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"TELEPHONE EXCISE TAX REPEAL AND TAXPAYER PROTECTION AND ASSISTANCE ACT OF 2006"

September __, 2006.−Ordered to be printed

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

R E P O R T

[To accompany S. 1321]

The Committee on Finance reported S. 1321, as modified by the Chairman's mark and amended by the Committee, to amend the Internal Revenue Code of 1986 to repeal the telephone excise tax on telephone and other communication services, having considered the same, reports favorably thereon and recommends that the bill do pass.

CONTENTS

Page

I. LEGISLATIVE BACKGROUND

Overview

The Senate Committee on Finance marked up S. 1321 and reported S. 1321 as modified by the Chairman's mark and amended by the Committee, the "Telephone Excise Tax Repeal and Taxpayer Protection and Assistance Act of 2006," on June 28, 2006, and, with a quorum present, ordered the bill favorably reported by a voice vote on that date.

Recent legislation

The bill as approved by the Committee contained several provisions that are identical or substantially similar to provisions in recently enacted legislation and therefore are not contained in the bill as reported.

The Pension Protection Act of 2006[1] contains provisions relating to:

- Administration of the United States Tax Court;
- Notification requirements for exempt entities not currently required to file annual information returns;
- Appraisers and substantial and gross overstatement of valuations of property;
- The disclosure to State officials of proposed actions related to certain section 501(c) organizations;
- The definition of a convention or association of churches; and
- Excise taxes imposed on public charities, social welfare organizations, and private foundations.

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[1] Pub. L. No. 109-280 (August 17, 2006).

II. EXPLANATION OF THE BILL

TITLE I − REPEAL OF THE TELEPHONE EXCISE TAX

A. Repeal Excise Tax on Communications Services (sec. 101 of the bill and secs. 4251-54 of the Code)

Present Law

The Internal Revenue Code of 1986 (the "Code") imposes a three-percent Federal excise tax on amounts paid for communications services. Communications services are defined as "local telephone service," "toll telephone service," and "teletypewriter exchange service."[2] The person paying for the service (i.e., the consumer) is liable for payment of the tax. Service providers are required to collect the tax; however, if a consumer refuses to pay, the service provider is not liable for the tax and is not subject to penalty for failure to collect if reasonable efforts to collect have been made. Instead, the service provider must report the delinquent consumer's name and address to the Internal Revenue Service ("IRS"), which then must attempt to collect the tax.[3]

Local telephone service is defined as the provision of voice-quality telephone access to a local telephone system that provides access to substantially all persons having telephone stations constituting a part of the local system.[4]

Toll telephone service (which is essentially long distance telephone service) is defined as voice quality communication for which (1) there is a toll charge that varies with the distance and elapsed transmission time of each individual call and payment for which occurs in the United States, or (2) a service (such as a wide area telephone service, or "WATS") which, for a periodic charge (determined as a flat amount or upon the basis of total elapsed transmission time), entitles the subscriber to an unlimited number of telephone calls to or from an area outside the subscriber's local system area.

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[2] Sec. 4251. "Teletypewriter exchange service" refers to a data system that provides access from a teletypewriter or other data station to a teletypewriter exchange system and the privilege of intercommunication by that station with substantially all persons having teletypewriter or other data stations in the same exchange system. Sec. 4252(c). While it is understood that the system to which the definition was initially intended to apply is no longer in use, the definition may fit other services provided now or that may be provided in the future.

[3] In general, the amount of tax is based on the sum of charges for taxable services included in the bill. If the person who renders the bill groups individual items for purposes of rendering the bill and computing the tax, then the tax base with respect to each such group is the sum of all items within that group. The tax on any remaining items not included in any such group is based on the charge for each item separately. Sec. 4254(a).

[4] The access to substantially all persons having telephone stations constituting a part of the local system is sometimes referred to as access to the public switched telephone network.

Telephone companies have historically collected excise tax on a toll telephone service even if the toll charge on such service does not vary with both distance and elapsed transmission time. However, in several recent cases, the Courts of Appeals held that the Federal excise tax on communications services does not apply to long distance (i.e., toll telephone) services sold at flat per-minute rates for interstate, intrastate, and international calls. The courts concluded that the excise tax does not apply because a flat per-minute rate does not vary with both distance and transmission time as required by the statute.[5] In response to these court decisions, the IRS issued Notice 2006-50, directing telephone companies to cease collecting and paying over tax on long distance services and bundled services that are billed after July 31, 2006.[6] In Notice 2006-50, the IRS also announced a program to refund approximately $13 billion in excise taxes on long distance and bundled services. The Federal excise tax on local-only telephone service remains in effect.

Reasons for Change

The Committee believes that the excise tax on communications services is regressive, and that the tax will become more regressive when the IRS ceases to collect taxes on long distance and bundled services. The Committee believes, therefore, that it is appropriate to repeal the tax in its entirety. The Committee also believes that the IRS needs additional resources to provide for the fast and efficient refunding of telephone excise taxes to taxpayers.

Explanation of Provision

The provision repeals the excise tax on communications services in its entirety. The provision also includes an authorization to appropriate $49 million to the IRS to implement the telephone excise tax refund program under Notice 2006-50. The authorization is intended to cover such costs as form revisions, taxpayer assistance, processing and enforcement.

Effective Date

The repeal of the excise tax applies to amounts paid pursuant to bills rendered more than 90 days after the date of enactment. The funding authorization is effective on the date of enactment.

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[5] See, e.g., *Reese Bros. v. United States*, 97 AFTR 2d 2006-2393 (3d Cir. 2006); *Fortis v. United States*, 97 AFTR 2d 2006-2228 (2d Cir. 2006); *American Bankers Insurance Group v. United States*, 408 F.3d 1328 (11th Cir. 2005); *Office Max, Inc. v. United States*, 428 F.3d 583 (6th Cir. 2005); *Nat'l R.R. Passenger Corp. v. United States*, 431 F.3d 374 (D.C. Cir. 2005).

[6] Notice 2006-50, 2006-50 I.R.B. 1141 (May 26, 2006). The notice defines long distance services as "telephonic quality communications with persons whose telephones are outside the local telephone system of the caller." Bundled services are defined as "local and long distance services provided under a plan that does not separately state the charge for the local telephone services." In general, bundled services include cellular phone services.

TITLE II – TAXPAYER PROTECTION AND ASSISTANCE

A. Low-Income Taxpayer Clinics (sec. 201 of the bill and new sec. 7526A of the Code)

Present Law

The Code provides that the Secretary is authorized to provide up to $6 million per year in matching grants to certain low-income taxpayer clinics.[7] 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 ("controversy clinics"). No clinic can receive more than $100,000 per year.

A "controversy 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").

Reasons for Change

The Committee believes that low-income taxpayer clinics contribute to compliance with the Code by providing representation to taxpayers who might otherwise be uncertain about their rights and obligations under the Code. Accordingly, the Committee believes that the amount authorized to be appropriated for matching grants to them should be increased. The Committee also believes that the scope of the work that clinics seeking grants may do should be broadened to encompass tax return preparation.

Explanation of Provision

The provision authorizes the Secretary to make $10 million in matching grants for low-income taxpayer return preparation clinics ("return preparation clinics"). Return preparation clinics are clinics that provide routine tax return preparation and filing services to low-income taxpayers, including individuals for whom English is a second language, for not more than a nominal fee.

Return preparation clinics are treated as assisting low-income taxpayers if at least 90 percent of the taxpayers assisted by the clinic have incomes which do not exceed 250 percent of the poverty level, as determined in accordance with criteria established by the Director of OMB. Under the provision, return preparation clinics eligible to receive grants include eligible educational institutions as defined in section 529(e)(5) and organizations described in section 501(c).

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[7] Sec. 7526.

The provision prohibits the use of grants for overhead expenses at both controversy clinics and return preparation clinics. The provision also authorizes the IRS to use mass communications, referrals, and other means to promote the benefits and encourage the use of low-income controversy clinics and return preparation clinics.

The authorization of $6 million for controversy clinics under present law is also increased to $10 million.

Effective Date

The provision is effective for grants made after the date of enactment.

B. Clarification of Enrolled Agent Credentials (sec. 202 of the bill and new sec. 7529 of the Code)

Present Law

Treasury Department Circular No. 230 provides rules relating to practice before the IRS by attorneys, certified public accountants, enrolled agents, enrolled actuaries, and others.

Reasons for Change

The Committee believes that individuals who meet the regulatory requirements established by the Secretary should be able to use the specified credentials or designation in any State or Federal jurisdiction.

Explanation of Provision

The provision permits the Secretary to promulgate regulations to regulate the conduct of enrolled agents in regard to their practice before the IRS, and to permit enrolled agents meeting the Secretary's qualifications to use the credentials or designation "enrolled agent," "EA," or "E.A."

Effective Date

The provision is effective on the date of enactment.

C. Regulation of Federal Tax Return Preparers (sec. 203 of the bill)

Present Law

The Secretary is authorized to regulate the practice of representatives of persons before the Treasury.[8] The Secretary also is authorized to suspend or disbar from practice before the Treasury a representative who is incompetent, who is disreputable, who violates the rules regulating practice before the Treasury, or who (with intent to defraud) willfully and knowingly misleads or threatens the person being represented (or a person who may be represented). The rules promulgated by the Secretary pursuant to this provision are contained in Circular 230. In general, the preparation and filing of tax returns (absent further involvement) has not been considered within the scope of the Circular 230 provisions.

Income tax return preparers are required to sign and include their taxpayer identification numbers on income tax returns and income return-related documents prepared for compensation. Under the Code, penalties are imposed on any income tax return preparer who, in connection with the preparation of an income tax return, fails to (1) furnish a copy of a return or claim for refund to the taxpayer, (2) sign the return or claim for refund, (3) furnish his or her identifying number, (4) retain a copy of the completed return or a list of the taxpayers for whom a return was prepared, (5) file a correct information return, and (6) comply with certain due diligence requirements in determining a taxpayer's eligibility for the earned income credit.[9] Generally, the penalty is $50 for each failure and the total penalties imposed for any single type of failure for any calendar year are limited to $25,000. The penalty for failing to comply with the due diligence requirements for determining a taxpayer's eligibility for the earned income credit is $100 for each failure. An income tax return preparer who endorses or negotiates a check issued to a taxpayer (other than the income tax return preparer) is liable for a penalty of $500 with respect to each such check.[10]

Reasons for Change

Approximately 60 percent of the 130 million U.S. individual taxpayers paid a return preparer to prepare their 2003 Federal income tax returns.[11] The Committee understands that many tax return preparers are not regulated by any licensing entity or subject to minimum competency requirements. Moreover, according to the National Taxpayer Advocate, more than

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[8] 31 U.S.C. sec. 330.

[9] Sec. 6695.

[10] Sec. 6695(f).

[11] Internal Revenue Service, *Statistics Of Income Bulletin Winter 2005-2006*.

32 percent of earned income credit claims are prepared by paid preparers and the error rate on those claims is over 34 percent.[12]

Tax practitioners play an important role in the tax system. While certain individuals authorized to practice before the IRS are already subject to oversight, many are not. For those taxpayers who use a paid tax practitioner, the Committee believes that compliance with the tax laws hinges on the practitioners competence and ethical standards. Therefore, the Committee believes that the IRS's failure to provide more oversight over such tax return preparers contributes to noncompliance. The Committee also believes that tax return preparer regulation will improve the accuracy of tax return preparation and, therefore, will reduce government burden and intrusion on taxpayers through IRS enforcement efforts (such as collection and examinations).

The Committee believes that requiring regulation of individuals preparing Federal income tax returns and other documents for submission to the IRS will improve the fairness and administration of the tax system. Additionally, the Committee believes that establishing within the IRS a permanent Office of Professional Responsibility and the use of administrative law judges will provide continuity and accountability in the regulation of tax return preparers. The Committee believes that testing, education, ethical training, and effective oversight of enrolled preparers are critical elements to improving tax compliance.

Explanation of Provision

The provision expands the Secretary's authority to regulate the practice of representatives before the Treasury to include individuals preparing Federal tax returns and other submissions to the IRS for compensation ("enrolled preparers"). The Secretary is required to issue regulations no later than one year after the date of enactment establishing eligibility requirements for enrolled preparers. Whether a preparer is compensated and, thus, subject to regulation as an enrolled preparer shall be determined by considering both indirect compensation, as well as direct forms of compensation. For example, the Committee understands there are cases where individuals prepare Federal tax returns for taxpayers without charging a direct fee, but bundle the return preparation services with other products or services for which the individual charges the taxpayer a monetary amount. The Committee intends for these indirect compensation arrangements to be covered by the enrolled preparer requirements.

The provision requires the Secretary to develop and administer an examination to establish the competency of enrolled preparers. Under the provision, any examination shall be designed to test the preparer's knowledge of technical tax issues, including the earned income credit, and the ethical standards for the preparation of tax returns.

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[12] Testimony of Nina Olson, National Taxpayer Advocate, Internal Revenue Service, before the Subcommittee on Oversight of the House Committee on Ways and Means, House of Representatives, July 20, 2005.

Practitioners authorized to practice before the IRS who are subject to oversight under regulations in effect on the date of enactment are excluded from the regulations establishing eligibility requirements for enrolled preparers. The provision requires the Secretary to accept the credentials of a State licensing or State registration program for enrolled preparers in lieu of testing, to the extent that such State licensing or State registration program has an eligibility examination that is comparable to the eligibility examination established by the Secretary.

Under the provision, the enrolled preparer regulations shall also require enrolled preparers to renew their eligibility every three years. As part of this renewal, enrolled preparers shall be required to establish completion of continuing education requirements in a manner set forth by the Secretary in regulations. Enrolled preparers failing to meet the eligibility requirements are subject to suspension or termination.

The provision also establishes the Office of Professional Responsibility within the IRS under the supervision and direction of the Director, an official reporting directly to the Commissioner, IRS. The duties of the Office of Professional Responsibility shall be limited to matters related to section 330 of title 31. The Director, Office of Professional Responsibility shall be entitled to compensation at the same rate as the highest rate of basic pay established for the Senior Executive Service, or, if higher, at a rate fixed under critical pay authority.

The provision authorizes the Secretary to appoint administrative law judges to conduct hearings of any action initiated by the Office of Professional Responsibility to impose sanctions on enrolled preparers and other representatives practicing before the Treasury. Under the provision, hearing records shall be open to the public. In addition, in the case of a sanction imposed on a representative without initiation of an action, the Office of Professional Responsibility shall make public the identity of the representative, employer, firm, or other entity sanctioned, as well as information about the conduct which gave rise to the sanction. Information about clients of the representative, employer, firm, or other entity sanctioned and medical information with respect to the representative shall not be released to the public or discussed in an open hearing except to the extent necessary to understand the nature, scope, and impact of the conduct giving rise to the sanction or proposed sanction.

Under the provision, the Secretary may impose fees for the registration and renewal of enrolled preparers. Such fees shall be made available to the Office of Professional Responsibility for the purpose of reimbursing the costs of administering and enforcing the rules and regulations regulating practice before the Treasury.

The provision also provides that the Secretary shall conduct a public awareness campaign to encourage taxpayers to use competent professionals in the preparation of their tax returns and other Federal tax matters. The public awareness campaign shall be conducted in a manner to inform the public of the registration requirements imposed on enrolled preparers and the general requirement that preparers must sign and provide their registration numbers on tax returns and display notice of compliance with the registration requirements. The provision also requires the Office of Professional Responsibility to coordinate with State officials in order to collect information regarding practitioners that have been disciplined or suspended under State or local rules.

The provision imposes a monetary penalty on any person preparing Federal tax returns and other tax submissions for compensation who has failed to meet the eligibility or renewal requirements for enrolled preparers or who has otherwise been suspended from practice by the Office of Professional Responsibility. The penalty amount is equal to $1,000 for each tax return or other tax submission (e.g., an application for offer-in-compromise) prepared during the period such person was not authorized to practice before the Treasury. This penalty shall be in addition to other penalties that may be imposed under the Code, such as the penalty for failure to furnish an identifying number on a tax return.

The provision also increases from $50 per return to the greater of $500 per return or $1,000 the penalties under section 6695 for failing to furnish a copy of a return or claim for refund, sign a return or claim for refund, and furnish his or her identifying number. The provision also eliminates the $25,000 annual cap on such penalties. In addition, amounts collected from the imposition of penalties under sections 6694 and 6695 or under regulations promulgated under section 330 of title 31 shall be directed to the Office of Professional Responsibility for the administration of the public awareness campaign. The provision also permits the Secretary to use any funds specifically appropriated for earned income credit compliance to improve compliance with the rules regulating practice before the Treasury.

The provision prohibits any practitioner authorized to practice before the Treasury from directly or indirectly offering or providing insurance to cover professional fees and other expenses incurred in responding to or defending a tax audit.

The provision also requires any form or other submission that can or must be submitted to the IRS separate from the taxpayer's signed tax return (e.g., reportable transaction disclosure statements and offer-in-compromise applications) to be signed under penalty of perjury. Paid preparer information, if applicable, is also required on such forms under the provision.

Effective Date

The provision is effective on the date of enactment.

D. Contract Authority for Examinations of Preparers (sec. 204 of the bill)

Present Law

The Secretary is authorized to regulate the practice of representatives of persons before the Treasury.[13] The Secretary also is authorized to suspend or disbar from practice before the Treasury a representative who is incompetent, who is disreputable, who violates the rules regulating practice before the Treasury, or who (with intent to defraud) willfully and knowingly misleads or threatens the person being represented (or a person who may be represented). The rules promulgated by the Secretary pursuant to this provision are contained in Circular 230.

Reasons for Change

The Committee believes the Secretary should have the authority to contract for the development and administration of any examinations implemented to regulate persons practicing before the Treasury, including examinations to regulate tax return preparers.

Explanation of Provision

The provision authorizes the Secretary to contract for both the development and administration of any examination implemented under the Secretary's authority to regulate the practice of representatives of persons before the Treasury.

Effective Date

The provision is effective on the date of enactment.

[13] 31 U.S.C. sec. 330.

E. Regulation of Refund Anticipation Loan Facilitators (sec. 205 of the bill and new sec. 7530 of the Code)

Present Law

The Secretary is authorized to regulate the practice of representatives of persons before the Treasury.[14] The Secretary is also authorized to suspend or disbar from practice before the Treasury a representative who is incompetent, who is disreputable, who violates the rules regulating practice before the Treasury, or who (with intent to defraud) willfully and knowingly misleads or threatens the person being represented (or a person who may be represented). The rules promulgated by the Secretary pursuant to this provision are contained in Circular 230. In general, the preparation and filing of tax returns (absent further involvement) has not been considered within the scope of these Circular 230 provisions.

Under Notice 99-58,[15] certain tax practitioners that file returns electronically and financial institutions may apply to obtain a Debt Indicator for their customer/client taxpayers in exchange for screening individual income tax returns for potential abuse. The Debt Indicator tells whether or not a taxpayer has any scheduled offsets against a claimed refund.

Section 6103 generally provides that return and return information are confidential and cannot be disclosed unless authorized by title 26. The definition of return information is very broad, and includes, among other things, information with respect to the determination of the existence or possible existence of liability of any person for any penalty under the Code.

Reasons for Change

The Committee is concerned that tax refunds and the IRS's Debt Indicator program are being used as a means for selling refund anticipation loans to taxpayers, particularly low-income taxpayers. The Committee believes that requiring regulation of refund anticipation loan facilitators will increase the ability of the IRS to hold such facilitators accountable. The Committee also believes that increasing the information that must be disclosed, both orally and in writing, to the taxpayer in connection with a refund anticipation loan will increase taxpayer awareness of the true costs and consequences of a refund anticipation loan.

Explanation of Provision

The provision requires the annual registration with the Secretary of refund loan facilitators. The annual registration shall include the name, address, and TIN of the refund loan facilitator applicant and the fee schedule of such facilitator for the year of such registration. A refund loan facilitator is any person who originates such electronic submission of income tax returns for another person and, in connection with the electronic submission, solicits, processes, or otherwise facilitates the making of a refund anticipation loan to the individual taxpayer on

[14] 31 U.S.C. sec. 330.

[15] 1999-51 I.R.B. 693.

whose behalf the tax return is submitted. A refund anticipation loan is any loan of money or any other thing of value to a taxpayer in connection with the taxpayer's anticipated receipt of a Federal tax refund.

The provision requires refund loan facilitators to disclose to taxpayers, both orally and in writing, information with respect to refund anticipation loans at the time taxpayers apply for such loans. Specifically, refund loan facilitators must disclose: (1) that the taxpayer is applying for a loan that is based upon the taxpayer's anticipated income tax refund; (2) the expected time within which the loan will be paid to the taxpayer if such loan is approved; (3) the time within which income tax refunds are typically paid based on different filing options; (4) that there is no guarantee that a refund will be paid in full or received within a specified time period and that the taxpayer is responsible for the repayment of the loan even if the refund is not paid in full or has been delayed; (5) the existence of any arrangements between the refund loan facilitators and a taxpayer's creditor to offset the taxpayer's expected refund against an outstanding liability owed to the creditor and the implication of any such offset; (6) that the taxpayer may file an electronic tax return without applying for a refund anticipation loan and the fee for filing such an electronic return; and (7) the cost of the refund anticipation loan compared to alternative sources of credit.

