interest in a corporation. However, other transactions that are part of a plan or series of related transactions could result in an acquisition of a 50-percent or greater interest.

In the case of acquisitions under section 355(e)(3)(A)(iv), the provision clarifies that the acquisition of stock in the distributing corporation or any controlled corporation is disregarded to the extent that the percentage of stock owned directly or indirectly in such corporation by each person owning stock in such corporation immediately before the acquisition does not decrease.

Example: Shareholder A owns 10 percent of the vote and value of the stock of corporation D (which owns all of corporation C). There are nine other equal shareholders of D. A also owns 100 percent of the vote and value of the stock of unrelated corporation P. D distributes C to all the shareholders of D. Thereafter, pursuant to a plan or series of related transactions, D (worth 100x) merges with corporation P (worth 900x). After the merger, each of the former shareholders of corporation D owns stock of the merged entity reflecting the vote and value attributable to that shareholder's respective 10 percent former stock ownership of D. Each of the former shareholders of D owns 1 percent of the stock of the merged corporation, except that shareholder A (who owned 100 percent of corporation P and 10 percent of corporation D before the merger) now owns 91 percent of the stock of the merged corporation. In determining whether a 50-percent or greater interest in D has been acquired, the interest of each of the continuing shareholders is disregarded only to the extent there has been no decrease in such shareholder's direct or indirect ownership. Thus, the 10 percent interest of A, and the 1 percent interest of each of the nine other former shareholders of D, is not counted. The remaining 81 percent ownership of the merged corporation, representing a decrease of nine percent in the interests of each of the nine former shareholders other than A, is counted in determining the extent of an acquisition. Therefore, a 50-percent or greater interest in D has been acquired.

Treasury regulatory authority

The bill also clarifies that the regulatory authority of the Treasury Department under section 358(c) applies to distributions after April 16, 1997, without regard to whether a distribution involves a plan (or series of related transactions) which involves an acquisition.

As stated in the Conference Report to the 1997 Act, with respect to the Treasury Department regulatory authority under section 358(c) as applied to intragroup spin-off transactions that are not part of a plan or series of related transactions that involve an acquisition of a 50-percent or greater interest under new section 355(f), it is expected that any Treasury regulations will be applied prospectively, except in cases to prevent abuse.

Section 351(c) and section 368(a)(2)(H) "control immediately after" requirement

In general, the 1997 Act modifications to the control immediately after requirement of Section 351(c) and section 368(a)(2)(H) were intended to minimize certain differences in the results of a transaction involving a contribution of assets to controlled corporation prior to a section 355 spin-off that could occur depending on whether the distributing or controlled corporation were acquired subsequent to the spin-off.

The bill clarifies that in the case of certain divisive transactions in which a corporation contributes assets to a controlled corporation and then distributes the stock of the controlled corporation in a transaction that meets the requirements of section 355 (or so much of section 356 as relates to section 355), solely for purposes of determining the tax treatment of the transfers of property to the controlled corporation by the distributing corporation, the fact that the shareholders of the distributing corporation dispose of part or all of the distributed stock shall not be taken into account for purposes of the control immediately after requirement of section 351(a) or 368(a)(1)(D). For purposes of determining the tax treatment of transfers of property to the controlled corporation by parties other than the distributing corporation, the disposition of part or all of the distributed stock continues to be taken into account, as under prior law, in determining whether the control immediately after requirement is satisfied.

Example 1: Distributing corporation D transfers appreciated business X to subsidiary C in exchange for 100 percent of C stock. D distributes its stock of C to D shareholders. As part of a plan or series of related transactions, C merges into unrelated acquiring corporation A, and the C shareholders receive 25 percent of the vote or value of A stock. If the requirements of section 355 are met with respect to the distribution, then the control immediately after requirement will be satisfied solely for purposes of determining the tax treatment of the transfers of property by D to C. Accordingly, the business X assets transferred to C and held by A after the merger will have a carryover basis from D. Section 355(e) will require D to recognize gain as if the C stock had been sold at fair market value.

Example 2: Distributing corporation D transfers appreciated business X to subsidiary C in exchange for 85 percent of C stock. Unrelated persons transfer appreciated assets to C in exchange for the remaining 15 percent of C stock. D distributes all its stock of C to D shareholders. As part of a plan or series of related transactions, C merges into acquiring corporation A; and the interests attributable to the D shareholders' receipt of C stock with respect to their D stock in the distribution represent 25 percent of the vote and value of A stock. If the requirements of section 355 are met with respect to the distribution, then the control immediately after requirement will be satisfied solely for purposes of determining the tax treatment of the transfers of property by D to C. Section 355(e) will require recognition of gain as if the C stock had been sold for fair market value. The business X assets transferred to C and held by A after the merger will have a carryover basis from D. The persons other than D who transferred assets to C for 15 percent of C stock will recognize gain on the appreciation in their assets transferred to C if the control immediately after requirement is not satisfied after taking into account any post-spin-off dispositions that would have been taken into account under prior law.

Example 3: The facts are the same as in example 2, except that the interests attributable to the D shareholders' receipt of C stock with respect to their D stock in the distribution represent 55 percent of the vote and value of A stock in the merger. If the requirements of section 355 are met with respect to the distribution, then the control immediately after requirement will be satisfied solely for purposes of determining the tax treatment of the transfers by D to C. The business X assets in C (and in A after the merger) will therefore have a carryover basis from D. Because the D shareholders retain more than 50 percent of the stock of A, section 355(e) will not apply. The persons other than D who transferred property for the 15 percent of C stock will recognize gain on the appreciation in their assets transferred to C if the control immediately after requirement is not satisfied after taking into account any post-spin-off dispositions that would have been taken into account under prior law.

Effective Date

The provision generally is effective for distributions after April 16, 1997.

7. Certain preferred stock treated as "boot"—statute of limitations (sec. 6010(e)(2) of the bill, sec. 1014 of the 1997 Act, and sec. 354(a) of the Code)

Present law

Under the 1997 Act, certain preferred stock received in otherwise tax-free transactions is treated as "other property." Exchanges of stock in certain recapitalizations of family-owned corporations are excepted from this rule. A family-owned corporation is defined as any corporation if at least 50 percent of the total voting power and value of the stock of such corporation is owned by the same family for five years preceding the recapitalization. In addition, a recapitalization does not qualify for the exception if the same family does not own 50 percent of the total voting power and value of the stock throughout the three-year period following the recapitalization.

Explanation of Provision

The bill provides that the statutory period for the assessment of any deficiency attributable to a corporation failing to be a family-owned corporation shall not expire before the expiration of three years after the date the Secretary of the Treasury is notified by the corporation (in such manner as the Secretary may prescribe) of such failure, and such deficiency may be assessed before the expiration of such three-year period notwithstanding the provisions of any other law or rule of law which would otherwise prevent such assessment.

Effective Date

The provision applies to transactions after June 8, 1997.

8. Certain preferred stock treated as "boot"—treatment of transferor (sec. 6010(e)(1) of the bill, sec. 1014 of the 1997 Act, and sec. 351(g) of the Code)

Present Law

The 1997 Act amended section 351 of the Code to provide that in the case of a person who transfers property to a controlled corporation and receives nonqualified preferred stock, section 351(b) will apply to such person. Section 351(b) provides that if section 351(a) of the Code would apply to an exchange but for the fact that there is received, in addition to stock permitted to be received under section 351(a), other property or money, then gain but no loss to such recipient shall be recognized. The Conference Report to the 1997 Act states that if nonqualified preferred stock is received, gain but not loss shall be recognized.

Explanation of Provision

The bill clarifies that section 351(b) applies to a transferor who transfers property in a section 351 exchange and receives nonqualified preferred stock in addition to stock that is not treated as "other property" under that section. Thus, if a transferor received only nonqualified preferred stock but the transaction in the aggregate otherwise qualified as a section 351 exchange, such a transferor would recognize loss and the basis of the nonqualified preferred stock and of the property in the hands of the transferee corporation would reflect the transaction in the same manner as if that particular transferor had received solely "other property" of any other type. As under the 1997 Act, the nonqualified preferred stock continues to be treated as stock received by a transferor for purposes of qualification of a transaction under section 351(a), unless and until regulations may provide otherwise.

Effective Date

The provision applies to transactions after June 8, 1997.

9. Application of section 304 to certain international transactions (sec. 6010(d) of the bill, sec. 1013 of the 1997 Act, and sec. 304 of the Code)

Present Law

Under section 304, if one corporation purchases stock of a related corporation, the transaction generally is recharacterized as a redemption. Under section 304(a), as amended by the 1997 Act, to the extent that a section 304 transaction is treated as a distribution under section 301, the transferor and the acquiring corporation are treated as if (1) the transferor had transferred the stock involved in the transaction to the acquiring corporation in exchange for stock of the acquiring corporation in a transaction to which section 351(a) applies, and (2) the acquiring corporation had then redeemed the stock it is treated as having issued. In the case of a section 304 transaction, both the amount which is a dividend and the source of such dividend is determined as if the property were distributed by the acquiring corporation to the extent of its earnings and profits and then by the issuing corporation to the extent of its earnings and profits (sec. 304(b)(2)). Section 304(b)(5), as added by the 1997 Act, provides special rules that apply if the acquiring corporation in a section 304 transaction is a foreign corporation. Under section 304(b)(5), the earnings and profits of the acquiring corporation that are taken into account are limited to the portion of such earnings and profits that (1) is attributable to stock of such acquiring corporation held by a corporation or individual who is the transferor (or a person related thereto) and who is a U.S. shareholder (within the meaning of section 951(b)) of such corporation and (2) was accumulated during periods in which such stock was owned by such person while such acquiring corporation was a controlled foreign corporation. For purposes of this rule, except as otherwise provided by the Secretary of the Treasury, the rules of section 1248(d) (relating to certain exclusions from earnings and profits) apply. The Secretary is to prescribe regulations as appropriate, including regulations determining the earnings and profits that are attributable to particular stock of the acquiring corporation.

For foreign tax credit purposes, under section 902, a U.S. corporation that receives a dividend from a foreign corporation in which it owns at least 10 percent of the voting stock is treated as if it had paid the foreign income taxes paid by the foreign corporation which are attributable to such dividend. The Internal Revenue Service issued rulings providing that a domestic corporation that is a transferor in a section 304 transaction may compute foreign taxes deemed paid under section 902 on the dividends from both a foreign acquiring corporation and a foreign issuing corporation. Rev. Rul. 92–86, 1992–2 C.B. 199; Rev. Rul. 91–5, 1991–1 C.B. 114. Both rulings involve section 304 transactions in which both the domestic transferor and the foreign acquiring corporation are wholly owned by a domestic parent corporation.

