DESCRIPTION OF THE
TAXPAYER ASSISTANCE AND SIMPLIFICATION ACT OF 2008

Scheduled for Markup
By the
HOUSE COMMITTEE ON WAYS AND MEANS
on April 9, 2008

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The House Committee on Ways & Means has scheduled a markup on April 9, 2008, of the Taxpayer Assistance and Simplification Act of 2008. This document,[1] prepared by the staff of the Joint Committee on Taxation provides a description of the Taxpayer Assistance and Simplification Act of 2008.

[1] This document may be cited as follows: Joint Committee on Taxation, *Description of the Taxpayer Assistance and Simplification Act of 2008* (JCX-26-08), April 8, 2008. This document may be cited at www.house.gov/jct.

A. Modified Standard for Imposition of Tax Return Preparer Penalties

Present Law

Taxpayer standards

Present law imposes accuracy-related penalties on a taxpayer at a rate of 20 percent of the portion of any underpayment that is attributable to any substantial understatement of income tax. In determining whether a substantial understatement exists, the amount of the understatement generally is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.

In the case of a tax shelter item of a non-corporate taxpayer, the substantial understatement penalty does not apply if the taxpayer had substantial authority for the tax position and the taxpayer can demonstrate that he or she had a reasonable belief that the position is "more likely than not" the proper treatment. A taxpayer will be considered to have a reasonable belief that the treatment is more likely than not the proper treatment if the taxpayer relies upon the opinion of a professional advisor and the opinion is based upon the pertinent facts and authorities analyzed similar to the manner described in the substantial authority standard.[2]

Tax return preparer standards

Prior to enactment of the Small Business and Work Opportunity Tax Act of 2007, an income tax return preparer who prepared a tax return with respect to which there was an understatement of tax that was due to an undisclosed position for which there was not a realistic possibility of being sustained on its merits was liable for a $250 penalty. For a disclosed position, the preparer was liable only if the position was frivolous.

Legislation enacted as part of the Small Business and Work Opportunity Tax Act of 2007 broadened the scope of the preparer penalty by applying it to all tax return preparers and altered the standards of conduct a tax return preparer is required to meet in order to avoid the imposition of penalties for the preparation of a return with respect to which there is an understatement of tax. A tax return preparer now can be penalized for preparing a return on which there is an understatement of tax liability as a result of an "unreasonable position." Any position that a return preparer does not reasonably believe is more likely than not to be sustained on its merits is an "unreasonable position" unless the position is disclosed on the return and there is a reasonable basis for the position.

In general, the term "tax return preparer" is broadly defined as any person who prepares for compensation, or who employs one or more persons to prepare for compensation, any return

[2] Treas. Reg. sec. 1.6662-4(g).

of tax or any claim for refund of tax.[3] Preparation of a substantial portion of a return is treated as if it were the preparation of such return.

Description of Proposal

The proposal changes the standards for imposition of the tax return preparer penalty. The preparer standard for undisclosed positions is reduced to "substantial authority." The preparer standard for disclosed positions is "reasonable basis." For tax shelters and reportable transactions to which section 6662A applies (i.e., listed transactions and reportable transactions with significant avoidance or evasion purposes), a tax return preparer is required to have a reasonable belief that such a transaction was more likely than not to be sustained on its merits.

Effective Date

The proposal generally is effective with respect to returns prepared after May 25, 2007. In the case of tax shelters and reportable transactions, the proposal is effective for returns prepared for taxable years ending after the date of enactment.

[3] Sec. 7701(a)(36)(A).

B. Removal of Cellular Telephones (or Similar Telecommunications Equipment) from Listed Property

Present Law

Employer Deduction

Property, including cellular telephones and similar equipment, used in carrying on a trade or business is subject to the general rules for deducting ordinary and necessary expenses under section 162. Under these rules, a taxpayer may properly claim depreciation deductions under the applicable cost recovery rules for only the portion of the cost of the property that is attributable to use in a trade or business.[4] Similarly, the business portion of monthly telecommunication service is generally deductible, subject to capitalization rules, as an ordinary and necessary expense of carrying on a trade or business.

In the case of certain listed property, special rules apply. Listed property generally is defined as (1) any passenger automobile; (2) any other property used as a means of transportation; (3) any property of a type generally used for purposes of entertainment, recreation, or amusement; (4) any computer or peripheral equipment; (5) any cellular telephone (or other similar telecommunications equipment);[5] and (6) any other property of a type specified in Treasury regulations.[6]

For listed property, no deduction is allowed unless the taxpayer adequately substantiates the expense and business usage of the property.[7] Under the applicable regulations, a taxpayer must substantiate the elements of each expenditure or use of listed property, including (1) the amount (e.g., cost) of each separate expenditure and the amount of business or investment use, based on the appropriate measure (e.g., mileage for automobiles), and the total use of the property for the taxable period, (2) the date of the expenditure or use, and (3) the business purposes for the expenditure or use.[8] The level of substantiation for business or investment use of listed property varies depending on the facts and circumstances. In general, the substantiation must contain sufficient information as to each element of every business or investment use.[9]

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[4] Sec. 212 allows deductions for ordinary and necessary expenses paid or incurred for the production or collection of income.

[5] Cellular telephones (or other similar telecommunications equipment) were added as listed property as part of the Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, sec. 7643 (1989).

[6] Sec. 280F(d)(4)(A).

[7] Sec. 274(d)(4).

[8] Temp. Reg. sec. 1.274-5T(b)(6).

[9] Temp. Reg. sec. 1.274-5T(c)(2)(ii)(C).

With regard to the business use of listed property made available by an employer for use by an employee, the employer may generally rely on adequate records maintained, and retained, by the employee or on the employee's own statement if it is corroborated by other sufficient evidence, unless the employer knows or has reason to know that the statement, records, or other evidence are not accurate.[10]

Taxation of Employee

Gross income includes all income unless a specific exclusion applies.[11] Exclusions from gross income are provided in the case of certain fringe benefits.[12] Gross income does not include the value of de minimis fringe benefits. A de minimis fringe is any property or service the value of which is (after taking into account the frequency in which similar fringes are provided by the employer to the employer's employees) so small as to make accounting for it unreasonable or administratively impracticable. An exclusion from employee gross income is also provided in the case of a working condition fringe.[13] A working condition fringe is any property or services provided to an employee of the employer to the extent that, if the employee paid for such property or services, such payment would be allowable as a deduction under section 162 or 167.[14] Treasury regulations provide that an employee may not exclude from gross income as a working condition fringe any amount of the value of the availability of listed property provided by an employer to the employee, unless the employee substantiates for the period of availability the amount of the exclusion in accordance with the substantiation requirements discussed above.[15] In general, under such requirements, in the case of listed property, the working condition fringe exception is allowed only in the case of substantiation of the employee's personal use of the property and that the employer included an appropriate amount (based on such personal use) in the employee's income.[16]

Cost Recovery

A taxpayer is allowed to recover through annual depreciation deductions the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system ("MACRS"). Under MACRS, different

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[10] Temp. Reg. sec. 1.274-5T(e)(2)(ii).

[11] Sec. 61.

[12] Sec. 132.