In addition, the provision requires refund loan facilitators to disclose to taxpayers all fees and interest charges associated with a refund anticipation loan, including fees and charges if the taxpayer's Federal tax refund is delayed or not paid. Refund loan facilitators also must disclose any other information required to be disclosed by the Secretary.

The provision amends the Code to permit the Secretary to impose monetary penalties on refund loan facilitators who fail to meet the registration or disclosure requirements, unless such failure was due to reasonable cause. The penalty for failure to register is not to exceed the gross income derived from all refund anticipation loans during the period the refund loan facilitator was not registered. The penalty for failure to disclose the information required by the provision is not to exceed the gross income derived from all refund anticipation loans with respect to which the refund loan facilitator failed to provide the required disclosure information.

The provision also amends the privacy rules under the Code to permit the Secretary to disclose the name and employer (including the employer's address) of any person with respect to whom a penalty has been imposed for failing to meet the registration or disclosure requirements of the provision.

The provision provides that the Secretary or the Secretary's delegate shall conduct a public awareness campaign to educate the public on the costs associated with refund anticipation loans, including the costs as compared to other forms of credit. The public awareness campaign shall be conducted in a manner that educates the public on making sound financial decisions with respect to refund anticipation loans. Amounts collected from the imposition of penalties on refund loan facilitators shall be directed to the IRS for the administration of the public awareness campaign.

The provision also requires the Secretary to terminate the Debt Indicator program announced in Notice 99-58 and prohibits the Secretary from implementing any similar program.

Effective Date

The provisions relating to the regulation of refund loan facilitators generally are effective one year after the date of enactment. The provision terminating the Debt Indicator program is effective on the date of enactment.

F. Taxpayer Access to Financial Institutions (sec. 206 of the bill)

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.

Reasons for Change

The Committee believes that effectiveness of tax incentives and assistance programs are diminished when individuals do not have an account at a financial institution. For example, the benefits received through the earned income tax credit diminish when taxpayers redirect their tax refund in exchange for a refund anticipation loan. In contrast, if such taxpayers had an account at an insured financial institution, such tax refund could be directly deposited into the taxpayer's account without a reduction for fees paid to a refund anticipation loan facilitator.

Between 25 and 56 million adults are do not have an account with an insured financial institution. These individuals rely on alternative financial service providers to cash checks, pay bills, send remittances, and obtain credit. Many of these individuals are low- and moderate-income families. The Committee believes that promoting the establishment of accounts with an insured financial institution will allow the taxpayer to keep more of his or her tax refund and encourage savings.

Explanation of Provision

The provision authorizes the Secretary of the Treasury to award demonstration project grants (totaling up to $10 million or such additional amounts as deemed necessary) to eligible entities to provide tax preparation assistance in connection with establishing an account in a Federally insured depository institution for individuals that do not have such an account. Entities eligible to receive grants are: tax-exempt organizations described in section 501(c)(3); Federally insured depository institutions; State or local governmental agencies; community development financial institutions; Indian tribal organizations; Alaska native corporations; native Hawaiian organizations; labor organizations; and a partnership of one or more of the listed eligible entities.

Under the provision, entities receiving grants may not use more than six percent of the total amount of such grant for the administrative costs of carrying out the program funded by such grant.

The provision also 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 provision 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 provision is effective on the date of enactment.

G. Expanded Use of Tax Court Practitioner Fees (sec. 7475 of the Code)

Present Law[16]

The United States Tax Court ("Tax Court") is authorized to impose a fee of up to $30 per year on practitioners admitted to practice before the Tax Court.[17] These fees are to be used to employ independent counsel to pursue disciplinary matters.

Reasons for Change

The Committee understands that many pro se taxpayers are not familiar with Tax Court procedures and applicable legal requirements. The Committee believes it is beneficial for Tax Court fees imposed on practitioners also to be available to provide services to pro se taxpayers.

Explanation of Provision

[The bill does not include the provision as approved by the Committee because an identical or substantially similar provision was enacted into law in the Pension Protection Act of 2006 (Pub. L. No. 109-280, sec. 860) subsequent to Committee action on the bill. The following discussion describes the provision as approved by the Committee.]

The provision provides that Tax Court fees imposed on practitioners also are available to provide services to *pro se* taxpayers (i.e., a taxpayer representing himself) that will assist such taxpayers in controversies before the Court. For example, fees could be used for programs to educate *pro se* taxpayers on the procedural requirements for contesting a tax deficiency before the Tax Court.

Effective Date

The provision is effective on the date of enactment.

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[16] Present law refers to the law in effect on the date of Committee action on the bill. It does not reflect the changes made by the Pension Protection Act of 2006, Pub. L. No. 109-280 (August 17, 2006).

[17] Sec. 7475.

TITLE III – IMPROVEMENTS IN TAX ADMINISTRATION AND TAXPAYER SAFEGUARDS

A. Waiver of User Fee for Installment Agreements Using Automated Withdrawals (sec. 301 of the bill and sec. 6159 of the Code)

Present Law

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.[18] An installment agreement does not reduce the amount of taxes, interest, or penalties owed. Generally, during the period installment payments are being made, other IRS enforcement actions (such as levies or seizures) with respect to the taxes included in that agreement are held in abeyance.

The IRS charges a user fee if a request for an installment agreement is approved.

Reasons for Change

The Committee believes that it improves collection results if taxpayers utilize automated installment payment mechanisms. Automated installment payment mechanisms provide efficiencies in processing and promote timely payment. The Committee believes that waiving this user fee for taxpayers who utilize automated installment payment mechanisms will encourage more taxpayers to utilize them.

Explanation of Provision

The provision waives the user fee for installment agreements in which the parties agree to the use of automated installment payments (such as automated debits from a bank account).

Effective Date

The provision applies to agreements entered into on or after the date which is 180 days after the date of enactment.

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[18] Sec. 6159.

B. Termination of Installment Agreements (sec. 302 of the bill and sec. 6159 of the Code)

Present Law

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.[19] An installment agreement does not reduce the amount of taxes, interest, or penalties owed. Generally, during the period installment payments are being made, other IRS enforcement actions (such as levies or seizures) with respect to the taxes included in that agreement are held in abeyance.

Under present law, the IRS is permitted to terminate an installment agreement only if: (1) the taxpayer fails to pay an installment at the time the payment is due; (2) the taxpayer fails to pay any other tax liability at the time when such liability is due; (3) the taxpayer fails to provide a financial condition update as required by the IRS; (4) the taxpayer provides inadequate or incomplete information when applying for an installment agreement; (5) the taxpayer's financial condition has significantly changed; or (6) the collection of the tax is in jeopardy.[20]

Reasons for Change

The Committee believes that taxpayers who are permitted to pay their previous tax obligations through an installment agreement should also be required to remain current with their Federal tax obligations. The Committee believes that giving the IRS the authority to terminate installment agreements in additional circumstances will improve the operation of the installment agreement process and enhance tax compliance.

Explanation of Provision

The provision grants the IRS authority to terminate an installment agreement when a taxpayer fails to timely make a required Federal tax deposit or fails to timely file a tax return. Under the provision, the IRS may terminate an installment agreement even if the taxpayer remains current with payments under the installment agreement.

Effective Date

The provision is effective for failures occurring on or after the date of enactment.

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[19] Sec. 6159.

[20] Sec. 6159(b)(2), (3), and (4).

C. Individuals Held Harmless on Improper Levy on Individual Retirement Plan (sec. 303 of the bill and sec. 6343 of the Code)

Present Law

IRAs

There are two general types of individual retirement arrangements ("IRAs"): traditional IRAs, to which deductible or nondeductible contributions may be made depending on an individual's circumstances, and Roth IRAs, contributions to which are not deductible. An individual generally may make contributions to a traditional IRA up to the lesser of a dollar limit (generally $4,000 for 2006) or the individual's compensation. Individuals with adjusted gross income below certain levels may make contributions to a Roth IRA. The maximum annual contributions that can be made to all of an individuals IRAs (both traditional and Roth) cannot exceed the maximum IRA contribution limit.

Amounts held in a traditional IRA are includible in income when withdrawn except to the extent the withdrawal is a return of nondeductible contributions (i.e., basis). Includible amounts withdrawn before attainment of age 59½ are subject to an additional 10-percent early withdrawal tax unless an exception applies.

Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income or subject to the additional 10-percent tax on early withdrawals. A qualified distribution is a distribution that (1) is made 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) is made after attainment of age 59½, on account of death or disability, or is made for first-time homebuyer expenses of up to $10,000. Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings and are subject to the 10-percent early withdrawal tax unless an exception applies.

Amounts distributed from a traditional or Roth IRA are not includible in income if they are rolled over to another IRA of the same type within 60 days of the distribution. In general, only one rollover from a traditional IRA and only one rollover from a Roth IRA may be made during any one-year period. Rollover amounts are not subject to the limits on IRA contributions.

IRS levy on IRA amounts

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. In the case of a Roth IRA, distributions that are not qualified distributions are includible in income to the extent attributable to earnings. 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.

Reasons for Change

IRA assets provide an important source of retirement income for many Americans. Under present law, if the IRS improperly levies on an IRA, the individual owning the IRA may not be made whole, even if the IRS returns the amount levied, with interest, because the individual may lose the opportunity to have those funds accumulate on a tax-favored basis until retirement. The Committee believes that improper levies should not reduce retirement income security for IRA owners. Thus, the Committee bill provides that IRA funds that are withdrawn pursuant to an improper IRS levy and returned by the IRS may be recontributed to the IRA.

Explanation of Provision

Under the provision, 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 provision 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 contribution has to be made to the same type of IRA (i.e., traditional or Roth) to which a rollover could be made from the IRA from which the levied amounts were withdrawn.

Under the provision, 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 and contributed to the IRA is treated as part of the distribution made from the IRA on account of the levy and is not includible in gross income. In addition, 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 provision is effective for levied amounts (and interest thereon) returned to individuals after December 31, 2005.

D. Office of Chief Counsel Review of Offers-In-Compromise (sec. 304 of the bill and sec. 7122 of the Code)

Present Law

The IRS has the authority to settle a tax debt pursuant to an offer-in-compromise. IRS regulations provide that such offers can be accepted if the taxpayer is unable to pay the full amount of the tax liability and it is doubtful that the tax, interest, and penalties can be collected or there is doubt as to the validity of the actual tax liability. Offers to compromise tax liabilities of $50,000 or more can only be accepted if the reasons for the acceptance are documented in detail and supported by a written opinion from the IRS Chief Counsel.[21]

Reasons for Change

Many offers-in-compromise cases do not present any significant legal issues, and the required legal review for cases meeting the statutory threshold can delay the acceptance process under current administrative procedures. The Committee believes that eliminating this threshold requiring review will permit the IRS to focus its review resources on the most important cases, regardless of dollar value.

Explanation of Provision

The provision repeals the requirement that offers to compromise liabilities of $50,000 or more must be supported by a written opinion from the IRS Chief Counsel. Under the provision, written opinions must only be provided if the Secretary determines that an opinion is required with respect to a compromise.

Effective Date

The provision applies to offers-in-compromise submitted or pending on or after the date of enactment.

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[21] Sec. 7122.

E. Elimination of Restriction on Offsetting Refunds From Former Residents (sec. 305 of the bill and sec. 6402 of the Code)

Present Law

Overpayments of Federal tax may be used to pay past-due child support and debts owed to Federal agencies, without the consent of the taxpayer.[22] Overpayments of Federal tax may also be used to pay specified past-due, legally enforceable State income tax debts, provided that the person making the Federal tax overpayment has shown on the Federal tax return for the taxable year of the overpayment an address that is within the State seeking the tax offset.

Reasons for Change

The Committee understands that the current refund procedure has proven an effective collection tool for State governments. The Committee believes that eliminating unnecessary restrictions on this program will improve the ability of States to collect past-due, legally enforceable State income tax debts.

Explanation of Provision

The provision eliminates the requirement that a person making a Federal tax overpayment show on the Federal tax return for the taxable year of the overpayment an address that is within the State seeking the tax offset. Accordingly, States may seek to offset refunds from residents of their own State as well as any other State to collect specified past-due, legally enforceable State income tax debts.

Effective Date

The provision applies to refunds payable for taxable years ending after the date of enactment.

[22] Sec. 6402.

F. Revisions Relating to Termination of Employment of IRS Employees for Misconduct (sec. 306 of the bill and new sec. 7804A of the Code)

Present Law

Section 1203 of the IRS Restructuring and Reform Act of 1998[23] requires the IRS to terminate the employment of an employee for certain proven violations committed by the employee in connection with the performance of official duties. The violations include: (1) willful 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) with respect to a taxpayer, taxpayer representative, or other IRS employee, the violation of any right under the U.S. Constitution, or any civil right established under Titles VI or VII of the Civil Rights Act of 1964, Title IX of the Educational Amendments of 1972, the Age Discrimination in Employment Act of 1967, the Age Discrimination Act of 1975, sections 501 or 504 of the Rehabilitation Act of 1973 and Title I of the Americans with Disabilities Act of 1990; (4) falsifying or destroying documents to conceal mistakes made by any employee with respect to a matter involving a taxpayer or a taxpayer representative; (5) assault or battery on a taxpayer or other IRS employee, but only if there is a criminal conviction or a final judgment by a court in a civil case, with respect to the assault or battery; (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; (7) willful misuse of section 6103 for the purpose of concealing data from a Congressional inquiry; (8) willful failure to file any tax return required under the Code on or before the due date (including extensions) unless failure is due to reasonable cause; (9) willful understatement of Federal tax liability, unless such understatement is due to reasonable cause; and (10) threatening to audit a taxpayer for the purpose of extracting personal gain or benefit.

Section 1203 also 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's employment. The Commissioner, in his sole discretion, may establish a procedure to determine whether an individual should be referred for such a determination by the Commissioner.

Reasons for Change

The Committee understands that two of the violations under present law have resulted in unintended consequences. First, the Committee does not believe that an IRS employee due a tax refund should be terminated from employment for filing that return late. No other taxpayer faces a comparable penalty for the late filing of a return due a refund. Investigating and resolving issues related to the late filing by IRS employees of refund returns expends resources that could be better spent on other tax administration efforts.

[23] Pub. L. No. 105-206.

Second, the Committee understands that employees are misusing the "employee versus employee" violation as retaliation against fellow employees. There are other administrative remedies that are more appropriate for resolving employee versus employee claims, such as Title V adverse action cases, as well as actions of the Merit Systems Protection Board.

The Committee believes that removing from the list of violations these two provisions that do not directly involve an IRS employee's interactions with taxpayers will improve the focus of the provision.

Explanation of Provision

The provision removes two items from the list of violations. These two items are: (1) the late filing of tax returns with no tax due and owing; and (2) employee versus employee assault or battery. The provision also adds unauthorized inspection of returns and return information to the list of violations requiring termination.

The provision also places the provisions of section 1203 in the Code.

Effective Date

The provision is effective on the date of enactment.

G. Modification of Collection Due Process Procedures for Employment Tax Liabilities (sec. 307 of the bill and sec. 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 a Federal tax lien has attached to such property. A Federal tax lien arises automatically when (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 10 days after the notice and demand.

In general, the IRS is required to notify taxpayers that they have a right to a fair and impartial collection due process ("CDP") hearing before levy may be made on any property or right to property.[24] Similar rules apply with respect to notices of tax liens, although the right to a hearing arises only on the filing of a notice.[25] The CDP hearing is held by an impartial officer from the IRS Office of Appeals, who is required to issue a determination with respect to the issues raised by the taxpayer at the hearing. The taxpayer is entitled to appeal that determination to a court. Under present law, taxpayers are not entitled to a pre-levy CDP hearing if a levy is issued to collect a Federal tax liability from a State tax refund or if collection of the Federal tax is in jeopardy. However, levies related to State tax refunds or jeopardy determinations are subject to post-levy review through the CDP hearing process.

Employment taxes generally consist of the taxes under the Federal Insurance Contributions Act ("FICA"), the tax under the Federal Unemployment Tax Act ("FUTA"), and the requirement that employers withhold income taxes from wages paid to employees ("income tax withholding").[26] Income tax 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.

Reasons for Change

Congress enacted the CDP hearing procedures to afford taxpayers adequate notice of collection activity and a meaningful hearing before the IRS deprives them of their property. However, the Committee understands that some taxpayers abuse the CDP procedures by raising frivolous arguments simply for the purpose of delaying or evading collection of tax. The opportunity to delay collection of employment tax liabilities presents a greater risk to the government than delay may present in other contexts because employment tax liabilities continue

[24] Sec. 6330(a).

[25] Sec. 6320.

[26] Secs. 3101-3128 (FICA), 3301-3311 (FUTA), and 3401-3404 (income tax withholding). FICA taxes consist of an employer share and an employee share, which the employer withholds from employees' wages.

to increase as ongoing wage payments are made to employees. Thus, the Committee believes it is appropriate to revise the CDP procedures in cases where taxpayers are liable for unpaid employment taxes.

Explanation of Provision

Under the provision, levies issued to collect Federal employment taxes are excepted from the pre-levy CDP hearing requirement. Thus, under the provision, taxpayers have no right to a CDP hearing before a levy is issued to collect employment taxes. However, the taxpayer is provided an opportunity for a hearing within a reasonable period of time after the levy. Collection by levy is permitted to continue during the CDP proceedings.

Effective Date

The provision is effective for levies issued after December 31, 2006.

H. Extension of Time Limit for Contesting IRS Levy (sec. 308 of the bill and secs. 6343 and 6532 of the Code)

Present Law

The IRS is authorized to return property that has been wrongfully levied upon.[27] In general, monetary proceeds from the sale of levied property 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 and that such property was wrongfully levied upon may bring a civil action for wrongful levy in a district court of the United States.[28] Generally, an action for wrongful levy must be brought within nine months from the date of levy.[29]

Reasons for Change

The Committee understands that in many cases the time period for bringing an action may be insufficient for taxpayers or third parties to discover a wrongful or mistaken levy and seek to remedy it. Accordingly, the Committee believes it is appropriate to provide for a longer period of time within which a person may contest a wrongful IRS levy.

Explanation of Provision

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

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

Effective Date

The provision 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.

[27] Sec. 6343.

[28] Sec. 7426.

[29] Sec. 6532.

I. Authorization for IRS to Require Increased Electronic Filing of Returns Prepared by Paid Return Preparers (sec. 309 of the bill and sec. 6011 and new sec. 6695B of the Code)

Present Law

The Code authorizes the IRS to issue regulations specifying which returns must be filed electronically.[30] There are several limitations on this authority. First, it can only apply to persons required to file at least 250 returns during the year.[31] Second, the IRS is prohibited from requiring that income tax returns of individuals, estates, and trusts be submitted in any format other than paper (although these returns may be filed electronically by choice).

Reasons for Change

The Committee believes that electronic filing promotes effective tax administration. Fewer IRS resources are required to process electronic returns, errors are reduced, and taxpayers receive their refunds more quickly. The Congress set a goal for the IRS to have 80 percent of tax returns filed electronically by 2007. The IRS and the IRS Oversight Board have reported this goal will not be achieved, and the Board has recommended extending the 80 percent deadline to 2011. Therefore, the Committee wants to encourage increased use of electronic filing. IRS statistics demonstrate that many more tax returns are prepared electronically than are filed electronically. The Committee believes that giving the IRS the authority to require electronic filing of individual tax returns will increase the number of returns that are filed electronically.

Explanation of Provision

For returns prepared by paid return preparers, the provision permits the IRS to expand the scope of returns that are required to be filed electronically by removing the present-law restrictions relating to the types of tax returns required to be filed electronically and by lowering the number of returns that trigger the requirement to file electronically to five. The Committee expects the IRS to expand the types of forms and schedules that may be filed electronically to permit full implementation of this provision.

The provision also imposes a monetary penalty on any person required to file a return electronically that fails to do so. The penalty is equal to the greater of $100 times the number of returns not filed electronically as required or $1,000. The penalty does not apply if the failure is due to reasonable cause.

Effective Date

The provision is effective on the date of enactment.

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[30] Sec. 6011(e).

[31] Partnerships with more than 100 partners are required to file electronically.

J. Require IRS to Develop Direct Electronic Filing (sec. 310 of the bill)

Present Law

The IRS has entered into cooperative relationships with commercial return preparation services to provide free electronic filing services to eligible low-income or elderly taxpayers. This program is called "Free File." Presently, the IRS does not permit individual taxpayers to file their tax returns electronically without the use of an intermediary.

Reasons for Change

The Committee believes that electronic filing promotes effective tax administration and wants to encourage increased use of electronic filing. Fewer IRS resources are required to process electronic returns, errors are reduced, and taxpayers receive their refunds more quickly. The Congress set a goal for the IRS to have 80 percent of tax returns filed electronically by 2007. The IRS and the IRS Oversight Board have reported this goal will not be achieved, and the Board has recommended extending the 80 percent deadline to 2011.