Explanation of Provision

Under the provision, in the case of a section 304 transaction in which the acquiring corporation or the issuing corporation is a foreign corporation, the Secretary of the Treasury is to prescribe regulations providing rules to prevent the multiple inclusion of an item of income and to provide appropriate basis adjustments, including rules modifying the application of sections 959 and 961 in the case of a section 304 transaction. It is expected that such regulations will provide for an exclusion from income for distributions from earnings and profits of the acquiring corporation and the issuing corporation that represent previously taxed income under subpart F. It further is expected that such regulations will provide for appropriate adjustments to the basis of stock held by the corporation treated as receiving the distribution or by the corporation that had the prior inclusion with respect to the previously taxed income. No inference is intended regarding the treatment of previously taxed income in a section 304 transaction under present law. The 1997 Act amendments to section 304, including the modifications under this provision, are not intended to change the foreign tax credit results reached in Rev. Rul. 92–86 and 91–5.

The provision also eliminates the cross-reference to the rules of section 1248(d) for purposes of determining the earnings and profits to be taken into account under section 304(b)(5).

Effective Date

The provision generally is effective for distributions or acquisitions after June 8, 1997.

10. Establish IRS continuous levy and improve debt collection (sec. 6010(f) of the bill, secs. 1024, 1025, and 1026 of the 1997 Act, and secs. 6331 and 6334 of the Code)

Present Law

If any person is liable for any internal revenue tax and does not pay it within 10 days after notice and demand by the IRS, the IRS may then collect the tax by levy upon all property and rights to property belonging to the person, unless there is an explicit statutory restriction on doing so. A levy is the seizure of the person's property or rights to property. A levy on salary and wages is continuous from the date it is first made until the date it is fully paid or becomes unenforceable.

The 1997 Act provides that a continuous levy is also applicable to non-means tested recurring Federal payments and specified wage replacement payments.

Explanation of Provision

The provision clarifies that the IRS must approve the use of a continuous levy before it may take effect.

Effective Date

The provision is effective for levies issued after the date of enactment of the 1997 Act (August 5, 1997).

11. Clarification regarding aviation gasoline excise tax (sec. 6010(g) of the bill, sec. 1031 of the 1997 Act, and sec. 6421 of the Code)

Present Law

Before enactment of the 1997 Act, aviation gasoline was subject to a 19.3-cents-per-gallon tax rate, with 15 cents per gallon being deposited in the Airport and Airway Trust Fund and 4.3 cents per gallon being retained in the General Fund. The 1997 Act extended the 15-cents-per-gallon rate for 10 years, through September 30, 2007, and expanded deposits to the Trust Fund to include revenues from the 4.3-cents-per-gallon rate. The tax does not apply to fuel used in flight segments outside the United States or to flight segments from the United States to foreign countries.

Explanation of Provision

The bill clarifies the application of the gasoline tax refund provisions to aviation gasoline used in flight segments outside the United States and to flight segments from the United States to foreign countries.

Effective Date

The provision is effective as if included in the 1997 Act.

12. Clarification of requirement that registered fuel terminals offer dyed fuel (sec. 6010(h) of the bill, sec. 1032 of the 1997 Act and sec. 4101 of the Code)[75]

Present Law

The 1997 Act provides that fuel terminals are eligible to register to handle non-tax-paid diesel fuel and kerosene only if the terminal operator offers both undyed (taxable) and dyed (nontaxable) fuel.

[75] S. 1173, as passed by the Senate, and H.R. 2400, as passed by the House, would delay the effective date of this requirement for two years, until July 1, 2000.

Explanation of Provision

The bill clarifies that the Code requires terminals eligible to handle non-tax-paid diesel to offer dyed diesel fuel and terminals eligible to handle non-tax-paid kerosene (including diesel fuel #1 and kerosene-type aviation fuel) to offer dyed kerosene. The bill does not require that a terminal offer for sale kerosene as a condition of receiving diesel fuel on a non-tax-paid basis. Similarly, the proposal does not require terminals that sell only kerosene to offer diesel fuel as a condition of receiving non-tax-paid kerosene.

Effective Date

The provision is effective as if included in the 1997 Act.

13. Clarification of treatment of prepaid telephone cards (sec. 6010(i) of the bill, sec. 1034 of the 1997 Act, and sec. 4251 of the Code)

Present Law

A 3-percent excise tax is imposed on amounts paid for local and toll (long-distance) telephone service and teletypewriter exchange service. The tax is collected by the provider of the service from the consumer. In the case of so-called "prepaid telephone cards", the tax is treated as paid when the card is transferred by any telecommunications carrier to any person who is not a telecommunications carrier.

A "prepaid telephone card" is defined as any card or other similar arrangement which permits its holder to obtain communications services and pay for such services in advance.

Explanation of Provision

The bill inserts the word "any" prior to "other similar arrangement" to clarify that payment to a telecommunications carrier from a third party such as a joint venture credit card company is treated as payment made by the holder of the credit card to obtain communication services and the tax is treated as paid in a manner similar to that applied to prepaid telephone cards. The tax applies to payments if the rights to telephone service for which payments are made can be used in whole or in part for telephone service that, if purchased directly, would be subject to the 3-percent excise tax on telephone service. Also, the tax applies without regard to whether telephone service ultimately is provided pursuant to the transferred rights.

Effective Date

The provision is effective as if included in the 1997 Act.

14. Modify UBIT rules applicable to second-tier subsidiaries (sec. 6010(j) of the bill, sec. 1041 of the 1997 Act, and sec. 512(b)(13) of the Code)

Present Law

In general, interest, rents, royalties and annuities are excluded from the unrelated business income ("UBI") of tax-exempt organizations. However, section 512(b)(13) treats otherwise excluded rent, royalty, annuity, and interest income as UBI if such income is received from a taxable or tax-exempt subsidiary that is controlled by the parent tax-exempt organization.

Under the provision, interest, rent, annuity, or royalty payments made by a controlled entity to a tax-exempt organization are subject to the unrelated business income tax to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity. In this regard, section 512(b)(13)(B)(i)(I) cross references a non-existent Code section.

The provision generally applies to taxable years beginning after the date of enactment. However, the provision does not apply to payments made during the first two taxable years beginning on or after the date of enactment if such payments are made pursuant to a binding written contract in effect as of June 8, 1997, and at all times thereafter before such payment.

Explanation of Provision

The bill clarifies that rent, royalty, annuity, and interest income that would otherwise be excluded from UBI is included in UBI under section 512(b)(13) if such income is received or accrued from a taxable or tax-exempt subsidiary that is controlled by the parent tax-exempt organization. The bill further clarifies that the provision does not apply to any payment received or accrued during the first two taxable years beginning on or after the date of enactment if such payment is received or accrued pursuant to a binding written contract in effect on June 8, 1997, and at all times thereafter before such payment (but not pursuant to any contract provision that permits optional accelerated payments).

Effective Date

The provision is effective as of August 5, 1997, the date of enactment of the 1997 Act.

15. Application of foreign tax credit holding period rule to RICs (sec. 6010(k) of the bill, sec. 1053 of the 1997 Act, and secs. 853 and 901 of the Code)

Present Law

Section 901(k), as added by the 1997 Act, generally imposes a holding period requirement for claiming foreign tax credits with respect to dividends. Under section 901(k), foreign tax credits with respect to a dividend from a foreign corporation or a regulated investment company (a "RIC") are disallowed if the shareholder has not held the stock for more than 15 days in the case of common stock or more than 45 days in the case of preferred stock. This disallowance applies both to foreign tax credits for foreign withholding taxes that are paid on the dividend where the dividend-paying stock is not held for the required period and to indirect foreign tax credits for taxes paid by a lower-tier foreign corporation or a RIC where any of the stock in the required chain of ownership is not held for the required period. Foreign taxes for which credits are disallowed under section 901(k) may be deducted.

Under section 853, a RIC may elect to flow through to its shareholders the foreign tax credits for foreign taxes paid by the RIC. Under this election, the RIC is not entitled to a deduction or credit for foreign taxes paid; the shareholders of an electing RIC are treated as having paid their proportionate shares of the foreign taxes paid by the RIC. Accordingly, foreign tax credits are claimed at the shareholder level and not at the RIC level.

Explanation of Provision

Under the provision, the flow-through election of section 853 does not apply to any foreign taxes paid by the RIC for which a credit is disallowed under section 901(k) because the RIC did not satisfy the applicable holding period. Accordingly, such taxes are deductible at the RIC level. The election of section 853 applies only to foreign taxes with respect to which the RIC has satisfied any applicable holding period requirement.

Effective Date

The provision is effective for dividends paid or accrued more than 30 days after the date of enactment of the 1997 Act.

16. Clarification of provision expanding the limitations on deductibility of premiums and interest with respect to life insurance, endowment and annuity contracts (sec. 6010(o) of the bill, sec. 1084 of the 1997 Act, and sec. 264 of the Code)

Present Law

Master contracts

The 1997 Act provided limitations on the deductibility of interest and premiums with respect to life insurance, endowment and annuity contracts. Under the pro rata interest disallowance provision added by the Act, an exception is provided for any policy or contract owned by an entity engaged in a trade or business, covering an individual who is an employee, officer or director of the trade or business at the time first covered. The exception applies to any policy or contract owned by an entity engaged in a trade or business, which covers one individual who (at the time first insured under the policy or contract) is (1) a 20-percent owner of the entity, or (2) an individual (who is not a 20-percent owner) who is an officer, director or employee of the trade or business.[76] The provision

[76] The exception also applies in the case of a joint-life policy or contract under which the sole insureds are a 20-percent owner and the spouse of the 20-percent owner. A joint-life contract under which the sole insureds are a 20-percent owner and his or her spouse is the only type of policy or contract with more than one insured that comes within the exception.

is silent as to the treatment of coverage of such an individual under a master contract.