[13] Sec. 132(a)(3).

[14] Sec. 132(d).

[15] Temp. Reg. sec. 1.274-5T(e)(1).

[16] Temp. Reg. sec. 1.274-5T(e)(2).

types of property generally are assigned applicable recovery periods and depreciation methods. The recovery periods applicable to most tangible personal property range from three to 25 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the taxpayer's depreciation deduction would be maximized.

In the case of certain listed property, special depreciation rules apply. First, if for the taxable year that the property is placed in service the use of the property for trade or business purposes does not exceed 50 percent of the total use of the property, then the depreciation deduction with respect to such property is determined under the alternative depreciation system.[17] The alternative depreciation system generally requires the use of the straight-line method and a recovery period equal to the class life of the property.[18] Second, if an individual owns or leases listed property that is used by the individual in connection with the performance of services as an employee, no depreciation deduction, expensing allowance, or deduction for lease payments is available with respect to such use unless the use of the property is for the convenience of the employer and required as a condition of employment.[19]

Description of Proposal

The proposal removes cellular telephones (or other similar telecommunications equipment) from the definition of listed property. Thus, under the proposal, the heightened substantiation requirements that apply to listed property do not apply to cellular telephones (or other similar telecommunications equipment).

Effective Date

The proposal is effective for taxable years beginning after December 31, 2008.

[17] Sec. 280F(b)(1). If for any taxable year after the year in which the property is placed in service the use of the property for trade or business purposes decreases to 50 percent or less of the total use of the property, then the amount of depreciation allowed in prior years in excess of the amount of depreciation that would have been allowed for such prior years under the alternative depreciation system is recaptured (i.e., included in gross income) for such taxable year.

[18] Sec. 168(g).

[19] Sec. 280F(d)(3).

C. Delayed Implementation of Government Withholding Requirement

Present law

For payments made after December 31, 2010, the Code requires withholding at a three-percent rate on certain payments to persons providing property or services made by the Government of the United States, every State, every political subdivision thereof, and every instrumentality of the foregoing (including multi-State agencies). The withholding requirement applies regardless of whether the government entity making such payment is the recipient of the property or services. Political subdivisions of States (or any instrumentality thereof) with less than $100 million of annual expenditures for property or services that would otherwise be subject to withholding under this provision are exempt from the withholding requirement.

Payments subject the three-percent withholding include any payment made in connection with a government voucher or certificate program which functions as a payment for property or services. For example, payments to a commodity producer under a government commodity support program are subject to the withholding requirement. The provision imposes information reporting requirements on the payments that are subject to withholding under the provision.

The three-percent withholding requirement does not apply to any payments made through a Federal, State, or local government public assistance or public welfare program for which eligibility is determined by a needs or income test. The three-percent withholding requirement also does not apply to payments of wages or to any other payment with respect to which mandatory (e.g., U.S.-source income of foreign taxpayers) or voluntary (e.g., unemployment benefits) withholding applies under present law. The provision does not exclude payments that are potentially subject to backup withholding under section 3406. If, however, payments are actually being withheld under backup withholding, withholding does not apply.

The three-percent withholding requirement also does not apply to the following: payments of interest; payments for real property; payments to tax-exempt entities or foreign governments; intra-governmental payments; payments made pursuant to a classified or confidential contract (as defined in section 6050M(e)(3)); and payments to government employees that are not otherwise excludable from the new withholding provision with respect to the employees' services as employees.

Description of Proposal

The proposal delays the effective date for the three-percent withholding requirement. Under the proposal, the requirement applies to payments made after December 31, 2011.

The proposal directs the Secretary to study issues associated with the three-percent withholding requirement, including (1) the problems, if any, which are anticipated in administering and complying with such requirement, (2) the burdens, if any, that such requirements will place on small businesses (taking into account such mechanisms as may be necessary to administer such requirements), and (3) the application of such requirements to small expenditures for services and goods by governments.

The Secretary is to submit his report to the Senate Committee on Finance and House Committee on Ways and Means no later than six months after the date of enactment.

Effective Date

The proposal is effective on the date of enactment.

D. Employment Tax Treatment of Home Care Service Recipients

Present Law

In general

Employment taxes generally consist of the taxes under the Federal Insurance Contributions Act ("FICA"), the tax under the Federal Unemployment Tax Act ("FUTA"), and income taxes required to be withheld by employers from wages paid to employees ("income tax withholding").[20]

FICA tax consists of two parts: (1) old age, survivor, and disability insurance ("OASDI"), which correlates to the Social Security program that provides monthly benefits after retirement, disability, or death; and (2) Medicare hospital insurance ("HI"). The OASDI tax rate is 6.2 percent on both the employee and employer (for a total rate of 12.4 percent). The OASDI tax rate applies to wages up to the OASDI wage base ($102,000 for 2008). The HI tax rate is 1.45 percent on both the employee and the employer (for a total rate of 2.9 percent). Unlike the OASDI tax, the HI tax is not limited to a specific amount of wages, but applies to all wages.

Under FUTA, employers must pay a tax of 6.2 percent of wages up to the FUTA wage base of $7,000. An employer may take a credit against its FUTA tax liability for its contributions to a State unemployment fund and, in certain cases, an additional credit for contributions that would have been required if the employer had been subject to a higher contribution rate under State law. For purposes of the credit, contributions means payments required by State law to be made by an employer into an unemployment fund, to the extent the payments are made by the employer without being deducted or deductible from employees' remuneration.

Employers generally are required to withhold income taxes from wages paid to employees. Withholding rates vary depending on the amount of wages paid, the length of the payroll period, and the number of withholding allowances claimed by the employee.

Wages paid to employees, and FICA and income taxes withheld from the wages, are required to be reported on employment tax returns (Forms 940 and 941) and on Form W-2.[21]

A number of special rules apply in the case of household employees. An exception from FICA exists in the case of domestic service in a private home if the cash remuneration paid during the year by the employer to the employee for such service is less than $1,600 (for 2008).[22] An employer of a household employee is liable for FUTA if the employer paid wages of $1,000

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[20] Secs. 3101-3128 (FICA), 3201-3241 (the Railroad Retirement Tax Act), 3301-3311 (FUTA), and 3401-3404 (income tax withholding). Sections 3501-3510 provide additional rules.

[21] Secs. 6011 and 6051.

[22] Sec. 3121(a)(7)(B).

for such service in any calendar quarter in the calendar year or the preceding calendar year.[23] An employer of a household employee is not required to withhold Federal income taxes from wages paid to household employees.[24] Household employers may report employment taxes annually on Schedule H (filed with their annual Federal income tax return) rather than quarterly on Form 941.

Responsibility for employment tax compliance

Employment tax responsibility generally rests with the person who is the employer of an employee under a common-law test that has been incorporated into Treasury regulations.[25] Under the regulations, an employer-employee relationship generally exists if the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work, but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer, not only as to what is to be done, but also as to how it is to be done. It is not necessary that the employer actually control the manner in which the services are performed, rather it is sufficient that the employer have a right to control. Whether the requisite control exists is determined on the basis of all the relevant facts and circumstances. The test of whether an employer-employee relationship exists is relevant in determining whether a worker is an employee or an independent contractor. However, the same test applies in determining whether a worker is an employee of one person or another.[26]

In some cases, a person other than the common-law employer may be liable for employment taxes. For example, if wages are paid to an employee by a person other than the employer and the payor, rather than the employer, has control of the payment of the wages, the payor is responsible for complying with the applicable employment tax requirements.[27] There

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[23] Sec. 3306(a)(3).