IRS statistics demonstrate that many more tax returns are prepared electronically than are filed electronically. The Committee understands that many taxpayers are unwilling to pay a fee to electronically file their tax returns even if they are electronically prepared. The Committee further understands that many taxpayers are unwilling to use an intermediary to electronically transmit their tax returns to the IRS because of privacy and security concerns. The Committee believes that the availability of free and direct electronic filing to the IRS will address those concerns and result in the increased use of electronic filing.

The Committee notes that taxpayers who file paper returns are not required to pay for the tax forms or to file their returns. The Committee also notes that certain business taxpayers can currently file their returns directly with the IRS without the use of an intermediary. As a matter of equity, the Committee believes all taxpayers who wish to file electronic returns should have the ability to do so without cost.

Explanation of Provision

The provision requires the Secretary to establish the "direct e-file program." The direct e-file program is a program that provides individual taxpayers with the ability to electronically file their Federal income tax returns through the IRS website without the use of an intermediary or with the use of an intermediary with which the IRS contracts to provide free universal access. The provision requires the Secretary to implement the direct e-file program for filings for taxable years beginning after the date which is not later than three year after the date of enactment. Under the provision, the IRS may develop its own electronic filing products in order to implement the direct e-file program.

In providing for the development and operation of the direct e-file program, the Secretary shall consult with nonprofit organizations representing the interests of taxpayers as well as other organizations and Federal, State, and local agencies as the Secretary considers appropriate. The

Secretary shall also conduct a public information and consumer education campaign to encourage taxpayers to use the direct e-file program. Further, if intermediaries are used to develop or operate the direct e-file program, such intermediaries may not advertise, market, or offer to sell any products or services.

Under the provision, the Secretary is required to report to Congress every six months regarding the status of the implementation of the direct e-file program. In addition, the Secretary, in consultation with the National Taxpayer Advocate, is required to report to Congress annually (not later than June 30 of each year) on taxpayer usage of the direct e-file program once it is implemented.

Effective Date

The provision is effective on the date of enactment.

K. Modifications and Report Regarding Free File Program (sec. 311 of the bill)

Present Law

The IRS has entered into cooperative relationships with commercial return preparation services to provide free electronic filing services to eligible low-income or elderly taxpayers. This program is called "Free File."

Reasons for Change

The Committee is concerned that the Free File program may not be free for many taxpayers because of the advertising, marketing and sale of products or services that are not directly related to the preparation of a tax return and believes prohibiting this practice will increase the number of tax returns that are filed electronically.

Explanation of Provision

The provision instructs the IRS to ensure that Free File companies do not advertise, market, or offer to sell products or services that are not directly related to the preparation of a tax return to any taxpayer utilizing Free File. The provision also requires the IRS to establish procedures to encourage companies participating in the Free File Alliance to provide accessible services for the blind.

No later than 270 days after the date of enactment, the Secretary shall report to Congress on the implementation of modifications to the Free File Alliance program required by this provision. As part of that report, the Secretary also shall report on the feasibility of ensuring that members of the Free File program that have contracted separately with a State be required to provide free Federal and State preparation and electronic filing directly through the IRS Free File website. Further, the Secretary shall report on the most optimal way of alerting taxpayers on the IRS Free File website of those companies that provide free services for preparing and filing State tax returns.

Effective Date

The provision is effective on the date of enactment.

L. Study on Clarifying Recordkeeping Responsibilities (sec. 312 of the bill)

Present Law

Every person liable for Federal tax must keep records, provide statements, make returns, and comply with rules and regulations, as prescribed by the Secretary.[32] In general, taxpayers are required to keep records for as long as the statute of limitations may be open.

Reasons for Change

The Committee understands that the present-law recordkeeping requirements do not reflect advances in technology. Specifically, the storage requirements may require taxpayers to maintain outdated and cumbersome technologies. The Committee understands that there is a balance, however, between minimizing taxpayer burden and ensuring that taxpayers maintain appropriate recordkeeping for purposes of IRS enforcement. The Committee believes that requiring the Secretary of the Treasury to conduct a study of the recordkeeping requirements will provide the Committee with valuable information as to whether it is appropriate to modify these requirements.

Explanation of Provision

The provision requires the Secretary of the Treasury to study:

- The scope of the records required to be maintained by taxpayers;
- The utility of requiring taxpayers to maintain all records indefinitely;
- The effects of the necessity to upgrade technological storage for outdated records;
- The number of negotiated records retention agreements requested by taxpayers and the number entered into by the IRS; and
- Proposals regarding taxpayer recordkeeping.

The Secretary is required to submit a report of the study, including recommendations, to the Congress not later than one year after the date of enactment.

Effective Date

The provision is effective on the date of enactment.

[32] Sec. 6001.

M. Modification of Treasury Inspector General for Tax Administration Reporting Requirements (sec. 313 of the bill and sec. 7803 of the Code)

Present Law

The Treasury Inspector General for Tax Administration ("TIGTA") conducts audits and reviews of IRS operations. TIGTA also is statutorily required to report to the Congress (both annually and semi-annually) on a number of specific issues.

Reasons for Change

The Committee understands that the present-law reporting requirements utilize significant resources and that the IRS does not necessarily maintain the data required for these reports. The Committee also understands that the current frequency of reporting gives the IRS a limited and, perhaps, insufficient amount of time to implement corrective actions before another review. The Committee believes that streamlining these TIGTA reporting requirements will yield a more meaningful picture of the IRS and its progress in meeting Congressional expectations.

Explanation of Provision

The provision repeals the statutory requirement that TIGTA issue the following reports:

- IRS compliance with the restrictions[33] on directly contacting taxpayers who have indicated that they prefer that their representatives be contacted.

- IRS compliance with the requirements relating to disclosure of collection information with respect to joint returns.

- IRS compliance with the fair debt collection provisions of the Code.

In addition, the provision requires that all reports currently required to be made semiannually and annually shall be provided biennially (once every two years).

Effective Date

The provision is effective on the date of enactment.

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[33] Sec. 7521.

N. Streamline Reporting Process for National Taxpayer Advocate (sec. 314 of the bill and sec. 7803 of the Code)

Present Law

The Code requires the National Taxpayer Advocate to produce two reports for the Congress each year. The first, due by June 30, reports on the objectives for the office; the second, due by December 31, reports on the activities of the office and contains detailed data and recommendations in specified areas.

Reasons for Change

The Committee believes that combining the reports required under present law will reduce burdens on the National Taxpayer Advocate. The Committee also believes that authorizing the National Taxpayer Advocate to report to the Congress at any time on any significant issues affecting taxpayer rights will improve the awareness of the Congress of these issues.

Explanation of Provision

The provision combines the two reports the National Taxpayer Advocate must produce under present law into one, due by December 31. The provision also provides that the National Taxpayer Advocate, in his or her sole discretion, may report to the Congress at any time on any significant issues affecting taxpayer rights.

Effective Date

The provision combining the reports is effective for reports in 2007 and thereafter. The provision authorizing reports on significant issues affecting taxpayer rights is effective on the date of enactment.

O. Whistleblower Reforms
(sec. 315 of the bill and sec. 7623 of the Code)

Present Law

The Code authorizes the IRS to pay such sums as deemed necessary for: "(1) detecting underpayments of tax; and (2) detecting and bringing to trial and punishment persons guilty of violating the internal revenue laws or conniving at the same."[34] Amounts are paid based on a percentage of tax, fines, and penalties (but not interest) actually collected based on the information provided. For specific information that caused the investigation and resulted in recovery, the IRS administratively has set the reward in an amount not to exceed 15 percent of the amounts recovered. For information, although not specific, that nonetheless caused the investigation and was of value in the determination of tax liabilities, the reward is not to exceed 10 percent of the amount recovered. For information that caused the investigation, but had no direct relationship to the determination of tax liabilities, the reward is not to exceed one percent of the amount recovered. The reward ceiling is $10 million (for payments made after November 7, 2002), and the reward floor is $100. No reward will be paid if the recovery was so small as to call for payment of less than $100 under the above formulas. Both the ceiling and percentages can be increased with a special agreement. The Code permits the IRS to disclose return information pursuant to a contract for tax administration services.[35]

Reasons for Change

A recent report by the Treasury Inspector General for Tax Administration concluded that the IRS's informant reward program has been an effective method of identifying and collecting unpaid taxes.[36] The report also made several recommendations for enhancing the effectiveness of the program, including centralizing management of the reward program and reducing the processing time for claims. The Committee also believes that an enhanced reward program would be more attractive to future informants wishing to report violations of the tax laws.

Explanation of Provision

The provision reforms the reward program for individuals who provide information regarding violations of the tax laws to the Secretary. Generally, the provision establishes a reward floor of 15 percent of the collected proceeds (including penalties, interest, additions to tax and additional amounts) if the IRS moves forward with an administrative or judicial action based on information brought to the IRS's attention by an individual. The provision caps the available reward at 30 percent of the collected proceeds. The provision permits awards of lesser amounts (but no more than 10 percent) if the action was based principally on allegations (other than

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[34] Sec. 7623.

[35] Sec. 6103(n).

[36] Treasury Inspector General for Tax Administration, *The Informants' Rewards Program Needs More Centralized Management Oversight,* 2006-30-092 (June 2006).

information provided by the individual) resulting from a judicial or administrative hearing, government report, hearing, audit, investigation, or from the news media. Under the provision, the reward amounts apply to actions in which the tax, penalties, interest, additions to tax, and additional amounts in dispute exceed $20,000, and, if the taxpayer is an individual, the individual's gross income exceeds $200,000 for any taxable year.

The provision creates a Whistleblower Office within the IRS to administer the reward program. To the extent possible, it is expected that the office will address the recommendations of the Treasury Inspector General for Tax Administration regarding the informants' reward program, including the recommendation to reduce the processing time for claims.[37] The Whistleblower Office may seek assistance from the individual providing information or from his or her legal representative, and may reimburse the costs incurred by any legal representative out of the amount of the reward. To the extent the disclosure of returns or return information is required to render such assistance, the disclosure must be pursuant to an IRS tax administration contract. It is expected that such disclosures will be infrequent and will be made only when the assigned task cannot be properly or timely completed without the return information to be disclosed.

The provision also provides an above-the-line deduction for attorneys' fees and costs paid by, or on behalf of, the individual in connection with any award for providing information regarding violations of the tax laws. The amount that may be deducted above-the-line may not exceed the amount includible in the taxpayer's gross income for the taxable year on account of such award (whether by suit or agreement and whether as lump sum or periodic payments).

The provision permits an individual to appeal the amount or a denial of an award determination to the United States Tax Court (the "Tax Court") within 30 days of such determination. Under the provision, Tax Court review of an award determination may be assigned to a special trial judge and, if assigned, decided by the special trial judge.

In addition, the provision requires the Secretary to conduct a study and report to Congress on the effectiveness of the whistleblower reward program and any legislative or administrative recommendations regarding the administration of the program.

Effective Date

The provision is effective for information provided on or after the date of enactment.

[37] Treasury Inspector General for Tax Administration, *The Informants' Rewards Program Needs More Centralized Management Oversight,* 2006-30-092 (June 2006).

P. Authorization for Financial Management Service Retention of Transaction Fees from Levied Amounts (sec. 316 of the bill)

Present Law

To facilitate the collection of tax, the IRS can generally levy upon all property and rights to property of a taxpayer.[38] With respect to specified types of recurring payments, the IRS may impose a continuous levy of up to 15 percent of each payment, which generally continues in effect until the liability is paid.[39] Continuous levies imposed by the IRS on specified Federal payments are administered by the Financial Management Service ("FMS") of the Department of the Treasury. FMS is generally responsible for making most non-defense related Federal payments. FMS is required to charge the IRS for the costs of developing and operating this continuous levy program. The IRS pays these FMS charges out of its appropriations.

Reasons for Change

The Committee believes that altering the bookkeeping structure of these costs will provide for cost savings to the government.

Explanation of Provision

The provision allows FMS to retain a portion of funds levied under continuous levies as payment of FMS charges for the continuous levy program. The amount credited to the taxpayer's account is not, however, reduced by the amount retained by FMS.

Effective Date

The provision is effective on the date of enactment.

[38] Sec. 6331.

[39] Sec. 6331(h).

Q. Clarification of Definition of Church Tax Inquiry (sec. 317 of the bill and sec. 7611 of the Code)

Present Law

Under present law, the IRS may begin a church tax inquiry only if an appropriate high-level Treasury official reasonably believes, on the basis of the facts and circumstances recorded in writing, that an organization (1) may not qualify for tax exemption as a church, (2) may be carrying on an unrelated trade or business, or (3) otherwise may be engaged in taxable activities.[40] A church tax inquiry is defined as any inquiry to a church (other than an examination) that serves as a basis for determining whether the organization qualified for tax exemption as a church or whether it is carrying on an unrelated trade or business or otherwise is engaged in taxable activities. An inquiry is considered to commence when the IRS requests information or materials from a church of a type contained in church records, other than routine requests for information or inquiries regarding matters that do not primarily concern the tax status or liability of the church itself.

Reasons for Change

The Committee believes that the present-law church tax inquiry procedures provide important safeguards against the IRS engaging in unnecessary and intrusive examinations of churches. However, the church tax inquiry procedures also have the effect of hampering IRS efforts to educate churches with respect to actions that are not permissible under section 501(c)(3). The Committee believes that a clarification of the scope of the church tax inquiry procedures to make it clear that the IRS may undertake educational outreach efforts with respect to specific churches (e.g., initiating meetings with representatives of a particular church to discuss the rules that apply to such church) will improve compliance with the law by churches.

Explanation of Provision

The provision clarifies that present-law church tax inquiry procedures do not apply to contacts made by the IRS for the purpose of educating churches with respect to the federal income tax law governing tax-exempt organizations. For example, the IRS does not violate the church tax inquiry procedures when written materials are provided to a church or churches for the purpose of educating such church or churches with respect to the types of activities that are not permissible under section 501(c)(3).

Effective Date

The provision is effective on the date of enactment.

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[40] Sec. 7611.

R. Treatment of Funds from Indian Tribal Governments as Public Support for Purposes of the Public Charity-Private Foundation Classification (sec. 318 of the bill and sec. 7871 of the Code)

Present Law

Organizations described in section 501(c)(3) are classified either as public charities or private foundations. The public charity classification generally is based on an organization's sources of support. Support from governmental entities is considered as public support in determining whether an organization is publicly or privately supported and thus is classified as a public charity or a private foundation. Support from an Indian Tribal Government is not treated as support from a governmental entity.

Reasons for Change

The Code treats Indian Tribal Governments as States for many purposes, including for purposes of the charitable deduction rules. The Committee believes that it is appropriate also to treat the funding of charitable activities by Indian Tribal Governments the same as funding of charitable activities by States for purposes of determining whether a section 501(c)(3) organization is publicly or privately supported.

Explanation of Provision

The provision provides that support from an Indian Tribal Government is treated as support from a State for purposes of determining whether an organization described in section 501(c)(3) is classified as a public charity or a private foundation.

Effective Date

The provision applies to support received before, on, or after the date of enactment and to the determination of the status of any organization with respect to any taxable year beginning after the date of enactment.

S. Tax Court Review of Requests for Equitable Relief from Joint and Several Liability (sec. 319 of the bill and sec. 6015 of the Code)

Present Law

In general

Generally, a husband and wife are liable jointly and individually for the entire tax on a joint return. Under certain circumstances, a spouse may be entitled to relief from joint and several liability, "innocent spouse relief."[41] Generally, the spouse must elect the form of innocent spouse relief no later than two years after the date the IRS began collection activities against the electing spouse.

There are three types of relief, general innocent spouse relief, relief for spouses no longer married or legally separated (separation of liabilities), and equitable relief.

For general relief, the electing spouse must

- Have filed a joint return that has an understatement of tax due to the erroneous items of the other spouse,
- Establish that at the time of signing the return the electing spouse did not know or have reason to know there was an understatement of tax, and
- Taking into account all the facts and circumstances, show that it is inequitable to hold the electing spouse liable for the deficiency in tax.[42]

For separation of liabilities relief, the electing spouse

- Must have filed a joint return and,
- Either (1) is no longer married to or is legally separated from the spouse with whom the return was filed or (2) must not have been a member of the same household with the spouse for a 12-month period.[43]

If an individual fails to qualify under the preceding two options, such individual may still be able to obtain equitable relief.[44] To obtain equitable relief, the IRS must determine that taking

[41] Sec. 6015.

[42] Sec. 6015(b).

[43] Sec. 6015(c).

[44] Sec. 6015(f).

into account all of the facts and circumstances, it is inequitable to hold the electing spouse liable for any unpaid tax or any deficiency in tax (or any portion of either).

In the case of an individual against whom a deficiency has been asserted and elects to have the general relief provisions or the separation of liabilities relief provisions apply, such individual may petition the Tax Court to review the IRS's determinations.

Some courts have noted the absence of an express statement of Tax Court jurisdiction over equitable relief claims in the statute.[45] Other courts have rejected Tax court jurisdiction over such claims on the basis that a deficiency has not been asserted against the claimant.[46] Recently, the United States Tax Court revisited its prior ruling that it had jurisdiction over nondeficiency stand-alone petitions for equitable relief. In light of adverse rulings in the Eighth and Ninth Circuits this year, the Tax Court in *Billings vs. Commissioner*, recently held that it does not have jurisdiction over such claims in the absence of a deficiency.[47]

Restrictions on collection and suspension of the running of the period of limitations

Unless the IRS determines that collection will be jeopardized by delay, no levy or proceeding in court is to be made, begun or prosecuted against a spouse seeking general innocent spouse relief or separation of liabilities relief for the collection of any assessment to which the election relates until (1) the expiration of the 90-day period following the date of mailing of the Service's final determination letter, or (2) if a petition is filed with the Tax Court, until the decision of the Tax Court becomes final.[48]

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[45] The Second Circuit has noted that the question of the Tax Court's jurisdiction over an appeal of an adverse determination under section 6015(f) is "not free from doubt." *Maier v. Comm'r*, 360 F.3d 361, 363 n. 1 (2d cir. 2004). The court pointed out that "only petitions to review IRS determinations under subsections (b) and (c) are expressly enumerated in section 6015(e) and (h)." Id.; see also *French v. United States (In re French)*, 255 B.R. 1, 2 (Bankr.N.D.Ohio 2000) (dismissing for lack of jurisdiction the debtor's claim that she was entitled to relief under § 6015(f) because "Congress chose to exclude from judicial review the issue of whether a taxpayer is entitled to equitable relief under § 6015(f)"); *Mira v. United States (In re Mira)*, 245 B.R. 788, 791-92 (Bankr.M.D.Pa.1999) (reasoning that sec. 6015(f) grants the Secretary of the Treasury discretion to grant equitable relief and, as a decision "committed to agency discretion by law," 5 U.S.C. sec. 701, it was not reviewable by the court).

[46] *Comm'r v. Ewing*, 439 F.3d 1009, 1012-14 (9th Cir.2006) rev'g *Ewing v. Comm'r*. 118 T.C. 494 (2002); and *Bartman v. Comm'r*, 446 F.3d 785, 787 (8th Cir. 2006).

[47] *Billings v. Commissioner*, 127 T.C. No. 2 (July 25, 2006) (holding that the Court lacks jurisdiction to review the Commissioner's decisions to deny relief under section 6015(f) when there is no deficiency but tax went unpaid). In *Billings*, the IRS had accepted the petitioner's amended return as filed and asserted no deficiency against him. His request for equitable relief from the unpaid tax arising from his wife's embezzlement was denied by the IRS.

[48] Sec. 6015(e)(1)(B) and Treas. Reg. sec. 1.6015-1(c)(1).

For the spouse seeking general or separation of liabilities relief, the running of the period of limitations on collections of the assessment to which the election relates is suspended for the period during which the IRS is prohibited from collecting by levy or proceeding in court and for 60 days thereafter. However, the requesting spouse may waive the restrictions on collection and the suspension of the period of limitations against collection will terminate 60 days after the date the waiver is filed with the IRS.[49]

Reasons for Change

The Committee finds that it is appropriate to confer Tax Court jurisdiction over equitable relief claims and to also suspend collection activity and the running of the period of limitations while such claims are pending, as is the case for other innocent spouse claims.

Explanation of Provision

The provision clarifies that the Tax Court has jurisdiction over equitable relief claims, even if the individual does not elect to have the general relief or separation of liabilities relief provisions apply and no deficiency is asserted. The provision also extends the present law suspension of collection activity and tolling of the period of limitations provisions to equitable relief claims. With respect to any case the dismissal of which results from or is based on the jurisdictional ruling in *Billings v. Commissioner*, and is final on or before the date of enactment, such case may be refiled in the United States Tax Court not later than the date which is six months after the date of enactment. The $60 petition filing fee for these cases is waived by the provision.[50]

Effective Date

The provision applies to requests for equitable relief with respect to liability for taxes arising or remaining unpaid on or after the date of enactment.