Reporting

The provision does not apply to any policy or contract held by a natural person; however, if a trade or business is directly or indirectly the beneficiary under any policy or contract, the policy or contract is treated as held by the trade or business and not by a natural person. In addition, the provision includes a reporting requirement. Specifically, the provision provides that the Treasury Secretary shall require such reporting from policyholders and issuers as is necessary to carry out the rule applicable when the trade or business is directly or indirectly the beneficiary under any policy or contract held by a natural person. Any report required under this reporting requirement is treated as a statement referred to in Code section 6724(d)(1) (relating to information returns). The provision does not specifically refer to Code section 6724(d)(2) (relating to payee statements).

Additional covered lives

The 1997 Act provision limiting the deductibility of certain interest and premiums is effective generally with respect to contracts issued after June 8, 1997. To the extent of additional covered lives under a contract after June 8, 1997, the contract is treated as a new contract.

Explanation of Provision

Master contracts

The technical correction clarifies that if coverage for each insured individual under a master contract is treated as a separate contract for purposes of sections 817(h), 7702, and 7702A of the Code, then coverage for each such insured individual is treated as a separate contract, for purposes of the exception to the pro rata interest disallowance rule for a policy or contract covering an individual who is a 20-percent owner, employee, officer or director of the trade or business at the time first covered. A master contract does not include any contract if the contract (or any insurance coverage provided under the contract) is a group life insurance contract within the meaning of Code section 848(e)(2). No inference is intended that coverage provided under a master contract, for each such insured individual, is not treated as a separate contract for each such individual for other purposes under present law.

Reporting

The technical correction clarifies that the required reporting to the Treasury Secretary is an information return (within meaning of sec. 6724(d)(1)), and any reporting required to be made to any other person is a payee statement (within the meaning of sec. 6724(d)(2)). Thus, the $50-per-report penalty imposed under sections 6722 and 6723 of the Code for failure to file or provide such an information return or payee statement apply. It is clarified that the Treasury Secretary may require reporting by the issuer or policyholder of any relevant information either by regulations or by any other appropriate guidance (including but not limited to publication of a form).

Additional covered lives

The technical correction clarifies that the treatment of additional covered lives under the effective date of the 1997 Act provision applies only with respect to coverage provided under a master contract, provided that coverage for each insured individual is treated as a separate contract for purposes of Code sections 817(h), 7702 and 7702A, and the master contract or any coverage provided thereunder is not a group life insurance contract within the meaning of Code section 848(e)(2).

Effective Date

The provisions are effective as if included in the 1997 Act.

17. Clarification of allocation of basis of properties distributed to a partner by a partnership (sec. 6010(m) of the bill, sec. 1061 of the 1997 Act, and sec. 732(c) of the Code)

Present Law

Present law, as amended by the 1997 Act, provides rules for allocating basis to property in the hands of a partner that receives a distribution from a partnership. Under these rules, basis is first allocated to unrealized receivables and inventory items in an amount equal to the partnership's adjusted basis in each property. If the basis to be allocated is less than the sum of the adjusted bases of the properties in the hands of the partnership, then, to the extent a decrease is required to make the total adjusted bases of the properties equal the basis to be allocated, the decrease is allocated (as described below) for adjustments that are decreases. To the extent of any basis not allocated to inventory and unrealized receivables under the above rules, basis is allocated to other distributed properties, first to the extent of each distributed property's adjusted basis to the partnership. Any remaining basis adjustment, if an increase, is allocated among properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation (to the extent of each property's appreciation), and then in proportion to their respective fair market values. If the remaining basis adjustment is a decrease, it is allocated among properties with unrealized depreciation in proportion to their respective amounts of unrealized depreciation (to the extent of each property's depreciation), and then in proportion to their respective adjusted bases (taking into account the adjustments already made).

For purposes of these rules, "unrealized receivables" has the meaning set forth in section 751(c) (as provided in sec. 732(c)(1)(A)(i)). Section 751(c) provides that the term "unrealized receivables" includes certain accrued but unreported income. In addition, the last two sentences of section 751(c) provide that for purposes of certain specified partnership provisions (sections 731, 741 and 751), the term "unrealized receivables" includes certain property the sale of which will give rise to ordinary income (for example, depreciation recapture under sections 1245 or 1250), but only to the extent of the amount that would be treated as ordinary income on a sale of that property at fair market value.

Explanation of Provision

The technical correction clarifies that for purposes of the allocation rules of section 732(c), "unrealized receivables" has the meaning in section 751(c) including the last two sentences of section 751(c), relating to items of property that give rise to ordinary income. Thus, in applying the allocation rules of section 732(c) to property listed in the last two sentences of section 751(c), such as property giving rise to potential depreciation recapture, the amount of unrealized appreciation in any such property does not include any amount that would be treated as ordinary income if the property were sold at fair market value, because such amount is treated as a separate asset for purposes of the basis allocation rules.[77]

For example, assume that a partnership has 3 partners, A, C and D. The partnership has 6 assets. Three are capital assets each with adjusted basis equal to fair market value of $20,000. The other three are depreciable equipment each with adjusted basis of $5,000 and fair market value of $30,000. Each of the pieces of equipment would have $25,000 of depreciation recapture if sold by the partnership for its $30,000 value. A has a basis in its partnership interest of $60,000. Assume that one of the capital assets and one of the pieces of equipment is distributed to A in liquidation of its interest. A is treated as receiving three assets: (1) depreciation recapture (an unrealized receivable) with a basis to the partnership of zero and a value of $25,000; (2) a piece of equipment with a basis to the partnership of $5,000 and a value of $5,000 (its $30,000 value reduced by the $25,000 of depreciation recapture); and (3) a capital asset with a basis to the partnership of $20,000 and a value of $20,000.

Under the provision, as clarified by the technical correction, A's $60,000 basis in its partnership interest is allocated as follows. First, basis is allocated to the depreciation recapture, an unrealized receivable, in an amount equal to the partnership's adjusted basis in it, or zero (sec. 732(c)(1)(A)(i)). Then basis is allocated to the extent of each of the other distributed properties' adjusted basis to the partnership, or $5,000 to the equipment (not including the depreciation recapture), and $20,000 to the capital asset. A's remaining $35,000 of basis is allocated next among properties (other than inventory and unrealized receivables) with unrealized appreciation, in proportion to their respective amounts of unrealized appreciation (to the extent of each property's appreciation), but neither of the distributed properties to which basis may be allocated has unrealized appreciation. Basis is then allocated then in proportion to the properties' respective fair market values ($5,000 for the equipment and $20,000 for the capital asset). Thus, of the remaining $35,000, $7,000 is allocated to the equipment, so that its total basis in the partner's hands is $12,000; and $28,000 is allocated to the capital asset, so that its total basis in the partner's hands is $48,000.

[77] Treasury regulations under section 751(b) provide for a similar bifurcation of assets among potential ordinary income amounts and other amounts in applying the definition of "unrealized receivables" for purposes of that section. Treas. Reg. 1.751–1(c)(4).

Effective Date

The provision is effective as if enacted with the 1997 Act.

18. Clarification to the definition of modified adjusted gross income for purposes of the earned income credit phaseout (sec. 6010(p) of the bill, sec. 1085(d) of the 1997 Act, and sec. 32(c) of the Code)

Present Law

The earned income credit ("EIC") is phased out above certain income levels. For individuals with earned income (or modified adjusted gross income ("modified AGI'), if greater) in excess of the beginning of the phaseout range, the maximum credit amount is reduced by the phaseout rate multiplied by the amount of earned income (or modified AGI, if greater) in excess of the beginning of the phaseout range. For individuals with earned income (or modified AGI, if greater) in excess of the end of the phaseout range, no credit is allowed. The definition of modified AGI used for the phase out of the earned income credit is the sum of: (1) AGI with certain losses disregarded, and (2) certain nontaxable amounts not generally included in AGI. The losses disregarded are: (1) net capital losses (if greater than zero); (2) net losses from trusts and estates; (3) net losses from nonbusiness rents and royalties; (4) 75 percent of the net losses from business, computed separately with respect to sole proprietorships (other than in farming), sole proprietorships in farming, and other businesses.[78] The nontaxable amounts included in modified AGI which are generally not included in AGI are: (1) tax-exempt interest; and (2) nontaxable distributions from pensions, annuities, and individual retirement arrangements (but only if not rolled over into similar vehicles during the applicable rollover period).

Explanation of Provision

The bill clarifies that the two nontaxable amounts that are added to adjusted gross income to compute modified AGI for purposes of the EIC phaseout are additions to adjusted gross income and not disregarded losses.

Effective Date

The provision is effective for taxable years beginning after December 31, 1997.

[78] The 1997 Act increased the amount of net losses from businesses, computed separately with respect to sole proprietorships (other than farming), sole proprietorships in farming, and other businesses disregarded from 50 percent to 75 percent.

J. AMENDMENTS TO TITLE XI OF THE 1997 ACT RELATING TO FOREIGN PROVISIONS

1. Application of attribution rules under PFIC provisions (sec. 6011(b)(2) of the bill, sec. 1121 of the 1997 Act, and sec. 1298 of the Code)

Present Law

Special attribution rules apply to the extent that the effect is to treat stock of a passive foreign investment company ("PFIC") as owned by a U.S. person. In general, if 50 percent or more in value of the stock of a corporation is owned (directly or indirectly) by or for any person, such person is considered as owning a proportionate part of the stock owned directly or indirectly by or for such corporation, determined based on the person's proportionate interest in the value of such corporation's stock. However, this 50-percent limitation does not apply in the case of a corporation that is a PFIC. Accordingly, a person that is a shareholder of a PFIC is considered as owning a proportionate part of the stock owned directly or indirectly by or for such PFIC, without regard to whether such shareholder owns at least 50 percent of the PFIC's stock by value.

A corporation is not treated as a PFIC with respect to a shareholder during the qualified portion of the shareholder's holding period for the stock of such corporation. The qualified portion of the shareholder's holding period generally is the portion of such period which is after the effective date of the 1997 Act and during which the shareholder is a United States shareholder (as defined in sec. 951(b)) and the corporation is a controlled foreign corporation.

If a corporation is not treated as a PFIC with respect to a shareholder for the qualified portion of such shareholder's holding period, it is unclear whether the attribution rules that apply with respect to stock owned by or for such corporation apply without regard to the requirement that the shareholder own 50 percent or more of the corporation's stock.

Explanation of Provision

The provision clarifies that the attribution rules apply without regard to the provision that treats a corporation as a non-PFIC with respect to a shareholder for the qualified portion of the shareholder's holding period. Accordingly, stock owned directly or indirectly by or for a corporation that is not treated as a PFIC for the qualified portion of the shareholder's holding period nevertheless will be attributed to such shareholder, regardless of the shareholder's ownership percentage of such corporation.