[24] Sec. 3401(a)(3).

[25] Treas. Reg. secs. 31.3121(d)-1(c)(1), 31.3306(i)-1(a), and 31.3401(c)-1.

[26] Issues relating to the classification of workers as employees or independent contractors are discussed in Joint Committee on Taxation, *Present Law and Background Relating to Worker Classification for Federal Tax Purposes* (JCX-26-07), May 2007. These issues are also discussed in Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS-3-01), April 2001, at Vol. II, Part XV.A, at 539-550.

[27] Sec. 3401(d)(1) (for purposes of income tax withholding, if the employer does not have control of the payment of wages, the person having control of the payment of such wages is treated as the employer); *Otte v. United States*, 419 U.S. 43 (1974) (the person who has the control of the payment of wages is treated as the employer for purposes of withholding the employee's share of FICA from wages); and *In re Armadillo Corporation*, 561 F.2d 1382 (10th Cir. 1977), and *In re The Laub Baking Company v. United States*, 642 F.2d 196 (6th Cir. 1981) (the person who has control of the payment of wages is the employer for purposes of the employer's share of FICA and FUTA). The mere fact that wages are paid by a person other than the employer does not necessarily mean that the payor has control of the payment

are also special rules under which if a lender, surety or other person pays wages directly to an employee or group of employees, the lender, surety, or other person is responsible for employment taxes.[28] There is also a special rule under which a qualified real estate agent, or direct seller of certain consumer products, performing services is not treated as an employee with respect to the person for whom the services are performed.[29]

In addition, certain designated agents are jointly and severally liable with the employer for FICA tax and income tax withholding with respect to wages paid to the employer's employees.[30] These designated agents prepare and file employment tax returns using their own names and employer identification numbers.[31] In contrast, reporting agents (often referred to as payroll service providers) are generally not liable for the employment taxes reported on their clients' returns. Reporting agents prepare and file employment tax returns for their clients using the client's name and employer identification number.

Penalties apply in the case of failures to comply with information reporting requirements.[32] In the case of failure to file a specified information return, a penalty of $50 for each return (not to exceed $100,000) is imposed.[33]

<u>Home-care services</u>

Many elderly and disabled individuals receive in-home care through state and local government health and welfare programs.[34] These programs generally are funded at least in part with Federal funds. In most cases, the service recipient (i.e., the elderly or disabled individual) is the common law employer.

IRS guidance provides rules for State and local government agencies as to how they can serve as agents for disabled individuals and other welfare recipients who employ home-care

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of the wages. Rather, control depends on the facts and circumstances. See, e.g., *Consolidated Flooring Services v. U.S.*, 38 Fed. Cl. 450 (1997), and *Winstead v. U.S.*, 109 F. 3d 989 (4th Cir. 1997).

[28] Sec. 3505

[29] Sec. 3508

[30] Sec. 3504. The designated payroll agent rules do not apply for FUTA purposes.

[31] The employer's name, address, and employer identification number, as well as the agent's, are provided when the agent is designated by the employer. Form 2678 is used to designate an agent.

[32] Secs. 6721 - 6724.

[33] Sec. 6723.

[34] *See* National Taxpayer Advocate 2007 Annual Report to Congress, December 31, 2007 at 355.

service providers to assist them in their homes.[35] In general, these rules provide that the elderly or disabled individual must complete a form designating the State or local government as their agent for employment tax purposes. Under IRS guidance, unlike the general rule for designated agents, a State that furnishes home-care service providers (or a third party subagent of the State) can act as an agent on behalf of the service recipient for FUTA purposes.[36] As previously discussed, in the case of a State or local government or independent third party serving as an agent on behalf of the service recipient, the service recipient remains liable for payment of the employment taxes and for any associated penalties for noncompliance.

Description of Proposal

The proposal provides that, in the case of amounts paid under a home care service program to a home care service provider by the fiscal administrator of such program, the fiscal administrator is solely liable for the payment of employment taxes with respect to amounts paid for services under the program. In such case, the home care service recipient is not liable for the payment of employment taxes.

A home care service program is a State or local government program which is funded in whole or part by Federal funds and under which domestic services are provided to elderly or disabled individuals in their home. A home care service program does not include any program to the extent home care service recipients make payments to the home care service providers for such in-home domestic services.

A home care service provider is an individual who provides domestic services to a home care service recipient under a home care service program. A home care service recipient is an individual receiving domestic services under a home care service program. A fiscal administrator is any person or governmental entity who pays amounts under a home care service program to home care service providers for the provision of domestic services under such program.

Employment tax returns (i.e., Forms W-2, 940 and 941) must be made under the name and employer identification number of the fiscal administrator rather than that of the common law employer, the service recipient. The fiscal administrator is required, as prescribed by the Secretary, to report to the IRS the name, address, and social security number of each home care service recipient for whom amounts are paid by such fiscal administrator under the home care services program. This is intended to assist the IRS in preventing collection action against the

[35] *See* Notice 2003-70, 2003-2 C.B. 916 (providing a proposed revenue procedure). *See also,* Rev. Proc. 76-6, 1970-1 C.B. 420, as modified by Rev. Proc. 80-4, 1980-1 C.B. 581.

[36] Notice 2003-70, 2003-2 C.B. 916. This is not the case if the independent third party is designated as the agent directly by the employer.

elderly or disabled common law employer. In the case of failure to file the required report, a penalty is imposed.[37]

Under the proposal, the Secretary may prescribe regulations or other guidance as may be necessary to carry out the purposes of the provision, including rules for timing of employment tax deposits.

It is intended that the present law rules that apply in the case of household employees continue to apply under the proposal. Relevant thresholds under these rules are also determined with respect to each home care recipient. For example, it is intended that the exception from FICA for domestic service in a private home if cash remuneration paid during the year by the employer to the employee for such service is less than $1,600 (for 2008) would continue to apply. Similarly, FUTA would be required only if the employer paid wages of $1,000 for household service in any calendar quarter in the calendar year or the preceding calendar year. In addition, the present law exception from Federal income tax withholding for household employees would continue to apply.

Effective Date

The proposal is effective for amounts paid after December 31, 2008.

[37] The section 6723 present law penalties are increased under another section of the bill. Under that proposal, the penalty of $50 per report (not to exceed $100,000 per calendar year) is increased to $100 per report (not to exceed $1,500,000 per calendar year).

E. Referrals to Low-Income Taxpayer Clinics

Present Law

The Code provides that the Secretary is authorized to provide up to $6 million per year in matching grants to certain qualified low-income taxpayer clinics.[38] Eligible clinics are 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. No clinic can receive more than $100,000 per year.