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[49] Sec. 6015(e)(2) and (5); and Treas. Reg. sec. 1.6015-1(c)(3).

[50] Rule 20(b) of the Tax Court Rules of Practice and Procedure.

T. Authorization of Appropriations for Tax Law Enforcement Relating to Human Sex Trafficking (sec. 320 of the bill)

Present Law

IRS undercover operations are statutorily exempt from the generally applicable restrictions controlling the use of Government funds (which generally provide that all receipts must be deposited in the general fund of the Treasury and all expenses be paid out of appropriated funds). In general, the Code permits the IRS to use proceeds from an undercover operation to pay additional expenses incurred in the undercover operation, through 2006. The IRS is required to conduct a detailed financial audit of large undercover operations in which the IRS is churning funds and to provide an annual audit report to the Congress on all such large undercover operations.

There is no explicit authorization of appropriations to the IRS to be used to combat tax crimes where the underlying income is derived from sex trafficking crimes.

Reasons for Change

The Committee believes that the IRS should pursue violations of the Code by those persons who are under investigation by Federal, State, or local law enforcement agencies for knowingly recruiting, enticing, harboring, transporting, or providing by any means a person knowing that force, threat, or coercion will be used to cause the person to engage in a commercial sex act, or that the person is a child and will be caused to engage in a commercial sex act. The Committee believes it is appropriate to provide the IRS with additional resources to combat Code violations related to these crimes.

Explanation of Provision

The provision authorizes the IRS to use $2 million toward the establishment of an office in IRS Criminal Investigation ("CI") to investigate tax law violations by human sex traffickers. For purposes of this provision, a human sex trafficker is any person who is under investigation by Federal, State, or local law enforcement agencies for knowingly recruiting, enticing, harboring, transporting, or providing by any means a person knowing that force, threat, or coercion will be used to cause the person to engage in a commercial sex act, or that the person has not attained the age of 18 and will be caused to engage in a commercial sex act (within the meaning of 18 U.S.C. sec. 1591(c)(1)). The Committee does not intend for the office to use its limited resources to investigate persons who are victims of human sex traffickers. The Committee expects the office to work closely with other divisions within the IRS and understands that non-CI personnel may be assigned to the office. The Committee also intends that the office will coordinate closely with the existing task forces in the Department of Justice that are focused on sex trafficking offenders, and also may coordinate with State and local agencies that are conducting investigations of human sex traffickers. Nothing in this provision shall be construed to limit the IRS's broad investigatory authority.

For fiscal years 2007 and 2008, the provision also authorizes and appropriates to the office for additional enforcement activities an amount equal to the income tax, interest, and civil and criminal penalties collected by the IRS as a result of the actions of the office. It is the Committee's intent that the IRS will focus on the employer/employee relationship in these cases and the failure of the human sex trafficker to file information reporting returns required under the existing rules applicable to employers and other payors.

The provision requires the Secretary to report to Congress within one year of the date of enactment on enforcement activities related to tax violations of human sex traffickers.

The provision also modifies the whistleblower reward provisions so that the victims of human sex traffickers will be eligible to participate in the program.

Effective Date

The provision is effective on the date of enactment.

U. Regulation of Payroll Tax Deposit Agents
(sec. 321 of the bill and new sec. 7531 of the Code)

Present Law

Taxpayers may choose to fulfill their payroll tax obligations using payroll tax deposit agents. In general, these payroll tax deposit agents are not required to register or post bonds with the IRS. Persons required to collect and pay over taxes to the IRS who fail to do so are subject to penalty.

Reasons for Change

The Committee believes that payroll tax deposit agents should be subject to more regulation and oversight. The services provided by these agents are an important part of the employment tax system but additional regulation is necessary to safeguard clients of these agents and ensure that these agents satisfy the payroll tax deposit and other requirements which they have contracted with their clients to do. The Committee believes that this new regulatory regime provides additional safeguards for employers who use payroll tax deposit agents without imposing undue burdens on payroll tax deposit agents.

Explanation of Provision

First, the provision requires the annual registration of payroll tax deposit agents with the IRS. The annual registration fee shall not exceed $100. A payroll tax deposit agent is defined as any person which provides payroll processing or tax filing and deposit services to one or more employers (other than an employer working on its own behalf) if such person has the contractual authority to access such employer's funds for the purpose of making employment tax deposits. A payroll tax deposit agent does not include a person who only transfers such funds (regardless of whether they have the right to determine the amount of such transfer) and does not have the authority to impound such funds for such purpose.

Second, the provision also provides that payroll tax deposit agents must elect either to: (1) post a reasonable bond or (2) submit to an annual audit. If the payroll tax deposit agent elects to post a bond, then the amount of such bond shall not be less than $50,000 nor more than $500,000 and shall be determined with respect to each payroll tax deposit agent under regulations. Any bond or security shall be in such form and with such surety or sureties as may be prescribed by regulations. If the payroll tax deposit agent elects to submit to an annual audit, then the audit shall be performed by an independent third party and shall be based on such audit principles as the Secretary deems necessary. In all cases the audits shall confirm that: (1) the escrow account in which the payroll tax deposit agent holds the employers' taxes is balanced annually to the total of the quarterly reconciliation statements; (2) the escrow account funds are not commingled with the agent's operating funds; (3) no escrow account funds are used to pay the agent's operating expenses; and (4) there is receipt evidence that the agent paid the required taxes for the employers to the proper government employment tax authorities.

Third, the provision directs the Secretary to require payroll tax deposit agents to disclose to each potential and existing client: (1) the client's continuing liability for payment of all

Federal and State employment taxes notwithstanding any contractual relationship with a payroll tax deposit agent; (2) the mechanisms available to the client to verify the amount and date of payment of all tax deposits made by the payroll tax deposit agent on behalf of such client; and (3) such information that the Secretary determines necessary or appropriate to assist employers in the selection and use of payroll tax deposit agents. These disclosures are required prior to or at the time of contracting for payroll services.

Fourth, the provision requires payroll tax deposit agents to ensure the direct notification of the employer(s) by any Federal or State employment tax authority regarding the nonpayment of such employment taxes.

Fifth, the provision provides penalties (not to exceed $10,000) for unregistered agents acting as payroll tax deposit agents with respect to Federal tax deposits for each 90 days of noncompliance.

Sixth, the provision provides that only persons registered as payroll tax deposit agents may: (1) make Federal tax deposits on behalf of an employer; (2) sign and file Federal employment tax returns of behalf of a taxpayer; and (3) have access to confidential tax information relating to such employer.

Finally, the provision clarifies that the penalty for failure to collect and pay over tax applies to payroll agents and is not dischargeable in bankruptcy.

The Secretary is directed to issue such guidance as necessary to carry out these provisions.

Effective Date

Generally the provisions are effective on January 1, 2007. The provision relating to penalties for failure to collect and pay over tax is effective for failures occurring after December 31, 2006.

V. Extension of the Statute of Limitations to File Claims for Refunds Relating to Disability Determinations by the Department of Veteran's Affairs (sec. 322 of the bill and sec. 6511 of the Code)

Present Law

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

Generally, military retirement benefits based on length of service are included in income, whereas veterans' benefits based on a service-connected disability are excluded from income. If an individual receives includible retirement benefits and is later retroactively determined to be eligible for service-connected disability benefits, the portion of the retirement benefits attributable to the disability is retroactively excluded from income. In that case, the individual may claim a refund of the tax paid on the retroactively excluded benefits, subject to the statute of limitations on filing a refund claim.

Reasons for Change

The Committee believes that disabled veterans should not erroneously be subjected to income tax on their service-connected disability benefits because of delays by the Department of Veterans' Affairs in making these disability determinations. The Committee believes that the applicable statute of limitations should be extended with regard to these benefits for such veterans. However, the Committee is mindful of the benefits to both taxpayers and the IRS in having a statute of limitations. The Committee believes that the provision strikes the correct balance between reducing the improper taxation of these service-connected disability benefits and an administrable tax system.

Explanation of Provision

The provision extends the time period for filing claims for credits or refunds for retired military personnel who receive disability determinations from the Department of Veterans Affairs (e.g. determinations after the tax return is filed). Specifically, the provision extends the period for filing such a refund claim until one year after the date of the disability determination (if later than the time periods allowed under present law). The provision applies to any taxable year which begins 5 years before the date of the determination or thereafter. In the case of a determination after December 31, 2000, and on or before the date of enactment, the period for filing a claim for credit or refund is extended until one year after the date of enactment (if later than the time periods allowed under present law).

Effective Date

The provision is effective for claims for credits or refunds filed after the date of enactment.

W. Notification Requirement for Exempt Entities Not Currently Required to File an Annual Information Return (secs. 6033, 6652, and 7428 of the Code)

Present Law[51]

Under present law, the requirement that an exempt organization file an annual information return does not apply to several categories of exempt organizations. Organizations excepted from the filing requirement include organizations (other than private foundations), the gross receipts of which in each taxable year normally are not more than $25,000.[52] Also exempt from the requirement are churches, their integrated auxiliaries, and conventions or associations of churches; the exclusively religious activities of any religious order; section 501(c)(1) instrumentalities of the United States; section 501(c)(21) trusts; an interchurch organization of local units of a church; certain mission societies; certain church-affiliated elementary and high schools; certain State institutions whose income is excluded from gross income under section 115; certain governmental units and affiliates of governmental units; and other organizations that the IRS has relieved from the filing requirement pursuant to its statutory discretionary authority.

Reasons for Change

The Committee believes that it is appropriate under present law that certain small exempt organizations not be required to file an annual information return. However, as a result, the Secretary of the Treasury is not able to maintain a record of the continuing existence of such organizations and the public is unable easily to obtain basic information about the organization, such as the organization's current address. The absence of a record is especially problematic for charitable exempt organizations. Although the Secretary publishes the names of organizations to which charitable contributions may be made, if the organization is not required to file with the Secretary and alert the Secretary of its termination, the Secretary does not know when to omit the organization from its list of names. Accordingly, the Committee believes that exempt organizations that do not have to file an annual information return by virtue of the amount of their gross receipts should file with the Secretary a simple, short annual notice. The Committee does not intend that the annual filing be burdensome and does not believe that a monetary penalty is appropriate for a failure to file the notice. However, if an organization is unable to file a notice with the Secretary for three consecutive years, the Committee believes that revocation of the organization's exempt status is an appropriate sanction under the circumstances. In addition,

[51] Present law refers to the law in effect on the date of Committee action on the bill. It does not reflect the changes made by the Pension Protection Act of 2006, Pub. L. No. 109-280 (August 17, 2006).

[52] Sec. 6033(a)(2); Treas. Reg. sec. 1.6033-2(a)(2)(i); Treas. Reg. sec. 1.6033-2(g)(1). Sec. 6033(a)(2)(A)(ii) provides a $5,000 annual gross receipts exception from the annual reporting requirements for certain exempt organizations. In Announcement 82-88, 1982-25 I.R.B. 23, the IRS exercised its discretionary authority under section 6033 to increase the gross receipts exception to $25,000, and enlarge the category of exempt organizations that are not required to file Form 990.

to ensure equitable treatment among exempt organizations, the sanction of loss of exempt status is extended to consecutive failures to file a required information return.

Explanation of Provision

[The bill does not include the provision as approved by the Committee because an identical or substantially similar provision was enacted into law in the Pension Protection Act of 2006 (Pub. L. No. 109-280, sec. 1223) subsequent to Committee action on the bill. The following discussion describes the provision as approved by the Committee.]

The provision requires organizations that are excused from filing an information return by reason of normally having gross receipts below a certain specified amount (generally, under $25,000) to furnish to the Secretary annually, in electronic form, the legal name of the organization, any name under which the organization operates or does business, the organization's mailing address and Internet web site address (if any), the organization's taxpayer identification number, the name and address of a principal officer, and evidence of the organization's continuing basis for its exemption from the generally applicable information return filing requirements. Upon such organization's termination of existence, the organization is required to furnish notice of such termination.

The provision provides that if an organization fails to provide the required notice for three consecutive years, the organization's tax-exempt status is revoked. In addition, if an organization that is required to file an annual information return under section 6033(a) (Form 990) fails to file such an information return for three consecutive years, the organization's tax-exempt status is revoked. If an organization fails to meet its filing obligation to the IRS for three consecutive years in cases where the organization is subject to the information return filing requirement in one or more years during a three-year period and also is subject to the notice requirement for one or more years during the same three-year period, the organization's tax-exempt status is revoked.

A revocation under the provision is effective from the date that the Secretary determines was the last day the organization could have timely filed the third required information return or notice. To again be recognized as tax-exempt, the organization must apply to the Secretary for recognition of tax-exemption, irrespective of whether the organization was required to make an application for recognition of tax-exemption in order to gain tax-exemption originally.

If, upon application for tax-exempt status after a revocation under the provision, the organization shows to the satisfaction of the Secretary reasonable cause for failing to file the required annual notices or returns, the organization's tax-exempt status may, in the discretion of the Secretary, be reinstated retroactive to the date of revocation. An organization may not challenge under the Code's declaratory judgment procedures (section 7428) a revocation of tax-exemption made pursuant to the provision.

There is no monetary penalty for failure to file the notice under the provision. The provision requires that the notices be made available to the public under the public disclosure and inspection rules generally applicable to exempt organizations. The provision does not affect an organization's obligation under present law to file required information returns or existing penalties for failure to file such returns.

The Secretary is required to notify every organization that is subject to the notice filing requirement of the new filing obligation in a timely manner. Notification by the Secretary shall be by mail, in the case of any organization the identity and address of which is included in the list of exempt organizations maintained by the Secretary, and by Internet or other means of outreach, in the case of any other organization. In addition, the Secretary is required to publicize in a timely manner in appropriate forms and instructions and other means of outreach the new penalty imposed for consecutive failures to file the information return.

The Secretary is authorized to publish a list of organizations whose exempt status is revoked under the provision.

Effective Date

The provision is effective for notices and returns with respect to annual periods beginning after 2006.

TITLE IV − REFORM OF PENALTIES AND INTEREST

A. Individual Estimated Tax
(sec. 401 of the bill and sec. 6654 of the Code)

1. Increase Estimated Tax Threshold

Present Law

The Federal income tax system is designed to ensure that taxpayers pay taxes throughout the year based on their income and deductions. To the extent that tax is not collected through withholding, taxpayers are required to make quarterly estimated payments of tax. If an individual fails to make the required estimated tax payments under the rules, a penalty is imposed under section 6654. The amount of the penalty is determined by applying the underpayment interest rate to the amount of the underpayment for the period of the underpayment. The amount of the underpayment is the excess of the required payment over the amount (if any) of the installment paid on or before the due date of the installment. The period of the underpayment runs from the due date of the installment to the earlier of (1) the 15th day of the fourth month following the close of the taxable year or (2) the date on which each portion of the underpayment is made. The penalty for failure to pay estimated tax is the equivalent of interest, which is based on the time value of money.

Taxpayers are not liable for a penalty for the failure to pay estimated tax when the tax shown on the return for the taxable year (or, if no return is filed, the tax), reduced by withholding, is less than $1,000. This safe harbor does not apply, however, when a taxpayer has paid tax throughout the year solely through estimated tax payments. For such taxpayers, any tax shown on the return for the taxable year, net of estimated tax paid, could subject the taxpayer to the penalty for failure to pay estimated tax (unless another safe harbor applies).

Reasons for Change

Some taxpayers are required to complete Form 2210 (Underpayment of Estimated Tax by Individuals, Estates, and Trusts) and attach it to their tax return to show that they qualify for an exception that can lower or eliminate the penalty for underpayment of estimated tax. The computations required to determine the amount of the individual estimated tax penalty are complex and difficult to administer. The Committee believes that by increasing the estimated tax payment threshold, fewer taxpayers will be required to make estimated tax payments.

Explanation of Provision

The threshold for imposing the penalty for failure to pay estimated tax is increased from $1,000 to $2,000.

Effective Date

The provision is effective for estimated tax payments made for taxable years beginning after December 31, 2006.

2. Apply one interest rate per estimated tax underpayment period for individuals, estates, and trusts

Present Law

The present-law penalty for failure to pay estimated tax is equal to the underpayment interest rate multiplied by the number of days the underpayment is outstanding, which is the number of days between when the taxpayer should have made the estimated payment and the earlier of (1) the 15th day of the fourth month following the close of the taxable year or (2) the date on which each portion of the underpayment is made. The interest rate, which equals the Federal short-term rate plus three percentage points, is subject to change on the first day of each quarter, which is January 1, April 1, July 1, and October 1.

If the applicable interest rate changes while an underpayment of estimated tax is outstanding, then taxpayers are required to make separate calculations for the periods before and after the interest rate change. Such calculations generally are needed to cover 15-day periods. For example, the July 1 interest rate occurs 15 days after the June 15 payment date (for calendar-year taxpayers). A change in interest rates, which occurs on the first day of each calendar quarter, would require the use of different interest rates during one estimated tax underpayment period and would increase the number of calculations that a taxpayer must make in calculating a penalty for failure to pay estimated tax.

Reasons for Change

The adjustment of the interest rate for underpayments greatly complicates the computation of interest. When interest rates change during an underpayment period, taxpayers must perform multiple calculations to account for the change in interest rate. Thus, the Committee finds that, if only one interest rate applied per underpayment period, complexity would be reduced because there generally would be only one interest calculation required per underpayment period.

Explanation of Provision

The interest rates applicable to tax underpayments are aligned so that, for any given estimated tax underpayment period, only one interest rate applies. The underpayment interest rate in effect on the first day of the quarter in which the pertinent estimated payment due date arises is the interest rate that applies during an entire underpayment period.

Effective Date

The provision is effective for estimated tax payments made for taxable years beginning after December 31, 2006.

3. Provide that underpayment balances are cumulative

Present Law

Section 6654(b)(1) defines "underpayment" as the amount of an installment due over the amount of any installment paid (including withholding) on or before the due date of the installment. In determining an underpayment penalty for a calendar year taxpayer, the period of underpayment runs for each underpayment from the payment's due date through the earlier of the date on which any portion of the payment is made or the 15th day of the fourth month following the close of the taxable year. Underpayment balances are not cumulative and must be tracked separately for each estimated tax underpayment period.

Reasons for Change

Tracking underpayments separately results in additional complexity in calculating interest on underpayments of estimated tax. The Committee thus finds that the calculation of interest on underpayments of estimated tax would be simplified by providing that underpayment balances would roll into the next estimated tax period so that interest would be calculated once per cumulative underpayment, per period.

Explanation of Provision

The definition of "underpayment" is modified to allow existing underpayment balances to be used in underpayment calculations for succeeding estimated payment periods. Under the provision, taxpayers calculate a cumulative underpayment at the end of each underpayment period.

Effective Date

The provision is effective for estimated tax payments made for taxable years beginning after December 31, 2006.

4. Require 365-day year for all estimated tax interest calculations for individuals, estates, and trusts

Present Law

Under current IRS procedures, taxpayers with outstanding underpayment balances that extend from a leap year through a non-leap year are required to make separate calculations solely to account for the different number of days in the two different years. For example, if a taxpayer has an underpayment outstanding from September 15, 2008, through January 15, 2009, then the taxpayer is required to account for the period from September 15, 2008 through December 31, 2008, using a 366-day formula.[53] The taxpayer then is required to account for the period from

[53] The year 2008 is a leap year, the year 2009 is not.

January 1, 2009, through January 15, 2009, under a 365-day formula. This calculation is required regardless of whether the interest rate changes on January 1, 2009.

Reasons for Change

The Committee finds that complexity in calculating interest on underpayments of estimated tax would be reduced by eliminating the extra calculation that is required for underpayment balances that extend from a leap year to a non-leap year or from a non-leap year to a leap year.

Explanation of Provision

A 365-day year is used for all individual, estate, and trust estimated tax interest calculations.

Effective Date

The provision is effective for estimated tax payments made for taxable years beginning after December 31, 2006.

B. Corporate Estimated Tax
(sec. 402 of the bill and sec. 6655 of the Code)

Present Law

In general, corporations are required to make quarterly estimated tax payments of their income tax liability.[54] An exception to this requirement applies if the amount of tax for the taxable year is less than $500.

Reasons for Change

The Committee believes that increasing the amount of this exception will reduce taxpayer burden and simplify administration of the tax laws.

Explanation of Provision

The provision increases the threshold amount of tax for requiring corporate estimated tax payments to $1,000.

Effective Date

The provision is effective for taxable years beginning after December 31, 2006.

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[54] Sec. 6655.

C. Increase in Large Corporation Threshold for Estimated Tax Payments (sec. 403 of the bill and sec. 6655 of the Code)

Present Law

In general, corporations are required to make quarterly estimated tax payments of their income tax liability.[55] In general, the total of the estimated payments must equal the lesser of 100 percent of the current year's tax or 100 percent of the previous year's tax. Large corporations, however, may not base their estimated payments on the previous year's tax. A large corporation is a corporation with taxable income of $1 million or more for any taxable year in the preceding three taxable years.