Effective Date

The provision is effective for taxable years of U.S. persons beginning after December 31, 1997 and taxable years of foreign corporations ending with or within such taxable years of U.S. persons.

2. Treatment of PFIC option holders (sec. 6011(b)(1) of the bill, sec. 1121 of the 1997 Act, and secs. 1297 and 1298 of the Code)

Present Law

Under the provisions of subpart F, a controlled foreign corporation (a "CFC") is defined generally as any foreign corporation if U.S. persons own more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only) (sec. 957). Stock ownership includes not only stock owned directly, but also stock owned indirectly through a foreign entity or constructively (sec. 958). Pursuant to the constructive ownership rules, a person that has an option to acquire stock generally is treated as owning such stock (secs. 958(b) and 318(a)(4)).

The U.S. 10-percent shareholders of a CFC are subject to current U.S. tax on their pro rata shares of certain income of the CFC and their pro rata shares of the CFC's earnings invested in certain U.S. property (sec. 951). For purposes of determining the U.S. shareholder's includible pro rata share of the CFC's income and earnings, only stock held directly or indirectly through a foreign entity (and not stock held constructively) is taken into account (secs. 951(b) and 958(a)).

A foreign corporation is a passive foreign investment company (a "PFIC") if it satisfies a passive income test or a passive assets test for the taxable year (sec. 1297). A U.S. shareholder of a PFIC generally is subject to U.S. tax, plus an interest charge, on distributions from a PFIC and gain realized upon a disposition of PFIC stock (sec. 1291). Alternatively, the U.S. shareholder may elect either to be subject to current U.S. tax on the shareholder's share of the PFIC's earnings or, in the case of PFIC stock that is marketable, to mark to market the PFIC stock (secs. 1293 and 1296). For purposes of the PFIC provisions, constructive ownership rules apply (sec. 1298(a)). Under these rules, an option to acquire stock is treated as stock for purposes of applying the interest charge regime to a disposition of such option, and the holding period for stock acquired pursuant to the exercise of an option includes the holding period for such option (sec. 1298(a)(4) and prop. Treas. reg. secs. 1.1291–1(d) and (h)(3)).

A corporation that is a CFC is also a PFIC if it meets the passive income test or the passive assets test. Under section 1297(e), as added by the 1997 Act, a corporation is not treated as a PFIC with respect to a shareholder during the period after December 31, 1997 in which the corporation is a CFC and the shareholder is a U.S. shareholder (within the meaning of section 951(b)) thereof. Under this rule eliminating the overlap between the PFIC and CFC provisions, a shareholder that is subject to the subpart F rules with respect to a corporation is not also subject to the PFIC rules with respect to such corporation.

Explanation of Provision

Under the provision, the elimination of the overlap between the PFIC and the CFC provisions generally does not apply to a U.S. person with respect to PFIC stock that such person is treated as owning by reason of an option to acquire such stock. Accordingly, for example, the PFIC rules continue to apply to a U.S. person that holds only an option on stock of a corporation that is a CFC because such person does not own stock of such corporation directly or indirectly through a foreign entity and therefore is not subject to the current inclusion rules of subpart F with respect to such corporation. However, under the provision, the elimination of the overlap will apply to a U.S. person that holds an option on stock if such stock is held by a person that is subject to the current inclusion rules of subpart F with respect to such stock and is not a tax-exempt person. Accordingly, an option holder is not subject to the PFIC rules with respect to an option if the option is on stock that is held by a non-tax-exempt person that is subject to the current inclusion rules of subpart F with respect to such stock.

Effective Date

The provision is effective for taxable years of U.S. persons beginning after December 31, 1997 and taxable years of foreign corporations ending with or within such taxable years of U.S. persons.

3. Application of PFIC mark-to-market rules to RICs (sec. 6011(c)(3) of the bill, sec. 1122 of the 1997 Act, and sec. 1296 of the Code)

Present Law

Under section 1296, as added by the 1997 Act, a shareholder of a passive foreign investment company (a "PFIC") may make a mark-to-market election with respect to the stock of the PFIC, provided that such stock is marketable. Under this election, the shareholder includes in income each year an amount equal to the excess, if any, of the fair market value of the PFIC stock as of the close of the taxable year over the shareholder's adjusted basis in such stock. The shareholder is allowed a deduction for the excess, if any, of the shareholder's adjusted basis in the PFIC stock over its fair market value as of the close of the taxable year, but only to the extent of any net mark-to-market gains with respect to such stock included by the shareholder under section 1296 for prior years.

The mark-to-market election of section 1296 is effective for taxable years of U.S. persons beginning after December 31, 1997 and taxable years of foreign corporations ending with or within such taxable years of U.S. persons. Prior to the enactment of section 1296, a proposed Treasury regulation provided for a mark-to-market election with respect to PFIC stock held by certain regulated investment companies ("RICs") (prop. Treas. reg. sec. 1.1291–8). Under this mark-to-market election, gains but not losses were recognized.

Section 1296(j) provides rules applicable in the case of a shareholder that makes a mark-to-market election under section 1296 later than the beginning of the shareholder's holding period for the PFIC stock. Special rules apply in the case of a RIC that makes such a mark-to-market election under section 1296 with respect to PFIC stock that the RIC had previously marked to market under the proposed Treasury regulation.

Explanation of Provision

Under the provision, for purposes of determining allowable deductions for any excess of the shareholder's adjusted basis in PFIC stock over the fair market value of the stock as of the close of the taxable year, deductions are allowed to the extent not only of prior mark-to-market inclusions under section 1296 but also of prior mark-to-market inclusions under the proposed Treasury regulation applicable to a RIC that holds stock in a PFIC.

Effective Date

The provision is effective for taxable years of U.S. persons beginning after December 31, 1997 and taxable years of foreign corporations ending with or within such taxable years of U.S. persons.

4. Interaction between the PFIC provisions and other mark-to-market rules (sec. 6011(c)(2) of the bill, sec. 1122 of the 1997 Act, and secs. 1291 and 1296 of the Code)

Present Law

A U.S. shareholder of a passive foreign investment company (a "PFIC") generally is subject to U.S. tax, plus an interest charge, on distributions from a PFIC and gain realized upon a disposition of PFIC stock (sec. 1291). As an alternative to this interest charge regime, the U.S. shareholder may elect to be subject to current U.S. tax on the shareholder's share of the PFIC's earnings (sec. 1293). Section 1296, as added by the 1997 Act, provides another alternative available in the case of a PFIC the stock of which is marketable; under section 1296, a U.S. shareholder of a PFIC may make a mark-to-market election with respect to the stock of the PFIC.

The interest charge regime generally does not apply to distributions from, and dispositions of stock of, a PFIC for which the U.S. shareholder has made either a mark-to-market election under section 1296 or an election to include the PFIC's earnings in income currently (sec. 1291(d)(1)). However, special coordination rules provide for limited application of the interest charge regime in the case of a U.S. shareholder that makes a mark-to-market election under section 1296 later than the beginning of the shareholder's holding period for the PFIC stock (sec. 1296(j)).

Under section 475(a), a dealer in securities is required to mark to market certain securities held by the dealer. Under section 475(f), as added by the 1997 Act, a trader in securities may elect to mark to market securities held in connection with the person's trade or business as a trader in securities. Other provisions similarly allow stock to be marked to market (e.g., sec. 1092(b)(1) and temp. Treas. reg. Sec. 1.1092–4T).

Explanation of Provision

Under the provision, the interest charge regime generally does not apply to distributions from, and dispositions of stock of, a PFIC where the U.S. shareholder has marked to market such stock under section 475 or any other provision (in the same manner that such regime does not apply where the shareholder has marked to market such stock under section 1296). In addition, under the provision, coordination rules like those provided in section 1296(j) apply in the case of a U.S. shareholder that marks to market PFIC stock under section 475 or any other provision later than the beginning of the shareholder's holding period for the PFIC stock.

Effective Date

The provision is effective for taxable years of U.S. persons beginning after December 31, 1997 and taxable years of foreign corporations ending with or within such taxable years of U.S. persons. No inference is intended regarding the treatment of PFIC stock that was marked to market prior to the effective date of the provision.

K. AMENDMENTS TO TITLE XII OF THE 1997 ACT RELATING TO SIMPLIFICATION PROVISIONS

1. Travel expenses of Federal employees participating in a Federal criminal investigation (sec. 6012(a) of the bill, sec. 1204 of the 1997 Act, and sec. 162 of the Code)

Present Law

Unreimbursed ordinary and necessary travel expenses paid or incurred by an individual in connection with temporary employment away from home (e.g., transportation costs and the cost of meals and lodging) are generally deductible, subject to the two-percent floor on miscellaneous itemized deductions. Travel expenses paid or incurred in connection with indefinite employment away from home, however, are not deductible. A taxpayer's employment away from home in a single location is indefinite rather than temporary if it lasts for one year or more; thus, no deduction is permitted for travel expenses paid or incurred in connection with such employment (sec. 162(a)). If a taxpayer's employment away from home in a single location lasts for less than one year, whether such employment is temporary or indefinite is determined on the basis of the facts and circumstances.

The 1997 Act provided that the one-year limitation with respect to deductibility of expenses while temporarily away from home does not include any period during which a Federal employee is certified by the Attorney General (or the Attorney General's designee) as traveling on behalf of the Federal Government in a temporary duty status to investigate or provide support services to the investigation of a Federal crime. Thus, expenses for these individuals during these periods are fully deductible, regardless of the length of the period for which certification is given (provided that the other requirements for deductibility are satisfied).

Explanation of Provision

The provision clarifies that prosecuting a Federal crime or providing support services to the prosecution of a Federal crime is considered part of investigating a Federal crime.

Effective Date

The provision is effective for amounts paid or incurred with respect to taxable years ending after the date of enactment of the 1997 Act.