A qualified low-income taxpayer clinic includes (1) a clinical program at an accredited law, business, or accounting school, in which students represent low-income taxpayers, or (2) an organization described in section 501(c) which either represents low-income taxpayers as described above or provides referrals to qualified representatives. A low-income taxpayer is an individual whose income does not exceed 250 percent of the poverty level, as determined in accordance with criteria established by the Director of the Office of Management and Budget ("OMB").

The Department of the Treasury prohibits its officers and employees from referring taxpayers to qualified low-income taxpayer clinics for advice and assistance.

Description of Proposal

The proposal allows officers and employees of the Department of the Treasury to refer taxpayers for advice and assistance to qualified low-income taxpayer clinics that receive funding, notwithstanding any other provision of law.

Effective Date

The proposal is effective for referrals made after the date of enactment.

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[38] Sec. 7526.

F. Programs for the Benefit of Low-Income Taxpayers

Present Law

The Code provides that the Secretary is authorized to provide up to $6 million per year in matching grants to certain qualified low-income taxpayer clinics.[39] Eligible clinics are 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. No clinic can receive more than $100,000 per year.

A qualified low-income taxpayer clinic includes (1) a clinical program at an accredited law, business, or accounting school, in which students represent low-income taxpayers, or (2) an organization described in section 501(c) which either represents low-income taxpayers as described above or provides referrals to qualified representatives. A low-income taxpayer is an individual whose income does not exceed 250 percent of the poverty level, as determined in accordance with criteria established by the Director of the Office of Management and Budget ("OMB").

Description of Proposal

The proposal authorizes the Secretary to make $10 million in matching grants for volunteer income tax programs. Volunteer income tax programs are programs that provide tax return preparation and filing services to low- and moderate-income (as determined by the Secretary) taxpayers. Under the proposal, volunteer income tax programs may not charge taxpayers for return preparation services. Volunteers assisting taxpayers through such programs must meet training requirements established by the Secretary.

The authorization of $6 million for qualified low-income taxpayer clinics under present law also is increased to $10 million.

Effective Date

The proposal is effective on the date of enactment.

[39] Sec. 7526.

G. Earned Income Credit Outreach

Present Law

In general

Low and moderate-income taxpayers may be eligible for the refundable earned income credit ("EIC").[40] Generally, the amount of the EIC is based on the presence and number of qualifying children in the taxpayer's family, as well as on adjusted gross income ("AGI") and earned income.[41] Other rules also apply.

Three separate schedules apply in computing the taxpayer's EIC: (1) one schedule for taxpayers with no qualifying children; (2) one schedule for taxpayers with one qualifying child; and (3) one schedule for taxpayers with more than one qualifying child.[42]

The EIC generally equals a specified percentage of earned income up to a maximum dollar amount. The maximum amount applies over a certain income range and then diminishes to zero over a specified phaseout range. For taxpayers with earned income (or AGI, if greater) in excess of the beginning of the phaseout range, the maximum EIC amount is reduced by the phaseout rate multiplied by the amount of earned income (or AGI, if greater) in excess of the beginning of the phaseout range. For taxpayers with earned income (or AGI, if greater) in excess of the end of the phaseout range, no credit is allowed. All income thresholds are adjusted annually for inflation.

Wage withholding

In general, the Code requires employers to withhold income tax on wages paid to employees, including wages and salaries of employees or elected officials of Federal, State, and local government units. Withholding rates vary depending on the amount of wages paid, the length of the payroll period, and the number of withholding allowances claimed by the

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[40] The EIC is a refundable credit, meaning that if the amount of the credit exceeds the taxpayer's Federal income tax liability, the excess is payable to the taxpayer as a direct transfer payment. Under an advance payment system, eligible taxpayers may elect to receive a portion of the credit in their paychecks, rather than waiting to claim a refund on their tax return filed by April 15 of the following year.

[41] Earned income is defined as (1) wages, salaries, tips, and other employee compensation, but only if such amounts are includible in gross income, plus (2) the amount of the taxpayer's net self-employment earnings.

[42] In general, a child is a qualifying child of a taxpayer if the child satisfies each of three tests: (1) the child has the same principal place of abode as the taxpayer for more than one-half of the taxable year; (2) the child has a specified relationship to the taxpayer; and (3) the child has not yet attained a specified age. A tie-breaking rule applies if more than one taxpayer claims a child as a qualifying child.

employee. The Code also requires that employers report wage withholding information annually to the IRS and their employees (e.g., Form W-2 and Form W-3).[43]

EIC outreach and assistance

Pre-tax return filing

The IRS has developed an outreach effort to inform taxpayers potentially eligible for the EIC and their employers about the EIC and how to claim the credit. One such public notice, contained in IRS Notice 797 (Rev. 12-2006), explains the EIC, its eligibility rules, and how to claim the credit. In addition, the IRS works with employers, community groups and other stakeholders to inform eligible taxpayers of the EIC. The IRS also helps taxpayers below certain income levels compute their Federal income tax liability, including the amount of EIC, if any.

Post-tax return filing

The IRS sends out notice letters addressed to taxpayers who it has identified as potentially eligible for the EIC in the immediately prior taxable year.

The notice letters are different depending on the presence of a qualifying child or children in the taxpayer's household. If the IRS identifies a taxpayer with one or more qualifying children as potentially eligible for the EIC, the notice letter informs the taxpayer that IRS records indicate that: (1) the taxpayer's income falls in the eligible range to receive the EIC; (2) the taxpayer has one or more dependents who may be an EIC qualifying child; and (3) the taxpayer did not claim the EIC for the applicable taxable year on his or her return filed with the IRS. If the IRS identifies a taxpayer without qualifying children as potentially eligible for the EIC, the notice letter informs the taxpayer that IRS records indicate that: (1) the taxpayer's income falls in the eligible range to receive the EIC and (2) the taxpayer did not claim the EIC for the applicable taxable year on his or her return filed with the IRS.

In all cases, the notice letters ask the taxpayers to complete an "EIC Eligibility Check-Sheet" and, if the check-sheet indicates eligibility for the EIC, to return it to the IRS. The EIC Eligibility Check-Sheet requests the taxpayer to provide all the information necessary to determine EIC eligibility. The EIC Eligibility Check-Sheet is completed under penalty of perjury by the taxpayer (and the taxpayer's spouse in the case of a joint return). The IRS reviews the information submitted by the taxpayer and either: (1) sends any applicable refund within eight weeks (net of any other amounts the IRS is required to collect), or (2) sends an explanation to the taxpayer stating why the taxpayer does not qualify for the EIC.

The notice letters also provide information to help eligible taxpayers correctly claim the EIC in future taxable years.

Under present law, these notice letters are sent by the IRS only to individuals who have filed a tax return for the applicable taxable year. The absence of the taxpayer's filed tax return,

[43] Information returns, such as Form W-2, are returns within the meaning of section 6103(b)(1).

notwithstanding the receipt by the IRS of return information or an information return (e.g., Form W-2 indicating wage withholding on the taxpayer) from the taxpayer's employer does not trigger a notice letter to the taxpayer.

Limitations on credits and refunds

Under section 6511, a claim for credit or refund of overpayment of tax with respect to which a return must be filed must be made within the later of: (1) three years from the time the return was filed or (2) two years from the time the tax was paid. If no return was filed by the taxpayer, then the applicable time period ends two years after the tax was paid.