Reasons for Change

The Committee believes that increasing the threshold for defining large corporations will reduce taxpayer burden and simplify administration of the tax laws.

Explanation of Provision

The provision increases the $1 million threshold defining large corporations (for purposes of quarterly estimated tax) by $50,000 every year beginning after 2006 until it reaches $1.5 million.

Effective Date

The provision is effective for taxable years beginning after December 31, 2006.

[55] Sec. 6655.

D. Expansion of Interest Netting (sec. 404 of the bill and sec. 6621 of the Code)

Present Law

A special net interest rate of zero applies to the extent that, for any period, interest is payable under subchapter A and allowable under subchapter B on equivalent underpayments and overpayments by the same taxpayer. If both the underpayment and overpayment are unsatisfied, the interest rate applied to both will be zero. If either the underpayment or overpayment has previously been satisfied, the interest rate applicable to the unsatisfied amount will be equal to the interest rate applicable to the satisfied amount to the extent that interest was allowable or payable on both the underpayment and the overpayment for the same period.

Interest must be both payable and allowable for interest netting to apply. If interest is not payable by the taxpayer with respect to an underpayment of tax, or interest is not allowable to the taxpayer on an overpayment of tax, the interest netting rules will not apply.

For example, on July 1, 2017, a deficiency of $1,500 is determined with respect to a taxpayer's 2014 Federal income tax return, which the taxpayer pays within 21 days. In the meantime, the taxpayer has filed returns for 2015 and 2016, showing a refund due to overwithholding each year of $1,000. The IRS issues the appropriate refund checks on May 15 of each year, within 45 days of the due date of the return. Thus, interest is not allowable to the taxpayer with respect to either 2015 or 2016. In this case, the taxpayer owes interest on the $1,500 year 2014 underpayment from the original due date of the return (April 15, 2015) until the underpayment is satisfied. Although there are offsetting periods of overpayment (April 15, 2016 to May 15, 2016 and April 15, 2017 to May 15, 2017), there is no offsetting period for which interest is allowable on an overpayment.

Reasons for Change

Interest represents the time value of money. The Committee believes that allowing taxpayers to consider the period of time the Secretary is allowed to process a refund in determining a net interest rate reflects this principle by recognizing that the government had use of the taxpayer's overpayment even though such overpayment was not allowable (i.e., periods of mutual indebtedness).

Explanation of Provision

In the case of any taxpayer (whether an individual or corporation or other), the interest netting rules with respect to tax underpayments and overpayments are applied without regard to the 45-day period in which the Secretary may refund an overpayment of tax without the payment of interest under section 6611(e). Solely for the purpose of the interest netting computation, the portion of the 45-day period before repayment of the overpayment is considered as a period for which overpayment interest was allowable at a zero rate. The provision does not modify the period for which interest is payable or allowable for any other purpose.

In the example discussed under present law, above, a net interest rate of zero would be applied to $1,000 of the taxpayer's year 2014 underpayment for the periods between the due date of the 2015 and 2016 returns and the dates on which the refunds are made. The taxpayer in the example would owe interest at the underpayment rate for the periods from April 16, 2015, to April 15, 2016; May 16, 2016 to April 15, 2017; and from May 16, 2017 to July 1, 2017. For the periods April 15, 2016, to May 15, 2016 and April 15, 2017 to May 15, 2017, a zero net interest rate applies.

Effective Date

The provision is effective for interest accrued after December 31, 2010.

E. Clarification of Application of Federal Tax Deposit Penalty (sec. 405 of the bill and sec. 6656 of the Code)

Present Law

In many instances, taxpayers are required to make deposits of Federal taxes.[56] Failure to do so is subject to a penalty.[57] The amount of that penalty depends on the length of time that the deposit was not made. The penalty is two percent of the underpayment if the failure to deposit is for not more than five days, 5 percent for six through 15 days, and 10 percent for more than 15 days. The IRS applies the 10 percent penalty rate automatically if a deposit is not made in the manner required.

Reasons for Change

The Committee believes that the position of the IRS does not reflect the intent of the Congress in enacting this penalty, that the rate of the penalty vary depending on the time of the failure, whether the failure being penalized is a failure to make a deposit in the manner required or a failure to make a deposit at all. The Committee considers it anomalous that the IRS would interpret this penalty so that individuals who make the correct deposit but not in the manner required are penalized at a higher rate than those that do not make a deposit at all until several days after the due date. The Committee believes it is more appropriate to penalize taxpayers in similar situations similarly.

Explanation of Provision

The application of the Federal tax deposit penalty is clarified so that the 10-percent penalty rate only applies in cases in which the failure to deposit extends for more than 15 days. Thus, a taxpayer who makes a deposit on time but not in the manner required is subject to a penalty of two percent.

Effective Date

The provision is effective on the date of enactment.

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[56] Sec. 6302.

[57] Sec. 6656.

F. Frivolous Tax Submissions (sec. 406 of the bill and sec. 6702 of the Code)

Present Law

The Code provides that an individual who files a frivolous income tax return is subject to a penalty of $500 imposed by the IRS.[58] The Code also permits the Tax Court[59] to impose a penalty of up to $25,000 if a taxpayer has instituted or maintained proceedings primarily for delay or if the taxpayer's position in a proceeding is frivolous or groundless.[60]

Reasons for Change

The Committee believes that frivolous returns and submissions consume resources at the IRS and in the courts that can better be utilized in resolving legitimate disputes with taxpayers. Expanding the scope of the penalty to cover all taxpayers and tax returns promotes fairness in the tax system. The Committee believes that adopting this provision will improve effective tax administration.

Explanation of Provision

The provision modifies the penalty on frivolous returns by increasing the amount of the penalty to up to $5,000 and by applying it to all taxpayers and to all types of Federal taxes.

The provision also modifies present law with respect to certain submissions that raise frivolous arguments or that are intended to delay or impede tax administration. The submissions to which the provision applies are requests for a collection due process hearing, installment agreements, offers-in-compromise, and taxpayer assistance orders. First, the provision permits the IRS to disregard such requests. Second, the provision permits the IRS to impose a penalty of up to $5,000 for such requests, unless the taxpayer withdraws the request after being given an opportunity to do so.

The provision requires the IRS to publish a list of positions, arguments, requests, and submissions determined to be frivolous for purposes of these provisions.

Effective Date

The provision applies to submissions made and issues raised after the date on which the Secretary first prescribes the required list of frivolous positions.

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[58] Sec. 6702.

[59] Because the Tax Court is the only pre-payment forum available to taxpayers, it addresses most of the frivolous, groundless, or dilatory arguments raised in tax cases.

[60] Sec. 6673(a).

G. Understatement of Taxpayer's Liability by Tax Return Preparers (sec. 407 of the bill and secs. 6694, 6695, and 7701 of the Code)

Present Law

An income tax return preparer is defined as any person who prepares for compensation, or who employs other people to prepare for compensation, all or a substantial portion of an income tax return or claim for refund.[61] Under present law, the definition of an income tax return preparer does not include a person preparing non-income tax returns, such as estate and gift, excise, or employment tax returns.

Income tax return preparers are required to sign and include their taxpayer identification numbers on income tax returns and income return-related documents prepared for compensation. Under the Code, penalties are imposed on any income tax return preparer who, in connection with the preparation of an income tax return, fails to (1) furnish a copy of a return or claim for refund to the taxpayer, (2) sign the return or claim for refund, (3) furnish his or her identifying number, (4) retain a copy of the completed return or a list of the taxpayers for whom a return was prepared, (5) file a correct information return, and (6) comply with certain due diligence requirements in determining a taxpayer's eligibility for the earned income credit.[62] Generally, the penalty is $50 for each failure and the total penalties imposed for any single type of failure for any calendar year are limited to $25,000. The penalty for failing to comply with the due diligence requirements for determining a taxpayer's eligibility for the earned income credit is $100 for each failure. An income tax return preparer who endorses or negotiates a check issued to a taxpayer (other than the income tax return preparer) is liable for a penalty of $500 with respect to each such check.

An income tax return preparer who prepares a return with respect to which there is an understatement of tax that is due to an undisclosed position for which there was not a realistic possibility of being sustained on its merits, or a frivolous position, is liable for a first-tier penalty of $250, provided the preparer knew or reasonably should have known of the position.[63] For purposes of the penalty, an understatement is generally defined as any understatement with respect to any tax imposed by subtitle A (i.e., income taxes). An income tax return preparer who prepares a return and engages in specified willful or reckless conduct with respect to preparing an income tax return is liable for a second-tier penalty of $1,000.

Reasons for Change

Penalties for the failure to comply with tax laws are a necessary component of any tax system if broad compliance is to be expected. Existing preparer penalties do not adequately

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

[62] Sec. 6695.

[63] Sec. 6694.

deter and prevent noncompliance with tax laws. They should be broadened to include returns other than income tax returns. The thresholds of behavior to establish preparer noncompliance should be raised so that scams and schemes and other abusive transactions are discouraged. Penalty amounts have remained constant for years and are considered by some preparers to be a cost of business instead of an economic deterrent. The amounts should be increased to restore their deterrent impact. Preparer penalties also should be broadened to apply to refund claims with no reasonable basis to discourage unnecessary use of IRS resources and delays.

Explanation of Provision

The provision broadens the scope of the present-law preparer penalties to include preparers of estate and gift tax, employment tax, and excise tax returns, and returns of exempt organizations.

The provision alters the standards of conduct that must be met to avoid imposition of the penalties for preparing a return with respect to which there is an understatement of tax. First, the provision replaces the realistic possibility standard for undisclosed positions with a requirement that there be a reasonable belief that the tax treatment of the position was more likely than not the proper treatment. The provision replaces the not-frivolous standard with the requirement that there be a reasonable basis for the tax treatment of the position.

The provision also imposes a penalty on a tax return preparer who prepares the portion of a claim for refund or credit that is disallowed if there is no reasonable basis for the claimed tax treatment of the disallowed portion of such claim for refund or credit.

The provision also increases the first-tier penalty from $250 to the greater of $1,000 or 50 percent of the income derived (or to be derived) by the tax return preparer from the preparation of a return or claim with respect to which the penalty is imposed. The provision increases the second-tier penalty from $1,000 to the greater of $5,000 or 50 percent of the income derived (or to be derived) by the tax return preparer.

Effective Date

The provision is effective for tax returns prepared after the date of enactment.

H. Penalty for Aiding and Abetting the Understatement of Tax Liability (sec. 408 of the bill and sec. 6701 of the Code)

Present Law

A penalty is imposed on a person who: (1) aids or assists in, procures, or advises with respect to a tax return or other document; (2) knows (or has reason to believe) that such document will be used in connection with a material tax matter; and (3) knows that this would result in an understatement of tax of another person.[64] In general, the amount of the penalty is $1,000. If the document relates to the tax return of a corporation, the amount of the penalty is $10,000.

Reasons for Change

The Committee understands that some tax practitioners and professionals assist taxpayers in understating their tax liability. The Committee believes that allowing aiders and abettors to profit from their wrongdoing undermines the integrity of the tax system. Existing aiding and abetting penalties do not adequately deter and prevent noncompliance with tax laws. Penalty amounts should be increased so they are an economic deterrent and not considered merely a cost of doing business. In addition, such penalties should not be deductible for tax purposes. Moreover, to discourage illegal tax shelters, scams and schemes, penalties should be applicable to each instance of aiding and abetting and be jointly and severally applicable so all aiders and abettors involved are responsible.

Explanation of Provision

The provision expands the scope of the aiding and abetting penalty in several ways. First, it applies the penalty to aiding or abetting with respect to tax liability reflected in a tax return. Second, it applies the penalty separately to each instance of aiding or abetting. Third, it increases the amount of the penalty to a maximum of 100 percent of the gross income derived (or to be derived) from the aiding or abetting. Fourth, if more than one person is liable for the penalty, all such persons are jointly and severally liable for the penalty. Fifth, the penalty, as well as amounts paid to settle or avoid the imposition of the penalty, is not deductible for tax purposes.

Effective Date

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

[64] Sec. 6701.

I. Increase in Criminal Monetary Penalty Limitation for the Underpayment or Overpayment of Tax Due to Fraud (sec. 409 of the bill and secs. 7201, 7203, and 7206 of the Code)

Present Law

Attempt to evade or defeat tax

In general, section 7201 imposes a criminal penalty on persons who willfully attempt to evade or defeat any tax imposed by the Code. Upon conviction, the Code provides that the penalty is up to $100,000 or imprisonment of not more than five years (or both). In the case of a corporation, the Code increases the monetary penalty to a maximum of $500,000.

Willful failure to file return, supply information, or pay tax

In general, section 7203 imposes a criminal penalty on persons required to make estimated tax payments, pay taxes, keep records, or supply information under the Code who willfully fails to do so. Upon conviction, the Code provides that the penalty is up to $25,000 or imprisonment of not more than one year (or both). In the case of a corporation, the Code increases the monetary penalty to a maximum of $100,000.

Fraud and false statements

In general, section 7206 imposes a criminal penalty on persons who make fraudulent or false statements under the Code. Upon conviction, the Code provides that the penalty is up to $100,000 or imprisonment of not more than three years (or both). In the case of a corporation, the Code increases the monetary penalty to a maximum of $500,000.

Uniform sentencing guidelines

Under the uniform sentencing guidelines established by 18 U.S.C. section 3571, a defendant found guilty of a criminal offense is subject to a maximum fine that is the greatest of: (a) the amount specified in the underlying provision, (b) for a felony[65] $250,000 for an individual or $500,000 for an organization, or (c) twice the gross gain if a person derives pecuniary gain from the offense. This Title 18 provision applies to all criminal provisions in the United States Code, including those in the Internal Revenue Code. For example, for an individual, the maximum fine under present law upon conviction of violating section 7206 is $250,000 or, if greater, twice the amount of gross gain from the offense.

Reasons for Change

The Committee believes that existing criminal tax penalties do not adequately deter criminal behavior resulting in noncompliance with tax laws and increasing the tax gap.

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[65] Section 7206 provides that the making of fraudulent or false statements is a felony. In addition, this offense is a felony pursuant to the classification guidelines of 18 U.S.C. sec. 3559(a)(5).

Increasing monetary penalties will raise the economic risk of failing to comply with tax laws. In addition, classifying certain willful failure to file cases as felonies should discourage criminal tax violations by substantially increasing the monetary and sentencing consequences of the offense together with the long term repercussions associated with a felony record.

Explanation of Provision

Attempt to evade or defeat tax

The provision increases the criminal penalty under section 7201 for individuals to $500,000 and for corporations to $1,000,000. The provision increases the maximum prison sentence to ten years.

Willful failure to file return, supply information, or pay tax

The provision increases the criminal penalty under section 7203 for individuals to $50,000 and, in the case of an "aggravated failure to file" (defined as a failure to file a return for a period of three or more consecutive taxable years if the aggregate tax liability for such period is at least $100,000 or any failure to file a return where the requirement to make such return is attributable to activities that are felonies under Federal or State criminal law), changes the crime from a misdemeanor to a felony and increases the maximum prison sentence to ten years. The provision clarifies that the aggravated failure to file penalty may be applied in addition to other criminal tax penalties.

Fraud and false statements

The provision increases the criminal penalty for making fraudulent or false statements to $500,000 for individuals and $1,000,000 for corporations. The provision increases the maximum prison sentence for making fraudulent or false statements to five years. The provision provides that in no event shall the amount of the monetary penalty under the provision be less than the amount of the underpayment or overpayment attributable to fraud.

Effective Date

The provision is effective for actions and failures to act occurring after the date of enactment.

J. Doubling of Certain Penalties, Fines, and Interest on Underpayments Related to Certain Offshore Financial Arrangements (sec. 410 of the bill)

Present Law

In general

The Code contains numerous civil penalties, such as the delinquency, accuracy-related, fraud, and assessable penalties. These civil penalties are in addition to any interest that may be due as a result of an underpayment of tax. If all or any part of a tax is not paid when due, the Code imposes interest on the underpayment, which is assessed and collected in the same manner as the underlying tax and is subject to the respective statutes of limitations for assessment and collection.

Delinquency penalties

Failure to file

Under present law, a taxpayer who fails to file a tax return on a timely basis is generally subject to a penalty equal to five percent of the net amount of tax due for each month that the return is not filed, up to a maximum of five months or 25 percent. An exception from the penalty applies if the failure is due to reasonable cause. In the case of fraudulent failure to file, the penalty is increased to 15 percent of the net amount of tax due for each month that the return is not filed, up to a maximum of five months or 75 percent. The net amount of tax due is the excess of the amount of the tax required to be shown on the return over the amount of any tax paid on or before the due date prescribed for the payment of tax.

Failure to pay

Taxpayers who fail to pay their taxes are subject to a penalty of 0.5 percent per month on the unpaid amount, up to a maximum of 25 percent. If a penalty for failure to file and a penalty for failure to pay tax shown on a return both apply for the same month, the amount of the penalty for failure to file for such month is reduced by the amount of the penalty for failure to pay tax shown on a return. If an income tax return is filed more than 60 days after its due date, then the penalty for failure to pay tax shown on a return may not reduce the penalty for failure to file below the lesser of $100 or 100 percent of the amount required to be shown on the return. For any month in which an installment payment agreement with the IRS is in effect, the rate of the penalty is half the usual rate (0.25 percent instead of 0.5 percent), provided that the taxpayer filed the tax return in a timely manner (including extensions).

Failure to make timely deposits of tax

The penalty for the failure to make timely deposits of tax consists of a four-tiered structure in which the amount of the penalty varies with the length of time within which the taxpayer corrects the failure. A depositor is subject to a penalty equal to two percent of the amount of the underpayment if the failure is corrected on or before the date that is five days after the prescribed due date. A depositor is subject to a penalty equal to five percent of the amount of the underpayment if the failure is corrected after the date that is five days after the prescribed due date but on or before the date that is 15 days after the prescribed due date. A depositor is subject to a penalty equal to 10 percent of the amount of the underpayment if the failure is corrected after the date that is 15 days after the due date but on or before the date that is 10 days after the date of the first delinquency notice to the taxpayer (under sec. 6303). Finally, a depositor is subject to a penalty equal to 15 percent of the amount of the underpayment if the failure is not corrected on or before the earlier of 10 days after the date of the first delinquency notice to the taxpayer and the date on which notice and demand for immediate payment of tax is given in cases of jeopardy.

An exception from the penalty applies if the failure is due to reasonable cause. In addition, the Secretary may waive the penalty for an inadvertent failure to deposit any tax by specified first-time depositors.

Accuracy-related penalties

In general

The accuracy-related penalties are imposed at a rate of 20 percent of the portion of any underpayment that is attributable, in relevant part, to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, and (4) any reportable transaction understatement. The penalty for a substantial valuation misstatement is doubled for certain gross valuation misstatements. In the case of a reportable transaction understatement for which the transaction is not disclosed, the penalty rate is 30 percent. These penalties are coordinated with the fraud penalty. This statutory structure operates to eliminate any stacking of the penalties.

No penalty is to be imposed if it is shown that there was reasonable cause for an underpayment and the taxpayer acted in good faith, and in the case of a reportable transaction understatement the relevant facts of the transaction have been disclosed, there is or was substantial authority for the taxpayer's treatment of such transaction, and the taxpayer reasonably believed that such treatment was more likely than not the proper treatment.

Negligence or disregard for the rules or regulations

If an underpayment of tax is attributable to negligence, the negligence penalty applies only to the portion of the underpayment that is attributable to negligence. Negligence means any failure to make a reasonable attempt to comply with the provisions of the Code. Disregard includes any careless, reckless, or intentional disregard of the rules or regulations.

Substantial understatement of income tax

Generally, an understatement is substantial if the understatement exceeds the greater of (1) 10 percent of the tax required to be shown on the return for the tax year, or (2) $5,000. In determining whether a substantial understatement exists, the amount of the understatement is reduced by any portion attributable to an item if (1) the treatment of the item on the return is or was supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed on the return or on a statement attached to the return.

Substantial valuation misstatement

A penalty applies to the portion of an underpayment that is attributable to a substantial valuation misstatement or gross valuation misstatement. Generally, a substantial valuation misstatement exists if the value or adjusted basis of any property claimed on a return is 200 percent or more but less than 400 percent of the correct value or adjusted basis. The amount of the penalty for a substantial valuation misstatement is 20 percent of the amount of the underpayment. If the value or adjusted basis claimed is 400 percent or more of the correct value or adjusted basis (a gross valuation misstatement), then the amount of the penalty is 40 percent of the underpayment.

Reportable transaction understatement

A penalty applies to any item that is attributable to any listed transaction, or to any reportable transaction (other than a listed transaction) if a significant purpose of such reportable transaction is tax avoidance or evasion.

Fraud penalty

The fraud penalty is imposed at a rate of 75 percent of the portion of any underpayment that is attributable to fraud. The accuracy-related penalty does not to apply to any portion of an underpayment on which the fraud penalty is imposed.