2. Effective date for provisions relating to electing large partnerships, partnership returns required on magnetic media, and treatment of partnership items of individual retirement arrangements (sec. 6012(d) of the bill and sec. 1226 of the 1997 Act)

Present Law

Rules for simplified flowthrough and simplified audit procedures for electing large partnerships, as well as a March 15 due date for furnishing information to partners of an electing large partnership, were added to present law by the 1997 Act. The 1997 Act also added a rule providing that partnership returns are required on magnetic media, and modified the treatment of partnership items of individual retirement arrangements. The 1997 Act statement of managers provided that these provisions apply to partnership taxable years beginning after December 31, 1997. The statute provided that the rules for simplified flowthrough for electing large partnerships apply to partnership taxable years beginning after December 31, 1997 (Act sec. 1221(c)), although the statute also provided that all the provisions apply to partnership taxable years ending on or after December 31, 1997 (Act sec. 1226).

Explanation of Provision

The technical correction provides that these provisions apply to partnership taxable years beginning after December 31, 1997.

Effective Date

The provision is effective as if enacted in the 1997 Act.

3. Modification of distribution rules for REITs (sec. 6012(f) of the bill, sec. 1256 of the 1997 Act, and sec. 857 of the Code)

Present Law

In general, a real estate investment trust ("REIT") is an entity that receives most of its income from passive real estate investments and meets certain other requirements. A REIT receives conduit treatment (i.e., one level of tax) for income distributed to its shareholders. A REIT generally must distribute 95 percent of its earnings (sec. 857(a)(1)). An entity loses its status as a REIT if it retains non-REIT earnings and profits (sec. 857(a)(2)). A REIT simplification provision in the 1997 Act provides that any distribution from a REIT will be deemed to first come from the earliest earnings and profits of the entity. As a result, in the case of a REIT with accumulated REIT earnings and profits that inherits subsequently earned non-REIT earnings and profits (e.g., by way of merger with a C corporation), that the entity must distribute both the accumulated REIT earnings and profits as well as the inherited non-REIT earnings and profits under the 1997 Act provision in order to retain its REIT status.

Explanation of Provision

The provision amends the simplification provision to provide that any distribution from a REIT will be deemed to first come from earnings and profits that were generated when the entity did not qualify as a REIT. The provision does not change the requirement that a REIT must distribute 95 percent of its REIT earnings, or any other requirement.

Effective Date

The provision is effective for taxable years beginning after August 5, 1997.

L. AMENDMENTS TO TITLE XIII OF THE 1997 ACT RELATING TO ESTATE, GIFT AND TRUST SIMPLIFICATION

1. Clarification of treatment of revocable trusts for purposes of the generation-skipping transfer tax (sec. 6013(a) of the bill, sec. 1305 of the 1997 Act and secs. 2652 and 2654 of the Code)

Present Law

The 1997 Act provided an irrevocable election to treat a qualified revocable trust as part of the decedent's estate for Federal income tax purposes. For this purpose, a qualified revocable trust is any trust (or portion thereof) which was treated as owned by the decedent with respect to whom the election is being made, by reason of a power in the grantor (i.e., trusts that are treated as owned by the decedent solely by reason of a power in a nonadverse party would not qualify). A conforming change was also made to section 2652(b) for generation-skipping transfer tax purposes.

Explanation of Provision

The provision clarifies that the election to treat a qualified revocable trust as part of the decedent's estate would apply for generation-skipping transfer tax purposes only with respect to the application of section 2654(b) (describing when a single trust may be treated as two or more trusts). The election has no other effect for generation-skipping transfer tax purposes.

Effective Date

The provision applies to decedents dying after the date of enactment of the 1997 Act.

2. Provision of regulatory authority for simplified reporting of funeral trusts terminated during the taxable year (sec. 6013(b) of the bill, sec. 1309 of the 1997 Act and sec. 685(f) of the Code)

Present Law

The 1997 Act provided an election which allows the trustee of a qualified pre-need funeral trust to elect special tax treatment for such a trust, to the extent the trust would otherwise be treated as a grantor trust. As part of this provision, the Secretary of the Treasury was granted regulatory authority to prescribe rules for simplified reporting of all trusts having a single trustee.

Explanation of Provision

The provision clarifies that a pre-need funeral trust may continue to qualify for these special rules for the 60-day period after the decedent's death, even though the trust ceases to be a grantor trust during that time. In addition, the provision extends the Secretary's regulatory authority to include rules providing for the inclusion of trusts terminated during the year (e.g., in the event of the death of the beneficiary) in the simplified reporting.

Effective Date

The provision applies to decedents dying after the date of enactment of the 1997 Act.

M. AMENDMENT TO TITLE XIV OF THE 1997 ACT RELATING TO EXCISE TAX SIMPLIFICATION

1. Clarify that the provision allowing wine imported in bulk to be transferred to a U.S. winery without payment of tax (sec. 6014(a) of the bill, sec. 1422 of the 1997 Act, and sec. 5364 of the Code)

Present Law

Wine is subject to an excise tax ranging from $1.07 per gallon to $3.40 per gallon, depending on its alcohol content. Distilled spirits are subject to excise tax at a rate of $13.50 per proof gallon. A tax credit equal to the difference between the distilled spirits tax rate and the wine tax rate is allowed for wine that is blended into distilled spirits products (sec. 5010). The wine excise tax is imposed on removal of the beverage from a winery, or on importation. The 1997 Act included a provision allowing wine to be imported in bulk and transferred to a U.S. winery without payment of tax (generally until the wine is removed from the winery).

U.S. law defines wine generally as alcohol that is derived from fruit or fruit residues ("natural wine"). Natural wine may not be fortified with grain or other non-fruit derived alcohol if produced in the U.S. Certain other countries allow wine that is marketed as a natural wine to be fortified with alcohol from other sources. U.S. law follows the laws of the country of origin in classifying imported wine.

Explanation of Provision

The provision clarifies that the provision of the 1997 Act liberalizing rules for bulk importation of wine applies only to alcohol that would qualify as a natural wine if produced in the United States.

Effective Date

The provision is effective as if included in the 1997 Act.

N. AMENDMENT TO TITLE XV OF THE 1997 ACT RELATING TO PENSIONS AND EMPLOYEE BENEFITS

1. Treatment of certain disability payments to public safety employees (sec. 6015(c) of the bill, sec. 1529 of the 1997 Act, and sec. 104 of the Code)

Present Law

Under present law, certain payments made on behalf of full-time employees of any police or fire department organized and operated by a State (or any political subdivision, agency, or instrumentality thereof) are excludable from income. This treatment applies to payments made on account of heart disease or hypertension of the employee and that were received in 1989, 1990, or 1991 pursuant to a State law as amended on May 19, 1992, which irrebuttably presumed that heart disease and hypertension are work-related illnesses (but only for employees separating from service before July 1, 1992). Claims for refund or credit for overpayments resulting from the provision may be filed up to 1 year after August 5, 1997, without regard to the otherwise applicable statute of limitations.

Explanation of Provision

In order to address problems taxpayers are encountering with the IRS in seeking refunds under the present-law provision, the bill clarifies the scope of the provision.

The bill provides that payments made on account of heart disease or hypertension of the employee and that were received in 1989, 1990, or 1991 pursuant to a State law as described under present law, or received by an individual referred to in such State law under any other statute, ordinance, labor agreement, or similar provision as a disability pension payment or in the nature of a disability pension payment attributable to employment as a police officer or as a fireman will be excludable from income.

Effective Date

The provision is effective as if included in the Taxpayer Relief Act.

O. AMENDMENTS TO TITLE XVI OF THE 1997 ACT RELATING TO TECHNICAL CORRECTIONS

1. Application of requirements for SIMPLE IRAs in the case of mergers and acquisitions (sec. 6016(a)(1) of the bill, sec. 1601(d)(1) of the 1997 Act, and sec. 408(p)(2) of the Code)

Present Law

If an employer maintains a qualified plan and a SIMPLE IRA in the same year due to an acquisition, disposition or similar transaction the SIMPLE IRA is treated as a qualified salary reduction arrangement for the year of the transaction and the following calendar year provided rules similar to the special coverage rules of section 410(b)(6)(C) apply. There is a similar provision with respect to an employer who, because of an acquisition, disposition or similar transaction, fails to be an eligible employer because such employer employs more than 100 employees. In this situation, the employer is treated as an eligible employer for two years following the transaction provided rules similar to the coverage rules of section 410(b)(6)(C)(i) apply.

Explanation of Provision

The bill conforms the treatment applicable to SIMPLE IRAs upon acquisition, disposition or similar transaction for purposes of (1) the 100 employee limit, (2) the exclusive plan requirement, and (3) the coverage rules for participation. In the event of such a transaction, the employer will be treated as an eligible employer and the arrangement will be treated as a qualified salary reduction arrangement for the year of the transaction and the two following years, provided rules similar to the rules of section 410(b)(6)(C)(i)(II) are satisfied and the arrangement would satisfy the requirements to be a qualified salary reduction arrangement after the transaction if the trade or business that maintained the arrangement prior to the transaction had remained a separate employer.

Effective Date

The provision is effective as if included in the Small Business Job Protection Act of 1996.

2. Treatment of Indian tribal governments under section 403(b) (sec. 6016(a)(2) of the bill, sec. 1601(d)(4)(A) of the 1997 Act, and sec. 403(b) of the Code)

Present Law

Any 403(b) annuity contract purchased in a plan year beginning before January 1, 1995, by an Indian tribal government is treated as purchased by an entity permitted to maintain a tax-sheltered annuity plan. Such contracts may be rolled over into a section 401(k) plan maintained by the Indian tribal government in accordance with the rollover rules of section 403(b)(8). An employee participating in a 403(b) annuity contract of the Indian tribal government may roll over amounts from such contract to a section 401(k) plan maintained by the Indian tribal government whether or not the annuity contract is terminated.

Explanation of Provision

The bill clarifies that an employee participating in a 403(b)(7) custodial account of the Indian tribal government may roll over amounts from such account to a section 401(k) plan maintained by the Indian tribal government.

Effective Date

The provision is effective as if included in the Small Business Job Protection Act of 1996.

Technical Corrections to Other Tax Legislation

A. Treatment of Adoption Tax Credit Carryovers (Sec. 6017 of the Bill, Sec. 1807(a) of the Small Business Job Protection Act of 1996, and Sec. 23 of the Code)

Present Law

Under present law taxpayers are allowed a maximum nonrefundable credit against income tax liability of $5,000 per child for qualified adoption expenses paid or incurred by the taxpayer. In the case of a special needs adoption, the maximum credit amount is $6,000 ($5,000 in the case of a foreign special needs adoption). To the extent the otherwise allowable credit exceeds the tax liability limitation of section 26 (reduced by other personal credits) the excess is carried forward as an adoption credit into the next taxable year, up to a maximum of five taxable years.