Description of Proposal

The proposal requires the IRS to provide annually, and to the extent possible,[44] notice to all taxpayers who have been identified based on return or return information as being potentially eligible for the EIC in any taxable year for which a claim for credit or refund is not barred by the limitation period under section 6511. Such notice must be in writing, address all open tax years, and be sent to the last known address of such taxpayers: (1) who did not file a claim for the EIC for such taxable year, and (2) who the IRS identified as potentially eligible for the EIC for such taxable year based on a return or return information (as defined in sec. 6103(b)).

Upon receipt of this notice letter, the taxpayer who had filed a return for the applicable taxable years would complete the applicable EIC Eligibility Check-Sheet for each of the applicable taxable years. It is anticipated that this Check-Sheet would ask for all the information relating to the taxpayer's eligibility for the EIC (e.g., earned income, AGI, presence and number of qualifying children, and taxpayer identification numbers). If eligible for the EIC, in one or more of the applicable taxable years, the taxpayer would return the EIC Eligibility Check-Sheet to the IRS for any refund (including wages withheld by the taxpayer's employer). In the case of an eligible taxpayer who had not filed a return for the applicable taxable years, the taxpayer would be instructed to file a tax return claiming the EIC with the IRS for any refund (including wages withheld by the taxpayer's employer) for each of the applicable taxable years.

Effective Date

The proposal is effective on the date of enactment.

[44] It is anticipated that the type of available return information and available IRS resources will affect the IRS's ability to issue the additional notice letters contemplated under this proposal.

H. Prohibition on IRS Debt Indicators for Predatory Refund Anticipation Loans

Present Law

A refund anticipation loan is a loan made by a commercial lender to a taxpayer based on the refund the taxpayer expects to receive. The loan is a private contract between the taxpayer and a commercial lender. The Code does not regulate the making of refund anticipation loans, but consumer groups, the Commissioner of the IRS, and the National Taxpayer Advocate all have raised concerns over the high interest rates and fees associated with such loans.[45]

Certain tax practitioners that file returns electronically and financial institutions may obtain a debt indicator from the IRS for their customer taxpayers. A debt indicator facilitates the making of refund anticipation loans because it tells whether or not a taxpayer has any scheduled offsets against a claimed refund. Thus, a debt indicator reduces the lender's risk of making a refund anticipation loan because it informs the lender whether the taxpayer's refund will be paid or reduced for certain debts.

Description of Proposal

The proposal prohibits the Secretary from providing a debt indicator to any person with respect to any refund anticipation loan if the Secretary determines that the business practices of such person involve refund anticipation loans and related charges and fees that are predatory. Under the proposal, a refund anticipation loan is any loan of money or any other thing of value to a taxpayer secured by the taxpayer's anticipated receipt of a Federal tax refund. For purposes of the proposal, a debt indicator means a notification provided to a tax practitioner or financial institution pursuant to a program or procedure that a taxpayer's refund will be reduced or offset to repay debts for delinquent Federal or State taxes, student loans, child support, or other Federal agency debt.

Effective Date

The proposal is effective on the date of enactment.

[45] See e.g., National Taxpayer Advocate, *2005 Annual Report to Congress*, Publication 2104 (Rev. 12-2005), at 162.

I. Study on Delivery of Tax Refunds

Present Law

A large number of individual taxpayers do not have bank accounts. Because of this, these taxpayers are unable to participate fully in electronic filing, because IRS cannot electronically transmit to them their tax refunds.

Description of Proposal

The proposal requires the Secretary to conduct a study, in consultation with the National Taxpayer Advocate, of the implementation of a program to deliver tax refunds through debit cards or other electronic means. The proposal requires the Secretary to submit a report to Congress on the results of such study no later than one year after the date of enactment.

Effective Date

The proposal is effective on the date of enactment.

J. Extension of Time Limit for Return of Property for Wrongful Levy

Present Law

The IRS is authorized to return property that has been wrongfully levied upon.[46] In general, monetary proceeds from the sale of levied property upon, or an amount equal to the amount of money levied upon, may be returned within nine months of the date of the levy.

Generally, any person (other than the person against whom is assessed the tax out of which such levy arose) who claims an interest in levied property may bring a civil action for wrongful levy in a district court of the United States.[47] Generally, an action for wrongful levy must be brought within nine months from the date of levy.[48] However, if a claim for a return of property is made to the IRS, the nine-month period is extended for the shorter of a period of 12 months from the date of filing of such request or six months from the date of mailing of an IRS notice of disallowance of such request.[49]

Description of Proposal

The proposal extends from nine months to two years the period for returning money and the monetary proceeds from the sale of property that has been wrongfully levied upon.

The proposal also extends from nine months to two years the period for bringing a civil action for wrongful levy.

Effective Date

The proposal is effective with respect to: (1) levies made after the date of enactment and (2) levies made on or before the date of enactment provided that the nine-month period has not expired as of the date of enactment.

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[46] Sec. 6343.

[47] Sec. 7426(a)(1).

[48] Sec. 6532.

[49] Sec. 6532(c)(2).

K. Individuals Held Harmless on Improper Levy on Individual Retirement Plan

Present Law

Distributions from an individual retirement arrangement ("IRA") made on account of an IRS levy are includible in the gross income of the individual under the rules applicable to the IRA subject to the levy. Thus, in the case of a traditional IRA, the amount distributed as a result of a levy is includible in gross income except to the extent such amount represents a return of nondeductible contributions (i.e., basis). In the case of a Roth IRA, earnings on a distribution are excludable from gross income if the distribution is made: (1) after the five-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA and (2) after attainment of age 59-1/2 or on account of certain other circumstances. Amounts withdrawn from an IRA due to a levy are not subject to the 10-percent early withdrawal tax, regardless of whether the amount is includible in income.

Present law provides rules under which the IRS returns amounts subject to an incorrect levy. For example, amounts withdrawn from an IRA pursuant to a levy are returned to the individual owning the IRA in the case of a wrongful levy or if the levy was not in accordance with IRS administrative procedures. In the case of a wrongful levy, the IRS is required to pay interest on the amount returned to the individual at the overpayment rate. The IRS is not required to pay interest if the levy was not in accordance with IRS administrative procedures.

Present law does not provide special rules to allow an individual to recontribute to an IRA amounts withdrawn from an IRA pursuant to a levy and later returned to the individual by the IRS (or interest thereon). Thus, if an individual wishes to contribute such returned amounts to an IRA, the contribution is subject to the normally applicable rules for IRA contributions.

Description of Proposal

Under the proposal, an individual is able to recontribute to an IRA amounts withdrawn pursuant to a levy and returned by the IRS (and any interest thereon) within 60 days of receipt by the individual, without regard to the normally applicable limits on IRA contributions and rollovers. The proposal applies to levied amounts returned to the individual because the levy (1) was wrongful or (2) is determined to be premature or otherwise not in accordance with administrative procedures. The recontribution may be made to the same IRA or to any other individuated retirement plan (other than an endowment contract) to which a rollover from the IRA levied upon is permitted. That is, the recontribution may be made to the same IRA or to an IRA of the same type.