Assessable penalties

In addition to the penalties described above, the Code imposes a number of additional penalties, including, for example, penalties for failure to file (or untimely filing of) information returns with respect to foreign trusts, and penalties for failure to disclose any required information with respect to a reportable transaction.

Interest provisions

Taxpayers are required to pay interest to the IRS whenever there is an underpayment of tax. An underpayment of tax exists whenever the correct amount of tax is not paid by the last date prescribed for the payment of the tax. The last date prescribed for the payment of the income tax is the original due date of the return.

Different interest rates are provided for the payment of interest depending upon the type of taxpayer, whether the interest relates to an underpayment or overpayment, and the size of the underpayment or overpayment. Interest on underpayments is compounded daily.

Offshore Voluntary Compliance Initiative

In January 2003, Treasury announced the Offshore Voluntary Compliance Initiative (“OVCI”) to encourage the voluntary disclosure of previously unreported income placed by taxpayers in offshore accounts and accessed through credit card or other financial arrangements. A taxpayer had to comply with various requirements in order to participate in the OVCI, including sending a written request to participate in the program by April 15, 2003. This request had to include information about the taxpayer, the taxpayer's introduction to the credit card or other financial arrangements and the names of parties that promoted the transaction. A taxpayer entering into a closing agreement under the OVCI is not liable for the civil fraud penalty, the fraudulent failure to file penalty, or the civil information return penalties. Such a taxpayer is responsible for back taxes, interest, and certain accuracy-related and delinquency penalties.[66]

Voluntary disclosure policy

A taxpayer's timely, voluntary disclosure of a substantial unreported tax liability has long been an important factor in deciding whether the taxpayer's case should ultimately be referred for criminal prosecution. The voluntary disclosure must be truthful, timely, and complete. The taxpayer must show a willingness to cooperate (as well as actual cooperation) with the IRS in determining the correct tax liability. The taxpayer must make good-faith arrangements with the IRS to pay in full the tax, interest, and any penalties determined by the IRS to be applicable. A voluntary disclosure does not guarantee immunity from prosecution. It creates no substantive or procedural rights for taxpayers.[67] The IRS treats participation in the OVCI as a voluntary disclosure.[68]

Reasons for Change

The Committee is aware that individuals and corporations, through sophisticated transactions, are placing unreported income in offshore financial accounts accessed through credit or debit cards or other financial arrangements in order to avoid or evade Federal income tax. Such a phenomenon poses a serious threat to the efficacy of the tax system because of both the potential loss of revenue and the potential threat to the integrity of the self-assessment system. The IRS estimates there may be several hundred thousand taxpayers using offshore financial arrangements to conceal taxable income from the IRS, potentially costing the government billions of dollars in lost revenue. On February 10, 2004, the IRS announced that over 1,300 applications to participate in the OVCI initiative were received, and that it had received over $175 million in taxes, interest, and penalties from these cases.[69] At the start of the program, the clear message to taxpayers was that those who failed to come forward would be pursued by the IRS and would be subject to more significant penalties and possible criminal sanctions. The Committee believes that doubling the civil penalties, fines, and interest applicable to taxpayers who participate in these types of arrangements and who do not

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[66] Rev. Proc. 2003-11, 2003-4 C.B. 311.

[67] Internal Revenue News Release 2002-135, IR-2002-135 (December 11, 2002).

[68] Rev. Proc. 2003-11, 2003-4 C.B. 311.

[69] Internal Revenue News Release 2004-19, IR-2002-19 (February 10, 2004).

voluntarily disclose such arrangements (through the OVCI or otherwise) will provide the IRS with the significant sanctions needed to stem the promotion of, and participation in, these abusive schemes.

Explanation of Provision

The provision doubles the amounts of civil penalties, interest, and fines related to taxpayers' underpayments of U.S. income tax liability through the direct or indirect use of certain offshore financial arrangements. The provision applies to taxpayers who did not (or do not) voluntarily disclose such arrangements through the OVCI or otherwise. Under the provision, the determination of whether any civil penalty is to be applied to such underpayment is made without regard to whether a return has been filed, whether there was reasonable cause for such underpayment, and whether the taxpayer acted in good faith.

The proscribed financial arrangements include, but are not limited to, the use of certain foreign leasing corporations for providing domestic employee services,[70] certain arrangements whereby the taxpayer may hold securities trading accounts through offshore banks or other financial intermediaries, certain arrangements whereby the taxpayer may access funds through the use of offshore credit, debit, or charge cards, and offshore annuities or trusts.

The Secretary of the Treasury is granted the authority to waive the application of the provision if the use of the offshore financial arrangements is incidental to the transaction and, in the case of a trade or business, such use is conducted in the ordinary course of the type of trade or business in which the taxpayer is engaged.

Effective Date

The provision generally is effective with respect to a taxpayer's open tax years on or after the date of enactment.

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[70] These arrangements were described and classified as listed transactions in Notice 2003-22, 2003-1 C.B. 851.

K. Increase in Penalty for Bad Checks and Money Orders (sec. 411 of the bill and sec. 6657 of the Code)

Present Law

The Code[71] imposes a penalty for bad checks and money orders on the person who tendered it. The penalty is two percent of the amount of the bad check or money order, with a minimum penalty of $15 (or, if less, the amount of the check).

Reasons for Change

The Committee believes that it is appropriate to increase the minimum amount of this penalty so that it is more consistent with amounts charged by the private sector for bad checks.

Explanation of Provision

The provision increases the minimum penalty for bad checks and money orders to $25 (or, if less, the amount of the check).

Effective Date

The provision applies to checks or money orders received after the date of enactment.

[71] Sec. 6657.

L. Increase the Amounts of Excise Taxes Relating to Public Charities, Social Welfare Organizations, and Private Foundations (sec. 412 of the bill and secs. 4912, 4941, 4942, 4943, 4944, 4945, 4955, and 4958 of the Code)

Present Law[72]

Public charities and social welfare organizations

The Code imposes excise taxes on excess benefit transactions between disqualified persons (as defined in section 4958(f)) and charitable organizations (other than private foundations) or social welfare organizations (as described in section 501(c)(4)).[73] An excess benefit transaction generally is a transaction in which an economic benefit is provided by a charitable or social welfare organization directly or indirectly to or for the use of a disqualified person, if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit.

The excess benefit transaction tax is imposed on the disqualified person and, in certain cases, on the organization manager, but is not imposed on the exempt organization. An initial tax of 25 percent of the excess benefit amount is imposed on the disqualified person that receives the excess benefit. An additional tax on the disqualified person of 200 percent of the excess benefit applies if the violation is not corrected. A tax of 10 percent of the excess benefit (not to exceed $10,000 with respect to any excess benefit transaction) is imposed on an organization manager that knowingly participated in the excess benefit transaction, if the manager's participation was willful and not due to reasonable cause, and if the initial tax was imposed on the disqualified person.[74] If more than one person is liable for the tax on disqualified persons or on management, all such persons are jointly and severally liable for the tax.[75]

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[72] Present law refers to the law in effect on the date of Committee action on the bill. It does not reflect the changes made by the Pension Protection Act of 2006, Pub. L. No. 109-280 (August 17, 2006).

[73] Sec. 4958. The excess benefit transaction tax is commonly referred to as "intermediate sanctions," because it imposes penalties generally considered to be less punitive than revocation of the organization's exempt status.

[74] Sec. 4958(d)(2). Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

[75] Sec. 4958(d)(1).

Private foundations

Self-dealing by private foundations

Excise taxes are imposed on acts of self-dealing between a disqualified person (as defined in section 4946) and a private foundation.[76] In general, self-dealing transactions are any direct or indirect: (1) sale or exchange, or leasing, of property between a private foundation and a disqualified person; (2) lending of money or other extension of credit between a private foundation and a disqualified person; (3) the furnishing of goods, services, or facilities between a private foundation and a disqualified person; (4) the payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person; (5) the transfer to, or use by or for the benefit of, a disqualified person of the income or assets of the private foundation; and (6) certain payments of money or property to a government official.[77] Certain exceptions apply.[78]

An initial tax of five percent of the amount involved with respect to an act of self-dealing is imposed on any disqualified person (other than a foundation manager acting only as such) who participates in the act of self-dealing. If such a tax is imposed, a 2.5-percent tax of the amount involved is imposed on a foundation manager who participated in the act of self-dealing knowing it was such an act (and such participation was not willful and was due to reasonable cause) up to $10,000 per act. Such initial taxes may not be abated.[79] Such initial taxes are imposed for each year in the taxable period, which begins on the date the act of self-dealing occurs and ends on the earliest of the date of mailing of a notice of deficiency for the tax, the date on which the tax is assessed, or the date on which correction of the act of self-dealing is completed. A government official (as defined in section 4946(c)) is subject to such initial tax only if the official participates in the act of self-dealing knowing it is such an act. If the act of self-dealing is not corrected, a tax of 200 percent of the amount involved is imposed on the disqualified person and a tax of 50 percent of the amount involved (up to $10,000 per act) is imposed on a foundation manager who refused to agree to correcting the act of self-dealing. Such additional taxes are subject to abatement.[80]

Tax on failure to distribute income

Private nonoperating foundations are required to pay out a minimum amount each year as qualifying distributions. In general, a qualifying distribution is an amount paid to accomplish one or more of the organization's exempt purposes, including reasonable and necessary

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[76] Sec. 4941.

[77] Sec. 4941(d)(1).

[78] See sec. 4941(d)(2).

[79] Sec. 4962(b).

[80] Sec. 4961.

administrative expenses.[81] Failure to pay out the minimum results in an initial excise tax on the foundation of 15 percent of the undistributed amount. An additional tax of 100 percent of the undistributed amount applies if an initial tax is imposed and the required distributions have not been made by the end of the applicable taxable period.[82] A foundation may include as a qualifying distribution the salaries, occupancy expenses, travel costs, and other reasonable and necessary administrative expenses that the foundation incurs in operating a grant program. A qualifying distribution also includes any amount paid to acquire an asset used (or held for use) directly in carrying out one or more of the organization's exempt purposes and certain amounts set-aside for exempt purposes.[83] Private operating foundations are not subject to the payout requirements.

Tax on excess business holdings

Private foundations are subject to tax on excess business holdings.[84] In general, a private foundation is permitted to hold 20 percent of the voting stock in a corporation, reduced by the amount of voting stock held by all disqualified persons (as defined in section 4946). If it is established that no disqualified person has effective control of the corporation, a private foundation and disqualified persons together may own up to 35 percent of the voting stock of a corporation. A private foundation shall not be treated as having excess business holdings in any corporation if it owns (together with certain other related private foundations) not more than two percent of the voting stock and not more than two percent in value of all outstanding shares of all classes of stock in that corporation. Similar rules apply with respect to holdings in a partnership ("profits interest" is substituted for "voting stock" and "capital interest" for "nonvoting stock") and to other unincorporated enterprises (by substituting "beneficial interest" for "voting stock"). Private foundations are not permitted to have holdings in a proprietorship. Foundations generally have a five-year period to dispose of excess business holdings (acquired other than by purchase) without being subject to tax.[85] This five-year period may be extended an additional five years in limited circumstances.[86]

The initial tax is equal to five percent of the value of the excess business holdings held during the foundation's applicable taxable year. An additional tax is imposed if an initial tax is

[81] Sec. 4942(g)(1)(A).

[82] Sec. 4942(a) and (b). Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

[83] Secs. 4942(g)(1)(B) and 4942(g)(2). In general, an organization is permitted to adjust the distributable amount in those cases where distributions during the five preceding years have exceeded the payout requirements. Sec. 4942(i).

[84] Sec. 4943. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

[85] Sec. 4943(c)(6).

[86] Sec. 4943(c)(7).

imposed and at the close of the applicable taxable period, the foundation continues to hold excess business holdings. The amount of the additional tax is equal to 200 percent of such holdings.

Tax on jeopardizing investments

Private foundations and foundation managers are subject to tax on investments that jeopardize the foundation's charitable purpose.[87] In general, an initial tax of five percent of the amount of the investment applies to the foundation and to foundation managers who participated in the making of the investment knowing that it jeopardized the carrying out of the foundation's exempt purposes. The initial tax on foundation managers may not exceed $5,000 per investment. If the investment is not removed from jeopardy (e.g., sold or otherwise disposed of), an additional tax of 25 percent of the amount of the investment is imposed on the foundation and five percent of the amount of the investment on a foundation manager who refused to agree to removing the investment from jeopardy. The additional tax on foundation managers may not exceed $10,000 per investment. An investment, the primary purpose of which is to accomplish a charitable purpose and no significant purpose of which is the production of income or the appreciation of property, is not considered a jeopardizing investment.[88]

Tax on taxable expenditures

Certain expenditures of private foundations are subject to tax.[89] In general, taxable expenditures are expenses: (1) for lobbying; (2) to influence the outcome of a public election or carry on a voter registration drive (unless certain requirements are met); (3) as a grant to an individual for travel, study, or similar purposes unless made pursuant to procedures approved by the Secretary; (4) as a grant to an organization that is not a public charity or exempt operating foundation unless the foundation exercises expenditure responsibility[90] with respect to the grant; or (5) for any non-charitable purpose. For each taxable expenditure, a tax is imposed on the foundation of 10 percent of the amount of the expenditure, and an additional tax of 100 percent is imposed on the foundation if the expenditure is not corrected. A tax of 2.5 percent of the expenditure (up to $5,000) also is imposed on a foundation manager who agrees to making a taxable expenditure knowing that it is a taxable expenditure. An additional tax of 50 percent of the amount of the expenditure (up to $10,000) is imposed on a foundation manager who refuses to agree to correction of such expenditure.

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[87] Sec. 4944. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

[88] Sec. 4944(c).

[89] Sec. 4945. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

[90] In general, expenditure responsibility requires that a foundation make all reasonable efforts and establish reasonable procedures to ensure that the grant is spent solely for the purpose for which it was made, to obtain reports from the grantee on the expenditure of the grant, and to make reports to the Secretary regarding such expenditures. Sec. 4945(h).

Lobbying and political activities

Lobbying

Under present law, an organization described in section 501(c)(3) may not engage in more than a substantial amount of lobbying. Organizations may make an election to limit their lobbying expenditures in accordance with specific rules and excise taxes.[91] Organizations not making such an election are subject to an excise tax if, as a result of lobbying expenditures during a taxable year, the organization is not described in section 501(c)(3).[92] The excise tax is five percent of the lobbying expenditures for such taxable year. In addition, a tax is imposed on an organization manager if the manager agreed to the making of a lobbying expenditure, knowing that the expenditure likely would result in the organization not being described in section 501(c)(3), unless such agreement is not willful and is due to reasonable cause. The tax is five percent of the amount of any such expenditure.

Political activities

Organizations described in section 501(c)(3) may not participate or intervene in any political campaign on behalf of (or in opposition) to any candidate for public office. This ban on political activities by section 501(c)(3) organizations may result in loss of tax exempt status. Political expenditures, i.e., amounts paid or incurred by a section 501(c)(3) organization for such participation or intervention, also are subject to an excise tax.[93] An initial tax of 10 percent of the amount of the expenditure is imposed on the organization; and an initial tax of 2.5 percent of the expenditure (not to exceed $5,000) is imposed on an organization manager who agrees to the making of a political expenditure, knowing that it is a political expenditure if such agreement is not willful and is due to reasonable cause. Additional taxes apply to the organization and the organization manager if the political expenditure is not corrected. Such additional tax on the organization manager may not exceed $10,000.

Reasons for Change

The Tax Reform Act of 1969 introduced the present-law regime of excise taxes that is applicable to certain actions of private foundations (self-dealing, failure to distribute income, excess business holdings, jeopardizing investments, and taxable expenditures). The amount of such taxes has not been changed since. The excise taxes were established to provide strong deterrents to foundations, and in some cases foundation managers, from engaging in abusive or

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[91] Secs. 501(h) and 4911.

[92] Sec. 4912. The excise tax does not apply to churches, certain other religious organizations, and private foundations. Sec. 4912(c)(2). Private foundations separately are subject to an excise tax for certain lobbying expenditures. Sec. 4945(d)(1)

[93] Sec. 4955. In the case of an organization which is formed primarily for purposes of promoting the candidacy (or prospective candidacy) of an individual for public office, political expenditures also include certain other amounts. Sec. 4955(d)(2).

disapproved transactions. In the years following passage of the 1969 Act, the IRS closely monitored the conduct of private foundations, and in 1990 the Treasury Department concluded that foundations were largely a compliant sector.[94] In subsequent years, however, audits of foundations and other section 501(c)(3) organizations generally has fallen significantly. With a decreased enforcement presence, there is an increased likelihood that private foundations are not as compliant as reported by the Treasury Department in 1990 and that the current excise tax rates, which have not increased in 35 years, are not providing a sufficient deterrent.[95] Thus, the Committee believes that it is appropriate to double the initial taxes and the dollar amount limitations on foundation manager liability. The Committee further believes that for consistency, the dollar amount limitations on organization managers subject to tax for approving participation in an excess benefit transaction should be doubled. In a similar vein, the Committee believes that the initial excise tax rates and dollar limitations on the political and excess lobbying activities of section 501(c)(3) organizations are too low to have a significant deterrent effect and that it is an appropriate minimum step to deter such conduct to double such rates and limitations.

Explanation of Provision

[The bill includes only the provisions relating to the increase in excise taxes on the lobbying and political activities of section 501(c)(3) organizations because provisions substantially similar to the provisions relating to the other excise taxes described below were enacted into law in the Pension Protection Act of 2006 (Pub. L. No. 109-280, sec. 1212) subsequent to Committee action on the bill. The following discussion describes the provision as approved by the Committee.]

Self-dealing and excess benefit transaction initial taxes and dollar limitations

For acts of self-dealing, the provision increases the initial tax on the self-dealer from five percent of the amount involved to 10 percent of the amount involved. The provision increases the initial tax on foundation managers from 2.5 percent of the amount involved to five percent of the amount involved and increases the dollar limitation on the amount of the initial and additional taxes on foundation managers per act of self-dealing from $10,000 per act to $20,000 per act. Similarly, the provision doubles the dollar limitation on organization managers of public charities and social welfare organizations for participation in excess benefit transactions from $10,000 per transaction to $20,000 per transaction.

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[94] Internal Revenue Service, "*Private Foundation Grant-Making Administrative Expenses Study*" (January 1990).

[95] A series of reports in the Boston Globe highlight many brazen abuses by private foundation managers. See, e.g., *Boston Globe*, "Some officers of charities steer assets to selves" (October 9, 2003); *Boston Globe*, "Foundation's sale of nonprofit hospital a windfall for administrator" (October 9, 2003); *Boston Globe*, "Charity money funding perks" (November 9, 2003); *Boston Globe*, "Costly furnishings come at charities' expense" (November 9, 2003); *Boston Globe*, "The trustees' perk that keeps on giving" (November 9, 2003); *Boston Globe*, "Foundations veer into business" (December 3, 2003); *Boston Globe*, "Philanthropist's millions enrich family retainers" (December 21, 2003); *Boston Globe*, "Foundation's tax returns left unchecked" (December 29, 2003).

Failure to distribute income, excess business holdings, jeopardizing investments, and taxable expenditures

The provision doubles the amounts of the initial taxes and the dollar limitations on foundation managers with respect to the private foundation excise taxes on the failure to distribute income, excess business holdings, jeopardizing investments, and taxable expenditures.

Specifically, for the failure to distribute income, the initial tax on the foundation is increased from 15 percent of the undistributed amount to 30 percent of the undistributed amount.

For excess business holdings, the initial tax on excess business holdings is increased from five percent of the value of such holdings to 10 percent of such value.

For jeopardizing investments, the initial tax of five percent of the amount of the investment that is imposed on the foundation and on foundation managers is increased to 10 percent of the amount of the investment. The dollar limitation on the initial tax on foundation managers of $5,000 per investment is increased to $10,000 and the dollar limitation on the additional tax on foundation managers of $10,000 per investment is increased to $20,000.

For taxable expenditures, the initial tax on the foundation is increased from 10 percent of the amount of the expenditure to 20 percent, the initial tax on the foundation manager is increased from 2.5 percent of the amount of the expenditure to five percent, the dollar limitation of the initial tax on foundation managers is increased from $5,000 to $10,000, and the dollar limitation of the additional tax on foundation managers is increased from $10,000 to $20,000.

Lobbying and political activities

The provision increases the rate of tax on lobbying expenditures imposed under section 4912 on the organization and on the organization manager from five percent to 10 percent of the amount of the expenditure.

For political expenditures, the provision increases the rate of the initial tax on the organization from ten percent of the amount of the expenditure to 20 percent. The provision increases the rate of the initial tax on the organization manager from 2.5 percent to five percent. In addition, the dollar limitation on the initial tax on organization mangers is increased from $5,000 to $10,000, and the dollar limitation on the additional tax on foundation managers is increased from $10,000 to $20,000.