The credit is phased out ratably for taxpayers with modified adjusted gross income (AGI) above $75,000, and is fully phased out at $115,000 of modified AGI. For these purposes modified AGI is computed by increasing the taxpayer's AGI by the amount otherwise excluded from gross income under Code sections 911, 931, or 933 (relating to the exclusion of income of U.S. citizens or residents living abroad; residents of Guam, American Samoa, and the Northern Mariana Islands, and residents of Puerto Rico, respectively).

Explanation of Provision

The bill clarifies that the AGI phaseout only applies in the year that the credit is generated and is not reapplied to further reduce any carryforward amounts.

Effective Date

The provision is effective as if included in the Small Business Job Protection Act of 1996.

B. Disclosure Requirements for Apostolic Organizations (Sec. 6018 of the Bill, Sec. 1313 of the Taxpayer Bill of Rights 2, and Sec. 6104 of the Code)

Present Law

Section 501(d) provides tax-exempt status to certain religious or apostolic associations or corporations, if such associations or corporations have a common treasury or community treasury, even if such associations or corporations engage in business for the common benefit of the members, but only if the members thereof include (at the time of filing their returns) in their gross income their entire pro rata shares, whether distributed or not, of the taxable income of the association or corporation for such year.[79] Any

[79] Under section 501(d), the requirement of a "common treasury" or "community treasury" is satisfied when all of the income generated from property owned by the organization is placed into a common fund that is maintained by such organization and is used for the maintenance and support of its members, with all members having equal, undivided interests in this common fund, but no right to claim title to any part thereof. See *Twin Oaks Community, Inc.* v. *Commissioner*, 87 T.C. 1233, at 1254 (1986). See also Rev. Rul. 78–100, 1978–1 C.B. 162 (sec. 501(d)

amount so included in the gross income of a member is treated as a dividend received. The effect of section 501(d) is to exempt the religious and apostolic associations or corporations which conduct communal activities (such as farming) from the Federal corporate-level income tax and the undistributed-profits tax, provided that members claim their shares of the corporation's income on their own individual returns.

Section 6033 generally requires tax-exempt organizations to file annual information returns, and such information returns are available for public inspection under sections 6104(b) and 6104(e), except that public disclosure is not required of the identity of contributors to an organization. Section 501(d) entities must include with their annual information return (Form 1065) a Schedule K–1 that identifies the members of the association or corporation and their ratable portions of net income and expenses.

Explanation of Provision

The provision amends sections 6104(b) and 6104(e) to provide that public disclosure is not required of a Schedule K–1 filed by a religious or apostolic organization described in section 501(d).

Effective Date

The provision is effective on the date of enactment.

C. ALLOW DEDUCTION FOR UNUSED EMPLOYER SOCIAL SECURITY CREDIT (SEC. 6019 OF THE BILL, SEC. 13443 OF THE OMNIBUS BUDGET RECONCILIATION ACT OF 1993, AND SEC. 196 OF THE CODE)

Present Law

The general business credit ("GBC") consists of various individual tax credits (including the employer social security credit of Code section 45B) allowed with respect to certain qualified expenditures and activities. In general, the various individual tax credits contain provisions that prohibit "double benefits," either by denying deductions in the case of expenditure-related credits or by requiring income inclusions in the case of activity-related credits. Unused credits may be carried back one year and carried forward 20 years. Section 196 allows a deduction to the extent that certain portions of the GBC expire unused after the end of the carry forward period. Section 196 does not allow a deduction to the extent that the portion of the GBC that expires unused after the end of the carry forward period relates to the employer social security credit.

Explanation of Provision

The provision allows a deduction to the extent that the portion of the GBC relating to the employer social security credit expires unused after the end of the carry forward period.

entity must be supported by internally operated business activities rather than merely being supported by wages of members who are engaged in outside employment).

Effective Date

The provision is effective as if included in the Omnibus Budget Reconciliation Act of 1993.

D. EARNED INCOME CREDIT QUALIFICATION RULES (SEC. 6020 OF THE BILL, SEC. 11111(A) OF THE OMNIBUS BUDGET RECONCILIATION ACT OF 1990, AS AMENDED BY SEC. 742 OF THE URUGUAY ROUND AGREEMENTS ACT AND SEC. 451(A) OF THE PERSONAL RESPONSIBILITY AND WORK OPPORTUNITY RECONCILIATION ACT OF 1996, AND SEC. 32 OF THE CODE)

Present Law

In general

In order to claim the earned income credit ("EIC"), an individual must be an eligible individual. To be an eligible individual, an individual must include a taxpayer identification number ("TIN") for the taxpayer and the taxpayer's spouse and must either have a qualifying child or meet other requirements. In order to claim the EIC without a qualifying child, an individual must not be a dependent and must be over age 24 and under age 65.

Qualifying child

A qualifying child must meet a relationship test, an age test, an identification test, and a residence test. Under the relationship and age tests, an individual is eligible for the EIC with respect to another person only if that other person: (1) is a son, daughter, or adopted child (or a descendent of a son, daughter, or adopted child); a stepson or stepdaughter; or a foster child of the taxpayer (a foster child is defined as a person whom the individual cares for as the individual's child; it is not necessary to have a placement through a foster care agency); and (2) is under the age of 19 at the close of the taxable year (or is under the age of 24 at the end of the taxable year and was a full-time student during the taxable year), or is permanently and totally disabled. Also, if the qualifying child is married at the close of the year, the individual may claim the EIC for that child only if the individual may also claim that child as a dependent.

To satisfy the identification test, an individual must include on their tax return the name, age, and "TIN" of each qualifying child.

The residence test requires that a qualifying child must have the same principal place of abode as the taxpayer for more than one-half of the taxable year (for the entire taxable year in the case of a foster child), and that this principal place of abode must be located in the United States. For purposes of determining whether a qualifying child meets the residence test, the principal place of abode shall be treated as in the United States for any period during which a member of the Armed Forces is stationed outside the United States while serving on extended active duty.

Explanation of Provision

The bill clarifies that the identification requirement is a requirement for claiming the EIC, rather than an element of the definitions of "eligible individual" and "qualifying child."

Effective Date

The provision is effective as if included in the originally enacted related legislation.

III. BUDGET EFFECTS OF THE BILL

A. COMMITTEE ESTIMATES

In compliance with paragraph 11(a) of Rule XXVI of the Standing Rules of the Senate, the following table is presented concerning the estimated budget effects of the bill as reported.

ESTIMATED BUDGET EFFECTS OF REFORM AND RESTRUCTURING OF THE INTERNAL REVENUE SERVICE AS REPORTED BY THE SENATE COMMITTEE ON FINANCE

Fiscal Years 1998 - 2007

[Millions of Dollars]

Provision	Effective	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1998-02	2003-07
Title I. Executive Branch Governance							*No Revenue Effect*						
Title II. Electronic Filing							*No Revenue Effect*						
Title III. Taxpayer Bill of Rights 3													
A. Burden of Proof	eca DOE	[1]	-221	-232	-243	-256	-269	-282	-295	-311	-326	-953	-1,483
B. Proceedings by Taxpayers													
1. Expansion of authority to award costs and certain fees at prevailing rate and CFR rule 68 provision with net worth limitation (includes outlay effects)	180da DOE	---	-14	-15	-16	-17	-20	-21	-22	-23	-25	-62	-111
2. Civil damages with respect to unauthorized collection actions (includes outlay effects)	DOE	-2	-15	-25	-50	-30	-25	-25	-25	-25	-25	-122	-125
3. Increase in size of cases permitted on small case calendar to $50,000	pca DOE						*No Revenue Effect*						
4. Expand Tax Court jurisdiction to include responsible person penalties	pia DOE	-11	-15	-13	-7	-7	-7	-7	-8	-8	-8	-53	-38
5. Actions for refund with respect to certain estates wh'ch have elected the installment method of payment	rfa DOE						*Negligible Revenue Effect*						
6. Provide Tax Court jurisdiction to review adverse IRS determination of a bond issuer's tax-exempt status	pfa DOE	[1]	-5	-2	-2	-2	-2	-2	-2	-2	-2	-11	-10
C. Relief for Innocent Spouses and Persons with Disabilities													
1. Innocent spouse relief - innocent spouses would be able to elect to be liable only for tax attributable to their income (assumes no interaction with any other proposal; includes anti-abuse rule; not innocent if have actual knowledge of understatement of tax)	laa & ulb DOE	-58	-350	-288	-273	-346	-480	-608	-773	-910	-1,071	-1,315	-3,842
2. Reports on collection activity against spouses	bi 1999						*No Revenue Effect*						
3. Suspension of statute of limitations on filing refund claims during periods of disability	[2]	-10	-70	-35	-15	-16	-17	-18	-19	-20	-21	-146	-95
4. Require the IRS to send separate notification to both spouses by certified mail	nma DOE						*No Revenue Effect*						
D. Provisions Relating to Interest and Penalties													
1. Elimination of interest rate differential on overlapping periods of interest on income tax overpayments and underpayments	cqba DOE	[1]	-9	-28	-42	-54	-57	-60	-63	-66	-69	-134	-315
2. Increase refund interest rate to Applicable Federal Rate ("AFR") + 3 for individual taxpayers (includes outlay effects) [3]	cqba DOE	-5	-51	-54	-56	-59	-62	-65	-69	-72	-76	-225	-344