Under the proposal, the IRS is required to pay interest on amounts returned to the individual at the overpayment rate in the case of a levy that is determined to be premature or otherwise not in accordance with administrative procedures (as well as in the case of a wrongful levy under present law). Interest paid by the IRS on the amount returned to the individual is excludable from gross income if the interest is contributed to an IRA under the provision. An amount contributed to an IRA under the provision will only be treated as interest paid by the IRS to the extent the total amount contributed under the provision exceeds the amount of the levy.

Any tax attributable to an amount distributed from an IRA by reason of a levy is abated if the amount is recontributed to an IRA pursuant to the provision.

Effective Date

The proposal is effective for levied amounts (and interest thereon) returned to individuals after the date of enactment.

L. Taxpayer Notification of Suspected Identity Theft

<u>Present Law</u>

Section 6103 provides that returns and return information are confidential and may not be disclosed by the Internal Revenue Service ("IRS"), other Federal employees, State employees, and certain others having access to the information except as provided in the Code.[50] The definition of "return information" is very broad and includes any information gathered by the IRS with respect to a person's liability or possible liability under the Code for any tax, penalty, interest, fine, forfeiture, or other imposition or offense.[51] Thus, information gathered by the IRS in connection with an investigation of a person for a Title 26 offense, such as fraud, is the return information of the person being investigated and is subject to the confidentiality restrictions of section 6103.

In July 2007, the IRS established the Privacy, Information Protection, and Data Security Office. Within that office is the Identity Theft and Incident Management office, which is responsible for implementing the IRS identity theft strategy and coordinating efforts within the IRS to provide assistance and consistent treatment to taxpayers who are victims of identity theft. The IRS also recently implemented a pilot program to notify IRS-identified tax fraud victims of identity theft.

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[50] Sec. 6103(a).

[51] Sec. 6103(b)(2). Return information is

- a taxpayer's identity, the nature, source, or amount of his income, payments, receipts, deductions, exemptions, credits, assets, liabilities, net worth, tax liability, tax withheld, deficiencies, overassessments, or tax payments, whether the taxpayer's return was, is being, or will be examined or subject to other investigation or processing, or any other data, received by, recorded by, prepared by, furnished to, or collected by the Secretary with respect to a return or with respect to the determination of the existence, or possible existence, of liability (or the amount thereof) of any person under this title for any tax, penalty, interest, fine, forfeiture, or other imposition, or offense,

- any part of any written determination or any background file document relating to such written determination (as such terms are defined in section 6110(b)) which is not open to public inspection under section 6110,

- any advance pricing agreement entered into by a taxpayer and the Secretary and any background information related to such agreement or any application for an advance pricing agreement, and

- any closing agreement under section 7121, and any similar agreement, and any background information related to such an agreement or request for such an agreement.

Return information does not include data in a form which cannot be associated with, or otherwise identify, directly or indirectly, a particular taxpayer.

Description of Proposal

The proposal provides that if, in the course of an investigation under the internal revenue laws, the Secretary determines that there was, or may have been, an unauthorized use of a taxpayer's identity or that of a dependent of the taxpayer, the Secretary shall, to the extent permitted by law, (1) as soon as practicable and without jeopardizing such investigation, notify the taxpayer of such determination, and (2) if any person is criminally charged by indictment or information with respect to such unauthorized use, notify such taxpayer as soon as practicable of such charge. Under the proposal, the IRS is not required to make such notification if disclosure would be barred by any statute (other than Title 26) or would be, for example, in violation of grand jury secrecy rules.[52] Further, notification would not be required if the IRS is unable to obtain an address or other contact information for the taxpayer. In such case notification would not be practicable because the IRS would not have the necessary information to notify that person.

Effective Date

The proposal applies to determinations made after the date of enactment.

[52] Persons bound by the rule of grand jury secrecy in Fed. R. Crim. P. 6(e)(2) are subject to prosecution for criminal contempt under 18 U.S.C. sec. 401 for the unauthorized disclosure of grand jury information. Thus, under the proposal, a notification that was in violation of the grand jury secrecy rules would not be "permitted by law" within the meaning of the proposal.

M. Repeal of Private Tax Collection Contracts

Present Law

Under present law, the IRS may use private debt collection companies to locate and contact taxpayers owing outstanding tax liabilities of any type and to arrange payment of those taxes by the taxpayers.

Description of Proposal

The proposal repeals the authority for the IRS to enter into, renew, or extend any private debt collection contract.

Effective Date

The proposal generally is effective on the date of enactment, except for any contract which was entered into before July 18, 2007, and is not renewed or extended on or after March 1, 2008. The proposal also provides that any private debt collection contract which is entered into on or after July 18, 2007, and any extension or renewal of any private debt collection contract on or after March 1, 2008, shall be void.

N. Clarification of IRS Unclaimed Refund Authority

Present Law

When the IRS is unable to find a taxpayer due a refund, present law provides that the IRS may use "the press or other media" to notify the taxpayer of the refund. Section 6103(m) allows the IRS to give the press taxpayer identity information for this purpose. Taxpayer identity includes name, mailing address, taxpayer identification number, or combination thereof.[53]

The IRS believes that the current statutory framework of "press and other media" does not permit disclosures via the Internet. The legislative history of the present-law provision does not address the meaning of "press and other media." At the time of the statute's enactment in 1976, the press (newspapers and periodicals) and other traditional media were the only means available for the IRS to distribute undelivered refund information to the public. Thus, the IRS interprets the term "other media" to exclude the Internet.

Description of Proposal

The proposal allows the IRS to use any means of "mass communication," including the Internet, to notify the taxpayer of an undelivered refund.

Effective Date

The proposal is effective on the date of enactment.

[53] Sec. 6103(b)(6).

O. Prohibition on Misuse of Department of the Treasury Names and Symbols

Present Law

Section 333 of Title 31 prohibits the use, in connection with advertisements, solicitations, and other business activities, of the words, abbreviations, titles, letters, symbols, or emblems associated with the Department of the Treasury (and services, bureaus, offices, or subdivisions of the Department, including the IRS) in a manner which could reasonably be interpreted as conveying a connection with or approval by the Department of the Treasury (or one of its bureaus, offices, or subdivisions) in the absence of such connection or approval.

The provision provides for a civil penalty of not more than $5,000 per violation (or not more than $25,000 in the case of a broadcast or telecast). In addition, the provision provides a criminal penalty of not more than $10,000 (or not more than $50,000 in the case of a broadcast or telecast) or imprisonment of not more than one year, or both, in any case in which the prohibition is knowingly violated. Any determination of whether there is a violation is made without regard to the use of a disclaimer of affiliation with the Federal Government.