Effective Date

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

M. Penalty for Filing Erroneous Refund Claims (sec. 413 of the bill and sec. 6662 of the Code)

Present Law

Present law imposes accuracy-related penalties on a taxpayer in cases involving a substantial valuation misstatement or gross valuation misstatement relating to an underpayment of income tax.[96] For this purpose, a substantial valuation misstatement generally means a value claimed that is at least twice (200 percent or more) the amount determined to be the correct value, and a gross valuation misstatement generally means a value claimed that is at least four times (400 percent or more) the amount determined to be the correct value.

The penalty is 20 percent of the underpayment of tax resulting from a substantial valuation misstatement and rises to 40 percent for a gross valuation misstatement. No penalty is imposed unless the portion of the underpayment attributable to the valuation misstatement exceeds $5,000 ($10,000 in the case of a corporation other than an S corporation or a personal holding company). Under present law, no penalty is imposed with respect to any portion of the understatement attributable to any item if (1) the treatment of the item on the return is or was supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed on the return or on a statement attached to the return and there is a reasonable basis for the tax treatment. Special rules apply to tax shelters.

Reasons for Change

Existing penalties are calculated on tax underpayments and not on claims for refund amounts. The Committee understands that the filing of erroneous refund claims is being used by some taxpayers to put a strain on IRS resources and to delay the resolution of tax matters. The Committee believes a meaningful penalty on a refund claim with no reasonable basis for the claimed treatment will deter the use of such claims for the purpose of impeding effective tax administration.

Explanation of Provision

The provision imposes a penalty on any taxpayer filing an erroneous claim for refund or credit. The penalty is equal to 20 percent of the disallowed portion of the claim for refund or credit for which there is no reasonable basis for the claimed tax treatment. The penalty does not apply to any portion of the disallowed portion of the claim for refund or credit for which the accuracy-related or fraud penalty is imposed.

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[96] Sec. 6662(b)(3) and (h).

Effective Date

The provision is effective for claims for refund or credit filed after the date of enactment or for claims for refund or credit filed prior to the date of enactment that are not withdrawn within 30 days after the date of enactment.

N. Provisions Relating to Appraisers and Substantial and Gross Overstatement of Valuations of Property (secs. 170, 6662, 6664, 6696, and new sec. 6695A of the Code)

Present Law[97]

Taxpayer penalties

Present law imposes accuracy-related penalties on a taxpayer in cases involving a substantial valuation misstatement or gross valuation misstatement relating to an underpayment of income tax.[98] For this purpose, a substantial valuation misstatement generally means a value claimed that is at least twice (200 percent or more) the amount determined to be the correct value, and a gross valuation misstatement generally means a value claimed that is at least four times (400 percent or more) the amount determined to be the correct value.

The penalty is 20 percent of the underpayment of tax resulting from a substantial valuation misstatement and rises to 40 percent for a gross valuation misstatement. No penalty is imposed unless the portion of the underpayment attributable to the valuation misstatement exceeds $5,000 ($10,000 in the case of a corporation other than an S corporation or a personal holding company). Under present law, no penalty is imposed with respect to any portion of the understatement attributable to any item if (1) the treatment of the item on the return is or was supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed on the return or on a statement attached to the return and there is a reasonable basis for the tax treatment. Special rules apply to tax shelters.

Present law also imposes an accuracy-related penalty on substantial or gross estate or gift tax valuation understatements.[99] In general, there is a substantial estate or gift tax understatement if the value of any property claimed on any return is 50 percent or less of the amount determined to be the correct amount, and a gross estate or gift tax understatement if such value is 25 percent or less of the amount determined to be the correct amount.

In addition, the accuracy-related penalties do not apply if a taxpayer shows there was reasonable cause for an underpayment and the taxpayer acted in good faith.[100]

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[97] Present law refers to the law in effect on the date of Committee action on the bill. It does not reflect the changes made by the Pension Protection Act of 2006, Pub. L. No. 109-280 (August 17, 2006).

[98] Sec. 6662(b)(3) and (h).

[99] Sec. 6662(g) and (h).

[100] Sec. 6664(c).

Penalty for aiding and abetting understatement of tax

A penalty is imposed on a person who: (1) aids or assists in or advises with respect to a tax return or other document; (2) knows (or has reason to believe) that such document will be used in connection with a material tax matter; and (3) knows that this would result in an understatement of tax of another person. In general, the amount of the penalty is $1,000. If the document relates to the tax return of a corporation, the amount of the penalty is $10,000.

Qualified appraisals

Present law requires a taxpayer to obtain a qualified appraisal for donated property with a value of more than $5,000, and to attach an appraisal summary to the tax return.[101] Treasury Regulations state that a qualified appraisal means an appraisal document that, among other things: (1) relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the appraised property and not later than the due date (including extensions) of the return on which a deduction is first claimed under section 170; (2) is prepared, signed, and dated by a qualified appraiser; (3) includes (a) a description of the property appraised; (b) the fair market value of such property on the date of contribution and the specific basis for the valuation; (c) a statement that such appraisal was prepared for income tax purposes; (d) the qualifications of the qualified appraiser; and (e) the signature and taxpayer identification number of such appraiser; and (4) does not involve an appraisal fee that violates certain prescribed rules.[102]

Qualified appraisers

Treasury Regulations define a qualified appraiser as a person who holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis, is qualified to make appraisals of the type of property being valued (as determined by the appraiser's background, experience, education and membership, if any, in professional appraisal associations), is independent, and understands that an intentionally false or fraudulent overstatement of the value of the appraised property may subject the appraiser to civil penalties.[103]

Appraiser oversight

The Secretary is authorized to regulate the practice of representatives of persons before the Department of the Treasury ("Department").[104] After notice and hearing, the Secretary is authorized to suspend or disbar from practice before the Department or the Internal Revenue Service ("IRS") a representative who is incompetent, who is disreputable, who violates the rules

[101] Sec. 170(f)(11).

[102] Treas. Reg. sec. 1.170A-13(c)(3).

[103] Treas. Reg. sec. 1.170A-13(c)(5)(i).

[104] 31 U.S.C. sec. 330.

regulating practice before the Department or the IRS, or who (with intent to defraud) willfully and knowingly misleads or threatens the person being represented (or a person who may be represented).

The Secretary also is authorized to bar from appearing before the Department or the IRS, for the purpose of offering opinion evidence on the value of property or other assets, any individual against whom a civil penalty for aiding and abetting the understatement of tax has been assessed. Thus, an appraiser who aids or assists in the preparation or presentation of an appraisal will be subject to disciplinary action if the appraiser knows that the appraisal will be used in connection with the tax laws and will result in an understatement of the tax liability of another person. The Secretary has authority to provide that the appraisals of an appraiser who has been disciplined have no probative effect in any administrative proceeding before the Department or the IRS.

Reasons for Change

Determining the correct value of property for tax purposes is essential to ensure that a taxpayer's return accurately states the amount of tax required to be shown on a return. Accordingly, present law imposes penalties if the value of property claimed by a taxpayer for income, estate, or gift tax purposes results in a substantial or gross valuation misstatement or understatement. The Committee believes, however, that the present-law definitions of a substantial and a gross valuation misstatement or understatement allow taxpayers, and those who prepare appraisals of property for taxpayers, too much leeway to misstate value without regard to penalty. Thus, the Committee believes that it is appropriate to revise the definitions of a substantial and a gross valuation misstatement or understatement for income, gift, and estate tax purposes in order to reduce the amount of misstatement or understatement that may be made without penalty. The Committee also believes that it is appropriate to impose a penalty on appraisers who prepare appraisals of property in connection with a tax return (whether for income, estate, or gift tax purposes) if, as a result of the appraisal, a penalty for substantial or gross misstatement or understatement of property results. In addition, because of the importance of ensuring that property is valued correctly, the Committee believes it is appropriate to impose new standards for appraisers and appraisals, and to improve the process for instituting disciplinary proceedings against appraisers.

Explanation of Provision

[The bill does not include the provision as approved by the Committee because an identical or substantially similar provision was enacted into law in the Pension Protection Act of 2006 (Pub. L. No. 109-280, sec. 1219) subsequent to Committee action on the bill. The following discussion describes the provision as approved by the Committee.]

Taxpayer penalties

The provision lowers the thresholds for imposing accuracy-related penalties on a taxpayer. Under the provision, a substantial valuation misstatement exists when the claimed value of any property is 150 percent or more of the amount determined to be the correct value. A gross valuation misstatement occurs when the claimed value of any property is 200 percent or more of the amount determined to be the correct value.

The provision tightens the thresholds for imposing accuracy-related penalties with respect to the estate or gift tax. Under the provision, a substantial estate or gift tax valuation misstatement exists when the claimed value of any property is 65 percent or less of the amount determined to be the correct value. A gross estate or gift tax valuation misstatement exists when the claimed value of any property is 40 percent or less of the amount determined to be the correct value.

Under the provision, the reasonable cause exception to the accuracy-related penalty does not apply in the case of gross valuation misstatements.

Appraiser oversight

Appraiser penalties

The provision establishes a civil penalty on any person who prepares an appraisal that is to be used to support a tax position if such appraisal results in a substantial or gross valuation misstatement. The penalty is equal to the greater of $1,000 or 10 percent of the understatement of tax resulting from a substantial or gross valuation misstatement, up to a maximum of 125 percent of the gross income derived from the appraisal. Under the provision, the penalty does not apply if the appraiser establishes that it was "more likely than not" that the appraisal was correct.

Disciplinary proceeding

The provision eliminates the requirement that the Secretary assess against an appraiser the civil penalty for aiding and abetting the understatement of tax before such appraiser may be subject to disciplinary action. Thus, the Secretary is authorized to discipline appraisers after notice and hearing. Disciplinary action may include, but is not limited to, suspending or barring an appraiser from: preparing or presenting appraisals on the value of property or other assets to the Department or the IRS; appearing before the Department or the IRS for the purpose of offering opinion evidence on the value of property or other assets; and providing that the appraisals of an appraiser who has been disciplined have no probative effect in any administrative proceeding before the Department or the IRS.

Qualified appraisers

The provision defines a qualified appraiser as an individual who (1) has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements to be determined by the IRS in regulations; (2) regularly performs appraisals for which he or she receives compensation; (3) can demonstrate verifiable education and experience in valuing the type of property for which the appraisal is being performed; (4) has not been prohibited from practicing before the IRS by the Secretary at any time during the three years preceding the conduct of the appraisal; and (5) is not excluded from being a qualified appraiser under applicable Treasury regulations.

Qualified appraisals

The provision defines a qualified appraisal as an appraisal of property prepared by a qualified appraiser (as defined by the provision) in accordance with generally accepted appraisal standards and any regulations or other guidance prescribed by the Secretary.

Effective Date

The provision amending the accuracy-related penalty applies to returns filed after the date of enactment. The provision establishing a civil penalty that may be imposed on any person who prepares an appraisal that is to be used to support a tax position if such appraisal results in a substantial or gross valuation misstatement applies to appraisals prepared with respect to returns or submissions filed after the date of enactment. The provisions relating to appraiser oversight apply to appraisals prepared with respect to returns or submissions filed after the date of enactment.

TITLE V – CONFIDENTIALITY AND DISCLOSURE

A. Collection Activities with Respect to a Joint Return Disclosable to Either Spouse Based on Oral Request (sec. 501 of the bill and sec. 6103 of the Code)

Present Law

Section 6103(e) concerns disclosures to persons with a material interest. Section 6103(e)(1)(B) requires, upon written request, the IRS to allow the inspection or disclosure of a joint return to either of the individuals with respect to whom the return is filed. Section 6103(e)(7) permits the IRS to disclose return information to the same persons who may have access to a return under the other proposals of section 6103(e). Requests for information pursuant to section 6103(e)(7) do not have to be in writing. Pursuant to section 6103(e)(7) and section 6103(e)(1)(B), either spouse may obtain return information regarding a joint return, including collection information without making a written request.

In response to concerns that former spouses were not able to obtain information regarding collection activities relating to a joint return, the Taxpayer Bill of Rights 2 added section 6103(e)(8).[105] When a deficiency is assessed with respect to a joint return and the individuals are no longer married or no longer reside in the same household, upon request in writing by either of such individuals, the IRS is required to disclose: (1) whether the IRS has attempted to collect such deficiency from the other individual; (2) the general nature of such collection activities; and (3) the amount collected.[106]

The Treasury Inspector General for Tax Administration conducts semiannual reports involving a review and certification of whether the Secretary is complying with the requirements of disclosing information to an individual filing a joint return on collection activity involving the other individual filing the return.[107]

Reasons for Change

The Committee believes that former spouses should be able to receive collection information with respect to a joint return in the same manner as if they were current spouses. Thus, a former spouse should not be required to make a written request, when in cases in which the spouses were still married, a written request would not be required.

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[105] "The IRS does not routinely disclose collection information to a former spouse that relates to tax liabilities attributable to a joint return that was filed when married." Joint Committee on Taxation, *General Explanation of Taxation Legislation Enacted in the 104th Congress* (JCS-12-96), December 18, 1996 at 29.

[106] Sec. 6103(e)(8).

[107] Sec. 7803(d)(1)(B).

Explanation of Provision

The provision eliminates the requirement for former spouses to make a written request for disclosure of collection activities with respect to a joint return. Section 312 of this bill eliminates the Inspector General for Tax Administration's reporting requirement associated with the disclosure of collection activities with respect to a joint return.

Effective Date

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

B. Prohibition of Disclosure of Taxpayer Identification Information with Respect to Disclosure of Accepted Offers-in-Compromise (sec. 502 of the bill and sec. 6103 of the Code)

Present Law

Section 6103 permits the IRS to disclose return information to members of the general public to permit inspection of accepted offers in compromise.[108] For one year after the date of execution, a copy of the Form 7249 (Offer Acceptance Report) for each accepted offer in compromise with respect to any liability for a tax imposed by Title 26 is made available for inspection and copying in the location designated by the Compliance Area Director or Compliance Services Field Director within the Small Business and Self-Employed Division of the taxpayer's geographic area of residence.[109] Currently, this form contains the taxpayer identification number of the taxpayer, e.g., the social security number in the case of an individual taxpayer, along with the taxpayer's name and full address.

Reasons for Change

The IRS's determination to accept an offer-in-compromise is based on decisions relating to analysis of the individual taxpayer's facts and circumstances and financial situation. Summaries of accepted offers-in-compromise, Form 7249 (Offer Acceptance Report), are available for public inspection in the IRS district offices. Currently, this form contains the taxpayer identification number of the taxpayer, e.g., the social security number in the case of an individual taxpayer, along with the taxpayer's name and full address. The Committee believes that if disclosure is warranted, such disclosure should be limited to the least amount of information necessary. The Committee believes that the disclosure of a taxpayer's taxpayer identification number is unnecessary and an unwarranted invasion of privacy. In addition, the Committee believes such disclosure provides an opportunity for identity fraud and abuse.

Explanation of Provision

The provision prohibits the disclosure of the taxpayer's taxpayer identification number as part of the publicly available summaries of accepted offers-in-compromise.

Effective Date

The provision applies to disclosures made after the date of enactment.

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[108] Sec. 6103(k)(l).

[109] Treas. Reg. sec. 601.702(d)(8).

C. Compliance By Contractors with Confidentiality Safeguards (sec. 503 of the bill and sec. 6103 of the Code)

Present Law

Section 6103 permits the disclosure of returns and return information to State agencies, as well as to other Federal agencies for specified purposes. Section 6103(p)(4) requires, as conditions of receiving returns and return information, that State agencies (and others) provide safeguards as prescribed by the Secretary of the Treasury by regulation to be necessary or appropriate to protect the confidentiality of returns or return information.[110] It also requires that a report be furnished to the Secretary at such time and containing such information as prescribed by the Secretary regarding the procedures established and utilized for ensuring the confidentiality of returns and return information.[111] After an administrative review, the Secretary may take such actions as are necessary to ensure these requirements are met, including the refusal to disclose returns and return information.[112]

Under present law, employees of a State tax agency may disclose returns and return information to contractors for tax administration purposes.[113] These disclosures can be made only to the extent necessary to procure contractually equipment, other property, or the providing of services, related to tax administration.[114]

The contractors can make redisclosures of returns and return information to their employees as necessary to accomplish the tax administration purposes of the contract, but only to contractor personnel whose duties require disclosure.[115] Treasury regulations prohibit redisclosure to anyone other than contractor personnel without the written approval of the IRS.[116]

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[110] Sec. 6103(p)(4)(D).

[111] Sec. 6103(p)(4)(E).

[112] Sec. 6103(p)(4) (flush language) and (7); Treas. Reg. sec. 301.6103(p)(7)-1.

[113] Sec. 6103(n) and Treas. Reg. sec. 301.6103(n)-1(a). "Tax administration" includes "the administration, management, conduct, direction, and supervision of the execution and application of internal revenue laws or related statutes (or equivalent laws and statutes of a State)…" Sec. 6103(b)(4).

[114] Treas. Reg. sec. 301.6013(n)-1(a). Such services include the processing, storage, transmission or reproduction of such returns or return information, the programming, maintenance, repair, or testing of equipment or other property, or the providing of other services for purposes of tax administration.

[115] Treas. Reg. sec. 301.6103(n)-1(a) and (b). A disclosure is necessary if such procurement or the performance of such services cannot otherwise be reasonably, properly, or economically accomplished without such disclosure. Treas. Reg. sec. 301.6103(n)-1(b). The regulations limit the quantity of information to that needed to perform the contract.

[116] Treas. Reg. sec. 301.6103(n)-1(a).

By regulation, all contracts must provide that the contractor will comply with all applicable restrictions and conditions for protecting confidentiality prescribed by regulation, published rules or procedures, or written communication to the contractor.[117] Failure to comply with such restrictions or conditions may cause the IRS to terminate or suspend the duties under the contract or the disclosures of returns and return information to the contractor.[118] In addition, the IRS can suspend disclosures to the State tax agency until the IRS determines that the conditions are or will be satisfied.[119] The IRS may take such other actions as deemed necessary to ensure that such conditions or requirements are or will be satisfied.[120]

Reasons for Change

The Committee notes the increasing use of contractors by government agencies to perform the work of the government. In the Committee's view, the IRS has insufficient resources to monitor the compliance of every contractor in addition to its other duties. Further, the Committee finds that it is appropriate to require that Federal, State and local agency recipients of tax information monitor and certify that their contractors and other agents have in place adequate safeguards to protect this information.

Explanation of Provision

The provision requires that a State, local, or Federal agency conduct on-site reviews every three years of all of its contractors or other agents receiving Federal returns and return information. If the duration of the contract or agreement is less than one year, a review is required at the mid-point of the contract. The purpose of the review is to assess the contractor's efforts to safeguard Federal returns and return information. This review is intended to cover secure storage, restricting access, computer security, and other safeguards deemed appropriate by the Secretary. Under the provision, the State, local or Federal agency is required to submit a report of its findings to the IRS and certify annually that such contractors and other agents are in compliance with the requirements to safeguard the confidentiality of Federal returns and return information. The certification is required to include the name and address of each contractor or other agent with the agency, the duration of the contract, and a description of the contract or agreement with the State, local, or Federal agency.

The provision does not apply to contracts for purposes of Federal tax administration.

This provision does not alter or affect in any way the right of the IRS to conduct safeguard reviews of State, local, or Federal agency contractors or other agents. It also does not affect the right of the IRS to initially approve the safeguard language in the contract or

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[117] Treas. Reg. sec. 301.6103(n)-1(d).

[118] Treas. Reg. sec. 301.6103(n)-1(d)(1).

[119] Treas. Reg. sec. 301.6103(n)-1(d)(2).

[120] Treas. Reg. sec. 301.6103(n)-1(d).

agreement and the safeguards in place prior to any disclosures made in connection with such contracts or agreements.

Effective Date

The provision is effective for disclosures made after the date of enactment. The first certification is required to be made with respect to the portion of calendar year 2006 following the date of enactment.

D. Higher Standards for Requests for and Consents to Disclosure (sec. 504 of the bill and sec. 6103 of the Code)

Present Law

In general

As a general rule, returns and return information are confidential and cannot be disclosed unless authorized by Title 26.[121] Under section 6103(c), a taxpayer may designate in a request or consent to the disclosure by the IRS of his or her return or return information to a third party. Treasury regulations set forth the requirements for such consent.[122] The request or consent may be written or nonwritten form. The Treasury regulations require that the taxpayer sign and date a written consent. At the time the consent is signed and dated by the taxpayer, the written document must indicate (1) the taxpayer's taxpayer identity information; (2) the identity of the person to whom disclosure is to be made; (3) the type of return (or specified portion of the return) or return information (and the particular data) that is to be disclosed; and (4) the taxable year covered by the return or return information. The regulations also require that the consent be submitted within 60 days of the date signed and dated, however, at the time of submission, the IRS generally is unaware of whether a consent form was completed or dated after the taxpayer signs it. Present law does not require that a recipient receiving returns or return information by consent maintain the confidentiality of the information received. Under present law, the recipient is also free to use the information for purposes other than for which the information was solicited from the taxpayer.