Provision	Effective	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1998-02	2003-07
3. Elimination of penalty on individual's failure to pay during installment agreements (for individuals and timely filed returns only)	iapma DOE	-29	-272	-287	-302	-317	-338	-354	-372	-390	-410	-1,207	-1,864
4. Mitigations of failure to deposit penalty cascading (all taxpayers)	dma 180da DOE	---	-47	-64	-64	-65	-66	-66	-67	-68	-68	-240	-335
5. Suspend accrual of interest and penalties if IRS fails to contact taxpayer within 12 months after a timely-filed return (except for fraud and criminal penalties)	tyea DOE	---	---	-438	-529	-596	-636	-754	-761	-769	-777	-1,563	-3,697
6. Notices of interest and penalties must show computation	na 180da DOE							No Revenue Effect					
7. Require management to approve non-computer generated penalties (excluding failure to file, pay, or estimated tax payment)	pa 180da DOE							Negligible Revenue Effect					
E. Protections for Taxpayers Subject to Audit or Collection													
1. Due process for IRS collection actions	caia 6ma DOE	---	-45	-1	-1	-1	-1	-1	-1	-1	-1	-48	-5
2. Extend the attorney client privilege to accountants and other tax practitioners for tax advice of accountant and other tax practitioners	DOE	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[5]	[5]
3. Expand the Taxpayer Advocate's authority to issue taxpayer assistance orders	DOE	[1]	[1]	[1]	[1]	[1]	[1]	[1]	[1]	[1]	[1]	[4]	[4]
4. Limitation on financial status audit techniques	DOE							No Revenue Effect					
5. IRS summons of computer source code	sia DOE & pfsib DOE	---	-26	-32	-39	-45	-53	-61	-66	-72	-74	-142	-326
6. Prohibition on extension of statute of limitations for collection beyond 10 years with estate tax exception	[6]	-6	-44	-38	-31	-25	-25	-25	-25	-25	-25	-144	-125
7. Notice of deficiency to specify deadlines for filing Tax Court petition	nma 12/31/98							Negligible Revenue Effect					
8. Refund or credit of overpayments before final determination	DOE							Negligible Revenue Effect					
9. Prohibition on improper threat of audit activity for tip reporting	DOE							No Revenue Effect					
10. Codify existing IRS procedures relating to appeal of examinations and collections and increase independence of appeals function	DOE							No Revenue Effect					
11. Appeals videoconferencing alternative for rural areas	DOE							No Revenue Effect					
12. Require IRS to notify taxpayer before contacting third parties regarding IRS examination or collection activities with respect to the taxpayer (does not apply for criminal cases)	180da DOE	---	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[5]	[5]
F. Disclosures to Taxpayers													
1. Explanation of joint and several liability	180da DOE							No Revenue Effect					
2. Explanation of taxpayers' rights in interviews with IRS	180da DOE	---	-13	[1]	[1]	[1]	[1]	[1]	[1]	[1]	[1]	[5]	[4]
3. Disclosure of criteria for examination selection	180da DOE							No Revenue Effect					
4. Explanations of appeals and collection process	180da DOE							No Revenue Effect					
5. Require IRS to explain reason for denial for refund	180da DOE							No Revenue Effect					
6. Statement to taxpayers with installment agreements	180da DOE							No Revenue Effect					
G. Low-Income Taxpayer Clinics	DOE							No Revenue Effect					
H. Other Taxpayer Rights Provisions													
1. Cataloging complaints of IRS employee misconduct	DOE							No Revenue Effect					
2. Archive of records of IRS	DOE							No Revenue Effect					
3. Payment of taxes to the U.S. Treasury [3]	DOE							No Revenue Effect					
4. Clarification of authority of Secretary relating to the making of elections	DOE							No Revenue Effect					

Provision	Effective	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1998-02	2003-07
I. Studies													
1. Study of penalty and interest administration and implementation	9ma DOE						No Revenue Effect						
2. Study of confidentiality of tax return information	1ya DOE						No Revenue Effect						
J. Limits on Seizure Authority													
1. IRS to implement approval process for liens, levies, or seizures	caca DOE						No Revenue Effect						
2. Prohibit the IRS from selling taxpayer's property for less than the minimum bid	Soa DOE						No Revenue Effect						
3. Require the IRS to provide an accounting and receipt to the taxpayer (including the amount credited to the taxpayer's account) for property seized and sold	soa DOE						Negligible Revenue Effect						
4. Require the IRS to study and implement a uniform asset disposal mechanism for sales of seized property to prevent revenue officers from conducting sales	DOE & 2 years						No Revenue Effect						
5. Increase the amount exempt from levy to $10,000 for personal property and $5,000 for books and tools of trade, indexed for inflation	cata DOE	[1]	-5	-5	-5	-5	-6	-6	-6	-6	-6	-21	-30
6. Require the IRS to immediately release a levy upon agreement that the amount is not collectible	lia DOE						Negligible Revenue Effect						
7. Codify IRS administrative procedures for seizure of taxpayer's property	DOE						No Revenue Effect						
8. Suspend collection by levy during refund suit	tyba 12/31/98						Negligible Revenue Effect						
9. Require District Counsel review of jeopardy and termination assessments and jeopardy levies	taa DOE						Negligible Revenue Effect						
10. Codify certain fair debt collection procedures	DOE						No Revenue Effect						
11. Ensure availability of installment agreements	DOE						No Revenue Effect						
12. Increase superpriority dollar limits	DOE						Negligible Revenue Effect						
13. Permit personal delivery of section 6672(b) notices	DOE						No Revenue Effect						
14. Allow taxpayers to quash all third-party summonses	ssa DOE						Negligible Revenue Effect						
15. Permit service of summonses by mail or in person	saa DOE						No Revenue Effect						
16. Provide new remedy for third parties who claim that the IRS has filed an erroneous lien	DOE						Negligible Revenue Effect						
17. Waive the 10% early withdrawal penalty when IRA or qualified plan is levied	la DOE	-1	-3	-4	-4	-4	-4	-5	-5	-5	-5	-17	-24
18. Prohibit seizure of residences in small deficiency cases	DOE						Negligible Revenue Effect						
19. Require the IRS to exhaust all payment options before seizing a business or principal residence	aa DOE						No Revenue Effect						
K. Offers-in-Compromise													
1. Rights of taxpayers entering into offers-in-compromise	DOE	[1]	[4]	[1]	[1]	[1]	[1]	[1]	[1]	[1]	[1]	[5]	[4]
2. Prohibit IRS rejection of low-income taxpayer's offer-in-compromise based on amount of offer	osa DOE						No Revenue Effect						
3. Prohibit IRS rejection of an offer-in-compromise solely based on a dispute as to liability because the taxpayer's file cannot be located by the IRS	osa DOE						No Revenue Effect						
4. Prohibit the IRS from requiring a financial statement for offer-in-compromise based solely on doubt as to liability	DOE						No Revenue Effect						
5. Suspend collection by levy while offer-in-compromise is pending	tao/a 60da DOE						Negligible Revenue Effect						
6. Rejected offers-in-compromise and requests for installment agreements to be reviewed	oara DOE						No Revenue Effect						
7. Appeals review of rejected offers-in-compromise	osa DOE						No Revenue Effect						

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Provision	Effective	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1998-02	2003-07
L. Additional Items													
1. Prohibit using tax enforcement results to evaluate IRS employees	DOE						No Revenue Effect						
2. IRS notices must contain name and telephone number of IRS employee to contact	60da DOE						No Revenue Effect						
3. Require approval of use of pseudonyms by IRS employees	DOE						No Revenue Effect						
4. National Office conferences without field personnel	DOE						No Revenue Effect						
5. Require the IRS to end the use of the illegal tax protestor label	DOE						No Revenue Effect						
6. Modify section 6103 to allow the tax-writing committees to obtain data from IRS employees regarding employee and taxpayer abuse	DOE						No Revenue Effect						
7. Publish telephone numbers for local IRS offices	1/1/99						No Revenue Effect						
8. Alternative to Social Security numbers for tax return preparers	DOE						No Revenue Effect						
9. Expand Alternative Dispute Resolution; binding arbitration pilot program	DOE						No Revenue Effect						
10. Treasury can not implement 98-11 regulations for 6 months, with no inference about transition rules	DOE	-8	-36	-10	-6	-3	-3	-2	-1	-1	-1	-63	-8
11. Require IRS to notify all partners of any resignation of the tax matters partner that is required by the IRS, and of the identity of any successor tax matters partner who was appointed to fill the vacancy created by such resignation	tyba 12/31/98	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[7]	-1	-1
Subtotal of Taxpayer Protections		-137	-1,251	-1,579	-1,693	-1,856	-2,079	-2,370	-2,588	-2,782	-2,986	-6,518	-12,819
Title IV. Congressional Accountability for the IRS							No Revenue Effect						
Title V. Revenue Offsets													
A. Repeal Schmidt Baking with Respect to Vacation and Severance Pay	tyea DOE	603	1,141	1,160	141	148	156	163	172	180	189	3,193	860
B. Allow Taxpayers to use Foreign Tax Credits to Reduce Income for 1 Year Back and Carryforward 7 Years	ftcai tyea DOE	76	525	468	441	416	390	275	271	267	263	1,926	1,466
C. Clarify and Expand Math Error Procedures	tyea DOE	---	12	25	26	27	28	29	30	31	32	90	150
D. Freeze Grandfathered Status of Stapled or Paired-Share REITs	tyea 3/26/98	[8]	1	3	6	10	14	19	26	35	45	20	139
E. Make Certain Trade Receivables Ineligible for Mark-to-Market Treatment With Spread	tyea DOE	33	317	500	333	117	70	73	77	81	85	1,300	386
F. Add Vaccines Against Rotavirus Gastroenteritis to the List of Taxable Vaccines ($0.75 per dose)	vpa DOE	---	1	2	3	4	5	6	6	6	7	10	30
G. Authorize the Federal Government to Offset a Federal Income Tax Refund to Satisfy a Past Due, Legally Owing State Income Tax Debt	rda DOE	2	2	3	3	3	3	3	4	4	4	13	18
Subtotal of Revenue Offsets		714	1,999	2,161	953	725	666	568	586	604	625	6,552	3,049

Provision	Effective	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1998-02	2003-07
Title VI. Tax Technical Corrections	No Revenue Effect												
NET TOTAL		577	748	582	-740	-1,131	-1,413	-1,802	-2,002	-2,178	-2,373	34	-9,770

Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding.

Legend for "Effective" column:

aa = actions after
bi = beginning in
caca = collection actions commenced after
caia = collection actions initiated after
cata = collection actions taken after
cqba = calendar quarters beginning after
dma = deposits made after
DOE = date of enactment
eca = examinations commencing after
ftcai = foreign tax credits arising in
iapma = installment agreement payments made after
ia = levies after
laa = liability arising after
lia = levies imposed after

na = notices after
nma = notices mailed after
oara = offers and requests after
osa = offers-in-compromise submitted after
pa = penalties after
pca = proceedings commencing after
pfa = petitions filed after
pfsib = protection for summonses issued before
pia = penalties imposed after
rda = refunds due after
rfa = refunds filed after
sia = summonses issued after
soa = seizures occurring after

Soa = sales occurring after
ssa = summonses served after
taa = taxes assessed after
tao/a = taxes assessed on or after
tyba = taxable years beginning after
tyea = taxable years ending after
ulb = unpaid liability before
vpa = vaccines purchased after
1ya = 1 year after
6ma = 6 months after
9ma = 9 months after
60da = 60 days after
180da = 180 days after

[1] Loss of less than $1 million.
[2] Effective for periods of disability before, on or after the date of enactment but would not apply to any claim for refund or credit which (without regard to the proposed provision) is barred by the statute of limitations as of 1/1/98.
[3] Estimate provided by the Congressional Budget Office.
[4] Loss of less than $5 million.
[5] Loss of less than $25 million.
[6] Effective for requests to extend the statute of limitations made after the date of enactment and to all extensions of the statute of limitations on collections that are open 180 days after the date of enactment.
[7] Loss of less than $500,000.
[8] Gain of less than $500,000.