The IRS has issued warnings to taxpayers about Internet sites that resemble the official IRS site:

> Taxpayers may be confused by the proliferation of Internet sites that contain some form of the Internal Revenue Service name or IRS acronym with a .com, .net, .org or other designation in the address instead of .gov. Since many of these sites also bear a striking resemblance to the real IRS site, taxpayers may be misled into thinking that the site they have accessed is indeed the official IRS government site. These sites are not the official IRS Web site and have no connection to the official IRS site or to the IRS.[54]

The IRS also has issued a number of warnings ongoing Internet scams.[55] The e-mails claim to be from the IRS and direct the consumer to a link (often resembling the IRS website) that requests personal and financial information. The practice is called "phishing" for information. Once the information is obtained, it could be used in identity theft and stealing a taxpayer's financial assets. Taxpayers who receive an unsolicited e-mail communication claiming to be from the IRS can forward the message to the IRS. The IRS reports it has received almost 33,000 forwarded e-mail scams.[56]

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[54] Internal Revenue Service, IRS Urges Caution about Internet Sites that Resemble the Official IRS Site (IR-2007-58, March 13, 2007).

[55] Internal Revenue Service, Identity Theft E-mail Scams a Growing Problem (FS-2008-9, January 2008).

[56] Id.

Description of Proposal

The proposal clarifies that “phishing,” misleading websites, and other mass communications by electronic means, which could reasonably be interpreted as falsely conveying a connection to or approval by the Department of the Treasury (or its components), are subject to the civil penalty of $25,000 per violation and criminal penalty of $50,000 per violation, currently applicable to broadcasts and telecasts. The proposal reaffirms that the use of the words, abbreviations, titles, letters, symbols, or emblems associated with the Department of the Treasury (and services, bureaus, offices or subdivisions of the Department, including the IRS) in an Internet domain name is covered by 31 U.S.C. sec. 333.

Effective Date

The proposal is effective for violations occurring after the date of enactment.

P. Health Savings Account Substantiation Requirement

Present Law

Health savings accounts

Present law section 223 provides that individuals with a high deductible health plan (and no other health plan other than a plan that provides certain permitted coverage)[57] may establish a health savings account ("HSA"). An HSA is a tax-exempt trust or custodial account. Subject to certain limitations, contributions made to an HSA by an individual are deductible above-the-line for income tax purposes and contributions made by an employer (including contributions made through a cafeteria plan through salary reduction) are excludable from income and wages. Earnings on amounts in an HSA accumulate on a tax-free basis.

Distributions from an HSA that are for qualified medical expenses are excludable from gross income. Distributions from an HSA that are not used for qualified medical expenses are includible in gross income and are subject to an additional tax of 10 percent. However, the additional 10-percent tax does not apply if the distribution is made after death, disability, or the individual attains the age of Medicare eligibility (i.e., age 65). Under present law, the individual maintaining the HSA is responsible for determining if the distribution was made for a qualified medical expense and whether the amount should be included in income and subject to the 10-percent additional tax.

HSAs provide the opportunity to pay for current out-of-pocket medical expenses on a tax-favored basis, as well as the ability to save for future medical and nonmedical expenses on a tax-favored basis. To the extent that amounts in an HSA are not used for qualified expenses, an HSA provides tax benefits similar to an individual retirement arrangement ("IRA").[58]

Qualified medical expenses generally are defined as under section 213(d) and include expenses for diagnosis, cure, mitigation, treatment, or prevention of disease, including prescription drugs, transportation primarily for and essential to such care, and qualified long-

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[57] An individual with other coverage in addition to a high deductible health plan is still eligible for an HSA if such other coverage is certain permitted insurance or permitted coverage. Permitted insurance is: (1) insurance if substantially all of the coverage provided under such insurance relates to (a) liabilities incurred under worker's compensation law, (b) tort liabilities, (c) liabilities relating to ownership or use of property (e.g., auto insurance), or (d) such other similar liabilities as the Secretary may prescribe by regulations; (2) insurance for a specified disease or illness; and (3) insurance that provides a fixed payment for hospitalization. Permitted coverage is coverage (whether provided through insurance or otherwise) for accidents, disability, dental care, vision care, or long-term care. Effective after December 20, 2006, with respect to coverage for years beginning after December 31, 2006, certain coverage under an FSA is disregarded in determining eligibility for an HSA.

[58] Other tax-favored vehicles may also be used to save for future medical expenses, but do not provide the same tax benefits. For example, funds in an IRA may be used to pay medical expenses, but distributions for medical expenses are includible in gross income to the same extent as other IRA distributions.

term care expenses. Qualified medical expenses do not include expenses for insurance other than for (1) long-term care insurance, (2) premiums for health coverage during any period of continuation coverage required by Federal law, (3) premiums for health care coverage while an individual is receiving unemployment compensation under Federal or State law, and (4) premiums for individuals who have attained the age of Medicare eligibility, other than premiums for Medigap policies.

A high deductible health plan is a health plan that has a deductible that is at least $1,100 for self-only coverage or $2,200 for family coverage (for 2008) and that has an out-of-pocket expense limit that is no more than $5,600 in the case of self-only coverage and $11,200 in the case of family coverage (for 2008).[59]

For 2008, the maximum aggregate annual contribution that can be made to an HSA is $2,900 in the case of self-only coverage and $5,800 in the case of family coverage.[60] The annual contribution limits are increased for individuals who have attained age 55 by the end of the taxable year (referred to as "catch up contributions"). In the case of policyholders and covered spouses who are age 55 or older, the HSA annual contribution limit is greater than the otherwise applicable limit by $900 in 2008, and $1,000 in 2009 and thereafter. Contributions, including catch-up contributions, cannot be made once an individual is enrolled in Medicare.

Health flexible spending arrangements

Health flexible spending arrangements ("FSAs") are commonly used by employers to reimburse medical expenses of their employees (and their spouses and dependents). Health FSAs typically are funded on a salary reduction basis, meaning that employees are given the option to reduce current compensation and instead have the compensation used to reimburse the employee for medical expenses. If the health FSA meets certain requirements, the compensation that is forgone is not includible in gross income or wages for employment tax purposes and reimbursements for medical care from the health FSA are excludable from gross income and wages. Health FSAs are subject to the requirements relating to cafeteria plans generally, including a requirement that a cafeteria plan generally may not provide deferred compensation.[61] This requirement is often referred to as the "use-it-or-lose-it-rule."[62] Health FSAs are subject to

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[59] These amounts are indexed for inflation.

[60] These amounts are the same as the maximum deductible amounts permitted under a high deductible plan for purposes of Archer medical savings accounts ("MSAs") and are indexed for inflation. In the case of individuals who are married to each other, if either spouse has family coverage, both spouses are treated as only having the family coverage with the lowest deductible and the contribution limit is divided equally between them unless they agree on a different division. Limitations based on the amount of the deductible under the high deductible plan applied to years beginning before January 1, 2007.

[61] Sec. 125(d)(2).

[62] This requirement has been interpreted to mean that amounts remaining in a health FSA as of the end of a plan year must be forfeited by the employee. However, Treasury guidance allows a grace

certain other requirements, including rules that require that the FSA have certain characteristics similar to insurance. In addition, health FSAs are also subject to certain requirements relating to substantiation of expenses.[63]

Description of Proposal

The proposal provides that in the case of a health savings account distribution, in order to be a qualified medical expense, the amount must be substantiated in a manner similar to that required for health flexible spending arrangements. It is intended that substantiation is required to the trustee (or to a party designated by the trustee). As under present law, distributions from a HSA would be allowed for any purpose. Substantiated expenses would be excludable from income. Expenses not substantiated would be includible in income and subject to the 10-percent additional tax. Under the proposal, not later than January 15 of each calendar year, the HSA trustee is required to report to the account beneficiary and to the Secretary, the name, address and identifying number of the account beneficiary and the amount paid or distributed out of the HSA for the preceding year not substantiated.

Effective Date

The proposal is effective with respect to amounts paid or distributions made out of a health savings account after December 31, 2008.

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period not to exceed two and one-half months immediately following the end of the plan year during which unused amounts may be used. Notice 2005-42, 2005-23 I.R.B. 1204. Prop. Treas. Reg. sec. 1.125-1.

[63] *See* Prop. Treas. Reg. sec. 1.125-6. *See also,* Notice 2002-45, 2002-2 C.B. 93, Rev. Rul. 2003-43, 2003-1 C.B. 935; Notice 2006-69, 2006-2 C.B. 107; and Notice 2007-2, 2007-1 C.B. 254.

Q. Increase in Information Return Penalties

Present Law

Present law imposes information reporting requirements on participants in certain transactions. Under section 6721 of the Code, any person required to file a correct information return who fails to do so on or before the prescribed filing date is subject to a penalty that varies based on when, if at all, the correct information return is filed. If a person files a correct information return after the prescribed filing date but on or before the date that is 30 days after the prescribed filing date, the amount of the penalty is $15 per return (the "first-tier penalty"), with a maximum penalty of $75,000 per calendar year. If a person files a correct information return more than 30 days after the prescribed filing date but on or before August 1, the amount of the penalty is $30 per return (the "second-tier penalty"), with a maximum penalty of $150,000 per calendar year. If a correct information return is not filed on or before August 1, of any year, the amount of the penalty is $50 per return (the "third-tier penalty"), with a maximum penalty of $250,000 per calendar year.

Special lower maximum levels for this penalty apply to small businesses. Small businesses are defined as firms having average annual gross receipts for the most recent three taxable years that do not exceed $5 million. The maximum penalties for small businesses are: $25,000 (instead of $75,000) if the failures are corrected on or before 30 days after the prescribed filing date; $50,000 (instead of $150,000) if the failures are corrected on or before August 1; and $100,000 (instead of $250,000) if the failures are not corrected on or before August 1.

Section 6722 of the Code also imposes penalties for failing to furnish correct payee statements to taxpayers. In addition, section 6723 imposes a penalty for failing to comply with other information reporting requirements. Under both section 6722 and section 6723, the penalty amount is $50 for each failure, up to a maximum of $100,000.

Description of Proposal

The proposal increases the penalties for failing to file correct information returns, for failing to furnish correct payee statements, and for failing to comply with other information reporting requirements. Specifically, the proposal increases the penalties for failing to file correct information returns as follows: the first-tier penalty would be increased from $15 to $25, with a maximum penalty of $250,000 per calendar year; the second-tier penalty would be increased from $30 to $60, with a maximum penalty of $500,000 per calendar year; and the third-tier penalty would be increased from $50 to $100, with a maximum penalty of $1,500,000 per calendar year. The maximum penalties for small businesses would be: $75,000 if the failures are corrected on or before 30 days after the prescribed filing date; $200,000 if the failures are corrected on or before August 1; and $500,000 if the failures are not corrected on or before August 1.

The proposal increases both the penalty for failing to furnish correct payee statements to taxpayers and the penalty for failing to comply with other information reporting requirements penalties to $100 for each such failure, up to a maximum of $1,500,000 in a calendar year.

The proposal also increases the minimum penalty for intentional disregard of the information reporting requirements to $250 per return.

Effective Date

The proposal is effective with respect to information returns required to be filed after December 31, 2008.

R. Increase in Penalty for Failure to File Partnership Returns

Present Law

A partnership generally is treated as a pass-through entity. Income earned by a partnership, whether distributed or not, is taxed to the partners. Distributions from the partnership generally are tax-free. The items of income, gain, loss, deduction or credit of a partnership generally are taken into account by a partner as allocated under the terms of the partnership agreement. If the agreement does not provide for an allocation, or the agreed allocation does not have substantial economic effect, then the items are to be allocated in accordance with the partners' interests in the partnership. To prevent double taxation of these items, a partner's basis in its interest is increased by its share of partnership income (including tax-exempt income), and is decreased by its share of any losses (including nondeductible losses).

Under present law, a partnership is required to file a tax return for each taxable year. The partnership's tax return is required to include the names and addresses of the individuals who would be entitled to share in the taxable income if distributed and the amount of the distributive share of each individual. In addition to applicable criminal penalties, present law imposes a civil penalty for the failure to timely file a partnership return. The penalty generally is $85 per partner for each month (or fraction of a month) that the failure continues, up to a maximum of 12 months.

Description of Proposal

Under the proposal, the penalty for failure to file partnership returns is increased by $15 per partner.

Effective Date

The proposal applies to returns required to be filed after December 31, 2008.

S. Penalty for Failure to File S Corporation Returns

Present Law

In general, an S corporation is not subject to corporate-level income tax on its items of income and loss. Instead, an S corporation passes through its items of income and loss to its shareholders. The shareholders take into account separately their shares of these items on their individual income tax returns.

Under present law, S corporations are required to file a tax return for each taxable year. The S corporation's tax return is required to include the following: the names and addresses of all persons owning stock in the corporation at any time during the taxable year; the number of shares of stock owned by each shareholder at all times during the taxable year; the amount of money and other property distributed by the corporation during the taxable year to each shareholder and the date of such distribution; each shareholder's pro rata share of each item of the corporation for the taxable year; and such other information as the Secretary may require.

Present law imposes a monthly penalty for any failure to timely file an S corporation return or any failure to provide the information required to be shown on such a return. The penalty is $85 times the number of shareholders in the S corporation during any part of the taxable year for which the return was required, for each month (or a fraction of a month) during which the failure continues, up to a maximum of 12 months.

Description of Proposal

Under the proposal, the penalty for failure to file S corporation returns is increased by $15 per shareholder.

Effective Date

The proposal applies to returns required to be filed after December 31, 2008.

T. Modifications to Corporate Estimated Tax Payments

Present Law

In general

In general, corporations are required to make quarterly estimated tax payments of their income tax liability. For a corporation whose taxable year is a calendar year, these estimated tax payments must be made by April 15, June 15, September 15, and December 15.

Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA")

TIPRA provided the following special rules:

In case of a corporation with assets of at least $1 billion, the payments due in July, August, and September, 2012, shall be increased to 106.25 percent of the payment otherwise due and the next required payment shall be reduced accordingly.

In case of a corporation with assets of at least $1 billion, the payments due in July, August, and September, 2013, shall be increased to 100.75 percent of the payment otherwise due and the next required payment shall be reduced accordingly.

Subsequent legislation

Several public laws have been enacted since TIPRA which further increase the percentage of payments due under each of the two special rules enacted by TIPRA described above.

Description of Proposal

Under the proposal, in the case of a corporation with assets of at least $1 billion, the payments due in July, August, and September, 2013, the otherwise applicable payment is increased by 0.25 percent of the payment otherwise due and the next required payment shall be reduced accordingly.

Effective Date

The proposal is effective on the date of enactment.