B. BUDGET AUTHORITY AND TAX EXPENDITURES

Budget authority

In compliance with section 308(a)(1) of the Budget Act, the Committee states that three provisions (expansion of authority to award costs and certain fees at prevailing rate, civil damages with respect to unauthorized collection actions, elimination of interest rate differential on overlapping periods of interest on income tax overpayments and underpayments, and increase refund interest rate to individuals) involve outlay effects (budget authority) totalling $989 million for fiscal years 1998–2007.

Tax expenditures

In compliance with section 308(a)(2) of the Budget Act, the Committee states that the bill does not involve changes in tax expenditures.

C. CONSULTATION WITH CONGRESSIONAL BUDGET OFFICE

The statement from the Congressional Budget Office has not been received at the time of filing of this report.

IV. VOTES OF THE COMMITTEE

In compliance with paragraph 7(b) of Rule XXVI of the Standing Rules of the Senate, the following statements are made concerning the roll call votes in the Committee's consideration of H.R. 2676 on March 31, 1998.

Motion to report the bill

The bill (H.R. 2676) was ordered favorably reported, as amended by the Chairman's amendment in the nature of a substitute, by a roll call vote of 12 yeas and 0 nays (20–0, including proxy votes). The vote, with a quorum present, was as follows:

Yeas.—Senators Roth, Chafee (proxy), Grassley, Hatch (proxy), D'Amato (proxy), Murkowski (proxy), Nickles, Gramm (proxy), Lott (proxy), Jeffords (proxy), Mack, Moynihan, Baucus, Rockefeller, Breaux, Conrad (proxy), Graham, Moseley-Braun, Bryan, and Kerrey.

Nays.—None.

Votes on other amendments

(1) An amendment by Senator Grassley to add a representative of the organization that represents a substantial number of IRS employees to the IRS Oversight board was approved by a roll call vote of 12 yeas and 8 nays. The vote was as follows:

Yeas.—Senators Grassley, D'Amato, Jeffords, Moynihan, Baucus, Rockefeller (proxy), Breaux, Conrad, Graham, Moseley-Braun, Bryan, and Kerrey.

Nays.—Senators Roth, Chafee, Hatch (proxy), Murkowski, Nickles, Gramm, Lott, and Mack.

(2) An amendment by Senator Moynihan to include the Secretary of the Treasury on the IRS Oversight Board was approved by a roll call vote of 12 yeas and 8 nays. The vote was as follows:

Yeas.—Senators Chafee, D'Amato, Jeffords, Moynihan, Baucus, Rockefeller (proxy), Breaux, Conrad, Graham, Moseley-Braun, Bryan, and Kerrey.

Nays.—Senators Roth, Grassley, Hatch (proxy), Murkowski, Nickles, Gramm, Lott, and Mack.

(3) An amendment by Senator D'Amato to guarantee coverage of inpatient hospital care for breast cancer was defeated by a roll call vote of 8 yeas and 10 nays. (The Chairman ruled this amendment non-germane.) The vote was as follows:

Yeas.—Senators Grassley, D'Amato, Murkowski, Moynihan, Breaux, Moseley-Braun, Bryan, and Kerrey.

Nays.—Senators Roth, Chafee, Nickles, Gramm, Lott, Jeffords, Mack, Baucus, Conrad, and Graham.

(4) An amendment by Senator Kerrey to substitute the language of the House-passed bill for the Chairman's Mark was defeated by a roll call vote of 8 yeas and 12 nays. The vote was as follows:

Yeas.—Senators Moynihan, Baucus, Rockefeller (proxy), Breaux, Conrad, Moseley-Braun, Bryan, and Kerrey.

Nays.—Senators Roth, Chafee (proxy), Grassley, Hatch, D'Amato (proxy), Murkowski, Nickles, Gramm, Lott (proxy), Jeffords (proxy), Mack, and Graham.

(5) An amendment by Senator Grassley to authorize State tax agencies to participate in the Federal program of refund offsets was approved by a roll call vote of 14 yeas and 6 nays. The vote was as follows:

Yeas.—Senators Chafee (proxy), Grassley, Hatch, D'Amato (proxy), Jeffords (proxy), Moynihan, Baucus, Rockefeller (proxy), Breaux, Conrad, Graham, Moseley-Braun, Bryan, and Kerrey.

Nays.—Senators Roth, Murkowski, Nickles, Gramm, Lott (proxy), and Mack.

(6) An amendment by Senator Conrad to strike the burden of proof provision of the Chairman's Mark was defeated by a roll call vote of 5 yeas and 15 nays. The vote was as follows:

Yeas.—Senators Moynihan, Baucus, Rockefeller (proxy), Conrad, and Graham.

Nays.—Senators Roth, Chafee (proxy), Grassley, Hatch, D'Amato (proxy), Murkowski (proxy), Nickles, Gramm, Lott (proxy), Jeffords (proxy), Mack, Breaux, Moseley-Braun, Bryan, and Kerrey.

(7) An amendment by Senators Graham and Moynihan to implement a tobacco tax increase of 5 cents per pack of cigarettes and accelerate a 15-cents-per-pack increase, and also to reduce the period for collecting taxes from 10 to 6 years, increase the refund claim period from 3 to 6 years, and to extend such periods to all taxes was defeated on a roll call vote of 8 yeas and 12 nays. The vote was as follows:

Yeas.—Senators Moynihan, Baucus, Rockefeller, Conrad (proxy), Graham, Moseley-Braun, Bryan, and Kerrey.

Nays.—Senators Roth, Chafee (proxy), Grassley, Hatch (proxy), D'Amato (proxy), Murkowski (proxy), Nickles, Gramm (proxy), Lott (proxy), Jeffords (proxy), Mack, and Breaux.

(8) An amendment by Senator Rockefeller to modify the privilege of practitioner-client confidentiality provision in the Chairman's Mark was defeated by a roll call vote of 3 yeas and 17 nays. The vote was as follows:

Yeas.—Senators Moynihan, Baucus, and Rockefeller.

Nays.—Senators Roth, Chafee (proxy), Grassley, Hatch (proxy), D'Amato (proxy), Murkowski (proxy), Nickles, Gramm (proxy), Lott (proxy), Jeffords (proxy), Mack, Breaux, Conrad (proxy), Graham, Moseley-Braun, Bryan, and Kerrey.

V. REGULATORY IMPACT AND OTHER MATTERS

A. REGULATORY IMPACT

Pursuant to paragraph 11(b) of Rule XXVI of the Standing Rules of the Senate, the Committee makes the following statement concerning the regulatory impact that might be incurred in carrying out the provisions of the bill as reported.

Impact on individuals and businesses

The bill as reported makes numerous changes designed to improve the management of the IRS, encourage electronic filing, protect taxpayer rights, improve Congressional oversight of the IRS, and provide necessary technical corrections to recent tax legislation.

Title I of the bill provides for restructuring of the IRS to improve management accountability and to improve taxpayer service.

Title II encourages electronic filing of tax and information returns, and requires a Treasury study of the feasibility of a return-free system for individuals.

Title III provides for additional protection of taxpayer rights, including relief for innocent spouses, and revises certain interest and penalty provisions. Title III also requires studies of the administration of penalties and interest and confidentiality of tax return information.

Title IV requires annual IRS reports to the Congressional tax committees on the sources of complexity in the Federal tax laws, and for the Joint Committee on Taxation to provide a "Tax Complexity Analysis" on tax legislation that has widespread applicability to individuals or small businesses.

Title V provides revenue offsets to the cost of the other provisions of the bill: (1) revises the deduction for vacation and severance pay (overruling *Schmidt Baking*); (2) modifies the foreign tax credit carryover rules; (3) clarifies and expands the mathematical error procedures; (4) freezes the grandfathered status of stapled REITs; (5) makes certain trade receivables ineligible for mark-to-market treatment; and (6) adds vaccines against rotavirus gastroenteritis to the list of taxable vaccines.

Title VI makes necessary technical corrections to the Taxpayer Relief Act of 1997 and certain other recent tax legislation.

Impact on personal privacy and paperwork

The provisions of the bill should not have any adverse impact on personal privacy. The bill modifies Code section 6103 to allow the tax committees to obtain information from IRS employees regarding IRS employee and taxpayer abuse.

B. UNFUNDED MANDATES STATEMENT

This information is provided in accordance with section 423 of the Unfunded Mandates Reform Act of 1995 (P.L. 104–4).

The Committee has reviewed the provisions of the bill as reported. In accordance with the requirements of Public Law 104–4, the Committee has determined that the following provisions of the bill contain Federal private sector mandates.

Repeal of *Schmidt Baking* with respect to the employer deduction for vacation and severance pay (bill sec. 5001);

Modification of the foreign tax credit carryover rules (bill sec. 5002);

Freezing of grandfathered status of stapled REITs (bill sec. 5004);

Certain trade receivables made ineligible for mark-to-market treatment (bill sec. 5005); and

Adding vaccines against rotavirus gastroenteritis to the list of taxable vaccines (bill sec. 5006).

As indicated in the revenue table (III.A., above), these provisions are estimated to increase tax revenues by $6,449 million in fiscal years 1998–2002 and $9,330 million in fiscal years 1998–2007, which are no greater than the aggregate estimated amounts that the private sector will be required to pay in order to comply with the Federal private sector mandates under the bill.

These provisions will not impose a Federal intergovernmental mandate on State, local, or tribal governments.

VI. CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In the opinion of the Committee, in order to expedite the business of the Senate, it is necessary to dispense with the requirements of the Senate of paragraph 12 of Rule XXVI of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the bill as reported by the Committee).

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