Section 6103(c) consents are often used in connection with mortgage loan applications. Mortgage originators qualify loan applicants as meeting or not meeting the requirements for loan approval. This process involves the verification and investigation of information and conditions. If the loan is granted, the mortgage originator may use its own money to fund the loan. Alternatively, another entity, an "investor," may buy the loan and provide the money. Investors typically perform a re-investigation of loans received for funding. Such re-investigations may include verification through the IRS of the tax return provided by the taxpayer to the mortgage originator.

Usually the mortgage originator does not know which investor will ultimately fund the loan. Thus, at the time of application, the originator asks the borrower/taxpayer to sign a consent (Form 4506) designating the originator as the third party to receive the taxpayer's returns. Subsequently, at closing, the investor may request that the originator obtain another Form 4506 naming the investor as the third party to receive the taxpayer's return.

Ostensibly to avoid confusion over why the taxpayer would be authorizing a party other than the originator to receive his tax return, the taxpayer may be asked to sign a blank Form 4506

[121] Sec. 6103(a).

[122] Treas. Reg. sec. 301.6103(c)-1.

at closing. In some cases, mortgage originators ask taxpayers not to date the Form 4506. This allows the form to be submitted to the IRS at a later date, often months or years later, for purposes of mortgage resale.

Criminal penalties

Under section 7206, it is a felony to willfully make and subscribe any document that contains or is verified by a written declaration that it is made under penalties of perjury and which such person does not believe to be true and correct as to every material matter.[123] Upon conviction, such person may be fined up to $100,000 ($500,000 in the case of a corporation) or imprisoned up to 3 years, or both, together with the costs of prosecution.

Under section 7213, criminal penalties apply to: (1) willful unauthorized disclosures of returns and return information by Federal and State employees and other persons; (2) the offering of any item of material value in exchange for a return or return information and the receipt of such information pursuant to such an offer; and (3) the unauthorized disclosure of return information received by certain shareholders under the material interest proposal of section 6103. Under section 7213, a court can impose a fine up to $5,000, up to five years imprisonment, or both, together with the costs of prosecution. If the offense is committed by a Federal employee or officer, the employee or officer will be discharged from office upon conviction.

The willful and unauthorized inspection of returns and return information can subject Federal and State employees and others to a maximum fine of $1,000, up to a year in prison, or both, in addition to the costs of prosecution. If the offense is committed by a Federal employee or officer, the employee or officer will be discharged from office upon conviction.

Civil damage remedies for unauthorized disclosure or inspection

If a Federal employee makes an unauthorized disclosure or inspection, a taxpayer can bring suit against the United States in Federal district court. If a person other than a Federal employee makes an unauthorized disclosure or inspection, suit may be brought directly against such person. No liability results from a disclosure based on a good faith, but erroneous, interpretation of section 6103. A disclosure or inspection made at the request of the taxpayer will also relieve liability.

Upon a finding of liability, a taxpayer can recover the greater of $1,000 per act of unauthorized disclosure (or inspection), or the sum of actual damages plus, in the case of an inspection or disclosure that was willful or the result of gross negligence, punitive damages. The taxpayer may also recover the costs of the action and, if found to be a prevailing party, reasonable attorney fees.

The taxpayer has two years from the date of the discovery of the unauthorized inspection or disclosure to bring suit. The IRS is required to notify a taxpayer of an unauthorized inspection

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[123] Sec. 7206(1).

or disclosure as soon as practicable after any person is criminally charged by indictment or information for unlawful inspection or disclosure.

Reasons for Change

The Committee does not believe that the practice of asking taxpayers to sign blank or undated consent forms is appropriate. While recognizing that investors may want to minimize their risks in buying a loan, the Committee finds that these practices can abuse the taxpayer consent process. It is doubtful that a taxpayer is aware that by not dating the form, it could be used months or years after the date it is executed. Taxpayers may be unaware that a blank consent form which does not designate a recipient can be used for purposes other than those related to the transaction under which the request for consent arose.

In addition, the IRS does not have the resources to verify that the return information was used solely for the stated purpose. The IRS estimates that it receives annually more than 800,000 requests from taxpayers directing that their returns or return information be sent to a third party. Examples of third party entities to which the IRS provides information include financial institutions (including the mortgage banking industry), colleges and universities, and Federal, State, and local governmental entities.

The Committee believes that to preserve the integrity of the consent process, a penalty must be placed on the third party soliciting a taxpayer to sign an undated or otherwise incomplete consent. Consistent with a taxpayer's reasonable expectation of privacy, the Committee believes that limitations should be placed on the use of returns and return information obtained by consent.

Explanation of Provision

The provision requires the consent form prescribed by the IRS to contain a warning, prominently displayed, informing the taxpayer that he or she should not sign the form unless it is complete. The provision requires the consent form to state that if the taxpayer believes there is an attempt to coerce him to sign an incomplete or blank form, the taxpayer should report the matter to the Treasury Inspector General for Tax Administration. The telephone number and address for the Treasury Inspector General for Tax Administration must be included on the form. The returns and return information of any taxpayer disclosed to a designee of the taxpayer for a purpose specified in writing, electronically, or orally may be disclosed or used by such persons only for the purpose of, and to the extent necessary in, accomplishing the purpose for the disclosure specified and cannot be disclosed or used for any other purpose. The provision makes a violation of these requirements, or use or disclosure of information obtained by consent for purposes not permitted by section 6103, punishable by a civil penalty.

The Secretary of the Treasury is required to submit a report to Congress on compliance with the designation and certification requirements no later than 18 months after the date of enactment. Such report must evaluate (on the basis of random sampling) whether the provision is achieving its purpose, whether requesters and submitters are continuing to evade the purpose of the provision, whether the sanctions are adequate, and whether additional provisions are necessary or appropriate to better achieve the purposes of the provision.

Any request for or consent to disclose any return or return information under section 6103(c) made before the date of enactment of the provision remains in effect until the earlier of the date such request or consent is otherwise terminated or the date three years after the date of enactment.

Effective Date

The provision applies to requests and consents made three months after the date of enactment.

E. Civil Damage Remedies for Unauthorized Disclosure or Inspection (sec. 505 of the bill and sec. 7431 of the Code)

Present Law

If a Federal employee makes an unauthorized disclosure or inspection, a taxpayer can bring suit against the United States in Federal district court. If a person other than a Federal employee makes an unauthorized disclosure or inspection, suit may be brought directly against such person. No liability results from a disclosure based on a good faith, but erroneous, interpretation of section 6103. A disclosure or inspection made at the request of the taxpayer will also relieve liability.

Upon a finding of liability, a taxpayer can recover the greater of $1,000 per act of unauthorized disclosure (or inspection), or the sum of actual damages plus, in the case of an inspection or disclosure that was willful or the result of gross negligence, punitive damages. The taxpayer may also recover the costs of the action and, if found to be a prevailing party, reasonable attorney fees.

The taxpayer has two years from the date of the discovery of the unauthorized inspection or disclosure to bring suit. The IRS is required to notify a taxpayer of an unauthorized inspection or disclosure as soon as practicable after any person is criminally charged by indictment or information for unlawful inspection or disclosure.

Reasons for Change

Currently, the IRS is not required to notify a taxpayer that an unlawful disclosure or inspection of the taxpayer's return or return information has occurred until the offender has been charged by criminal indictment or information. Accordingly, the Committee believes that the IRS should provide notice to taxpayers if an administrative determination is made as to any disciplinary or adverse action against an IRS employee when returns or return information have been unlawfully accessed or disclosed. The Committee also believes that it is important that such notice include the date of inspection or disclosure and the rights of the affected taxpayer.

The Committee believes that a taxpayer should exhaust all administrative remedies within the IRS prior to receiving an award of damages.

The Committee believes that the Secretary of Treasury should report annually to the Committee on Finance of the Senate and the Committee on Ways and Means of the House of Representatives when damage claim payments are made from the United States Judgment Fund.

The Committee also believes that the IRS should provide as part of its public annual report information on unauthorized disclosures or inspections of return and return information. The Committee believes such information will allow review of the enforcement efforts in this area and the extent to which taxpayer privacy is being protected.

Explanation of Provision

The provision requires the Secretary to notify a taxpayer if the IRS or, upon notice to the Secretary by a Federal or State agency, if such Federal or State agency, proposes an administrative determination as to disciplinary or adverse action against an employee arising from the employee's unauthorized inspection or disclosure of the taxpayer's return or return information. The provision requires the notice to include the date of the inspection or disclosure and the rights of the taxpayer as a result of such administrative determination.

Under the provision, in action for civil damages for unauthorized disclosure or inspection, any person who made the inspection or disclosure bears the burden of proving the existence of a good faith interpretation of section 6103 to avoid liability.

The provision adds a new exhaustion of administrative remedies requirement. A judgment for damages will not be awarded unless the court determines that the plaintiff has exhausted the administrative remedies available. The provision also clarifies that unauthorized disclosure or inspection damage claims are payable out of funds appropriated under section 1304 of title 31 of the United States Code (relating to the United States Judgment Fund). Both administrative settlements and settlements of judicial proceedings are paid out of this fund. The Secretary of the Treasury will report annually to the Committee on Finance of the Senate and the Committee on Ways and Means of the House of Representatives regarding damage claim payments made from the United States Judgment Fund.

As part of its public report on disclosures, the provision requires the Secretary to furnish information regarding the willful unauthorized disclosure and inspection of returns and return information. Such information includes the number, status, and results of: (1) administrative investigations, (2) civil lawsuits brought under section 7431 (including the amounts for which such lawsuits were settled and the amounts of damages awarded), and (3) criminal prosecutions.

Effective Date

The provision is effective: (1) for determinations made after 180 days after the date of enactment with respect to the taxpayer notice requirement; (2) for inspections and disclosures occurring on and after 180 days after the date of enactment with respect to the provisions relating to the exhaustion of administrative remedies and burden of proof; (3) 180 days after the date of enactment with respect to the payment authority; and (4) for calendar years ending after 180 days after the date of enactment with respect to the reporting requirements.

F. Expanded Disclosure in Emergency Circumstances (sec. 506 of the bill and sec. 6103 of the Code)

Present Law

Section 6103(i)(3)(B) permits the IRS to disclose return information to the extent necessary to apprise Federal or State law enforcement officials of circumstances involving an imminent danger of death or physical injury to an individual. Recipients of such information are required to adhere to certain recordkeeping, reporting, and safeguard requirements as a condition of receiving such information (sec. 6103(p)(4)). Upon completion of use of such information, the Code requires the recipient to return the information to the IRS or make the information undisclosable and furnish a report to the IRS as to the manner in which the information was made undisclosable ("destruction requirements") (sec. 6103(p)(4)(F)(i)).

Reasons for Change

Local law enforcement officials need to receive information regarding exigent circumstances in the same manner that Federal and State law enforcement officials receive such information. The Committee believes that expanding this provision to permit disclosure to local law enforcement authorities will permit more rapid response to these situations.

Explanation of Provision

The provision expands present law to permit disclosure of return information to local law enforcement authorities to apprise them of circumstances involving imminent danger of death or physical injury to an individual. The provision eliminates the recordkeeping, safeguard and destruction requirements for all such disclosures to Federal, State or local law enforcement officials.

Effective Date

The provision is effective on the date of enactment.

G. Disclosure of Taxpayer Identity for Tax Refund Purposes (sec. 507 of the bill and sec. 6103 of the Code)

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.[124] Section 6103(m) allows the IRS to give the press taxpayer identity information for this purpose.[125] Taxpayer identity includes name, mailing address, taxpayer identification number or combination thereof.

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 proposal 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.

Reasons for Change

In October 2005, the IRS announced that the IRS is seeking 84,290 taxpayers whose income tax refund checks could not be delivered in 2005. These checks totaled approximately $73 million. It is the understanding of the Committee that the current method of notifications, by newspaper, is ineffective. The Committee believes that the IRS should be able to use any method of mass communication, including the Internet, to reach a taxpayer who is due a refund.

Explanation of Provision

The provision allows the IRS to use any means of "mass communication," including the Internet, to notify the taxpayer of an undelivered refund. It limits the amount of return information that may be disclosed to a taxpayer's name, and the city, State, and zip code of the taxpayer's mailing address.

Effective Date

The provision is effective upon date of enactment.

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[124] Sec. 6103(m)(1). This section provides:

> The Secretary may disclose taxpayer identity information to the press or other media for purposes of notifying persons entitled to tax refunds when the Secretary, after reasonable effort and lapse of time, has been unable to locate such persons.

[125] Sec. 6103(m)(1), and (b)(6) (definition of "taxpayer identity").

H. Treatment of Public Records (sec. 508 of the bill and sec. 6103 of the Code)

Present Law

Section 6103 provides that "returns and return information shall be confidential and except as authorized by this title . . . [none of the identified persons] shall disclose any return or return information obtained by him . . ."[126] A taxpayer can sue the United States government for the unauthorized disclosure and/or inspection of returns and return information.[127] Section 6103 does not expressly address the disclosure of returns and return information made a part of the public record.

Returns and return information become part of the public record in many ways. For example, returns and return information introduced in judicial proceedings constitutes publicly available court records.[128] As another example, notices of Federal tax lien filed with the county recorder alert the public of the IRS's interest in a taxpayer's property.[129]

The courts are divided on whether section 6103 applies to publicly disclosed returns and return information. Some courts have strictly interpreted section 6103, applying it despite the information's public availability. Other courts have found that returns and return information found in the public record loses its confidential status so that a person disclosing it does not violate section 6103. Still other courts have looked to the source of the information being disclosed. These courts find that section 6103 does not protect returns and return information taken directly from a public source, while information taken directly from IRS records remains protected.

Reasons for Change

The Committee believes that Congress sought to prohibit only the disclosure of confidential tax return information. Once tax return information is made a part of the public domain, the taxpayer may no longer claim a right of privacy in that information. The Committee believes that, in general, it is inappropriate to treat information that has properly been made part of the public record as continuing to be subject to the general rules of confidentiality contained in the Code.

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[126] Sec. 6103(a).

[127] Sec. 7431.

[128] *See, e.g.,* sec. 7461 regarding the publicity of U.S. Tax Court proceedings.

[129] *See* sec. 6323(f) regarding where to file notices of Federal tax lien.

Explanation of Provision

Under the provision, the general confidentiality restrictions do not apply to returns and return information disclosed: (1) in the course of any judicial or administrative proceeding or pursuant to tax administration activities, and (2) properly made part of the public record. In a situation in which a third-party is seeking to have the IRS divulge information that would otherwise be protected by section 6103, it is expected that the third party seeking the information will be required to point to specific information in the public record that appears to duplicate that being withheld. For example, if a third party makes a Freedom of Information Act request for a record that is contained both in a publicly available court file and also in an IRS administrative file, the requester would need to provide to the IRS evidence that the information sought from the IRS is also in the court file.

Effective Date

The provision is effective before, on, and after the date of enactment.

I. Taxpayer Identification Number Matching (sec. 509 of the bill and sec. 6103 of the Code)

Present Law

A taxpayer identification number (TIN) is an identification number used by the IRS for purposes of tax administration. A TIN must be furnished on all returns, statements, or other tax related documents.[130] The Code imposes information reporting requirements upon payors of income. The Code provides that a person (the payor) required to make a return with respect to another person (the payee) must ask the payee for the identifying number prescribed for securing the proper identification of the payee and include that number in the return.[131] Typically, if there is an error with the name/TIN combination furnished by the payee, the disclosure of such error to the payor is permitted when the reportable payment is already subject to backup withholding.[132]

Reasons for Change

The Committee is concerned with the number of information returns that the IRS receives each year containing missing or incorrect name and TIN information. Therefore, the Committee believes that compliance will be greatly enhanced if payors have the ability to verify with the IRS payee TINs prior to filing information returns for reportable payments on behalf of such payees.

Explanation of Provision

The provision permits the IRS to disclose to any person required to provide a taxpayer identifying number to the IRS whether such information matches records maintained by the IRS. This will allow a payor to verify the TIN furnished by a payee prior to filing information returns for reportable payments on behalf of the payee. Under the provision, the IRS informs the payor whether there is an error with the name/TIN combination furnished by the payee. The verification is limited to whether the information provided by the payor matches the records of the IRS. The IRS will not disclose correct TINs if an error arises, as it will be the responsibility of the payor to obtain the correct TIN from the payee.

Effective Date

The provision is effective on the date of enactment.

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[130] Sec. 6109(a)(1).

[131] Sec. 6109(a)(3).

[132] Sec. 3406.

J. Form 8300 Disclosures (sec. 510 of the bill and sec. 6103 of the Code)

Present Law

Under the Code, any person engaged in a trade or business who receives more than $10,000 in cash in one transaction (or in two or more related transactions) is required to report the receipt of cash to the IRS and the Financial Crimes Enforcement Network (FinCEN) on Form 8300 (Report of Cash Payments Over $10,000 Received in a Trade or Business).[133] Any Federal agency, State or local government agency, or foreign government agency may have access, upon written request, to the information contained in returns filed under section 6050I. The Code provides that disclosures of information from Form 8300 be made on the same basis and subject to the same conditions as apply to disclosures of information filed on Currency Transaction Reports under the Bank Secrecy Act.[134] This proposal however, cannot be used to obtain disclosures for tax administration purposes. The general safeguard requirements of the Code apply to such disclosures.[135] For example, as a condition of disclosure, requesting agencies must file with the IRS a report describing the procedures established and utilized by the agency for ensuring the confidentiality of return information.

Reasons for Change

Form 8300 is similar to a Currency Transaction Report, which is required to be filed by financial institutions in connection with currency transactions of more than $10,000. Both Form 8300 and Currency Transaction Reports are filed with the IRS; however, Title 31 governs Currency Transaction Reports. The USA Patriot Act (Pub. L. No. 107-56) imposed a duplicate reporting requirement for Form 8300 information under Title 31 of the U.S. Code, in part to facilitate law enforcement's access to such information. The Code's safeguard requirements for return information were perceived to be cumbersome in comparison to the disclosure rules imposed on similar information governed by Title 31, such as Currency Transaction Reports. Because the Code envisions that Form 8300 information will be disclosed on the same basis and subject to the same conditions as Currency Transaction Reports, and a duplicate report of the same information is required under Title 31, the Committee believes it is appropriate to conform treatment and remove the specific Title 26 safeguards with respect to these information reports.

Explanation of Provision

The provision repeals the safeguard requirements applicable to the disclosure of returns filed reflecting cash receipts of more than $10,000 received in a trade or business.

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[133] Sec. 6050I and 31 U.S.C. sec. 5331.

[134] 31 U.S.C. sec. 5313.

[135] Sec. 6103(p)(4).

Effective Date

The provision is effective on the date of enactment.

K. Expanded Definition of Return Preparer for Purposes of Sections 6713 and 7216 (sec. 511 of the bill and secs. 6713 and 7216 of the Code)

Present Law

Section 7216 imposes criminal penalties on return preparers of income tax returns who knowingly or recklessly make unauthorized disclosures or use information furnished to them in connection with the preparation of an income tax return. A violation of section 7216 is punishable by a fine of not more than $1,000, one year of imprisonment, or both, together with the costs of prosecution. The penalties do not apply to disclosures authorized by the Code or made pursuant to an order of a court. The penalties also do not apply to the use of information in the preparation of State and local tax returns and declarations of estimated tax of the person to whom the information relates. Finally, the penalties do not apply to any disclosure or use permitted under the applicable Treasury regulations.

In addition, tax return preparers are subject to civil penalties under section 6713 for disclosure or use of tax return information unless an exception under the rules of section 7216 applies to the disclosure or use. The civil penalty is $250 for each unauthorized disclosure or use, but the total amount imposed on a person for any calendar year cannot exceed $10,000.

Under present law Treasury regulations, "tax return preparer" means any person:

- who is engaged in the business of preparing tax returns,
- who is engaged in the business of providing auxiliary services in connection with the preparation of tax returns,
- who is remunerated for preparing, or assisting in preparing, a tax return for any other person, or
- who, as part of his duties or employment with any person described in (1), (2) or (3) above, performs services which assist in the preparation of, or assist in providing auxiliary services in connection with the preparation of, a tax return.[136]

A person is engaged in the business of preparing tax returns if, in the course of his business, he holds himself out to taxpayers as a person who prepares tax returns, whether or not tax return preparation is his sole business activity and whether or not he charges a fee for such services. A person is engaged in the business of providing auxiliary services in connection with the preparation of tax returns if, in the course of his business, he holds himself out to tax return preparers or taxpayers as a person who performs such auxiliary services, whether or not providing auxiliary services is his sole business activity and whether or not he charges a fee for such services. For example, a person part or all of whose business is to provide a computerized tax return processing service based on tax return information furnished by another person is a tax return preparer.

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[136] Treas. Reg. 301.7216-1(b)(2).

A person is not a tax return preparer merely because he leases office space to a tax return preparer, furnishes credit to a taxpayer whose tax return is prepared by a tax return preparer, or otherwise performs some service which only incidentally relates to the preparation of tax returns.

Reasons for Change

The privacy, security and accuracy of tax return information is a cornerstone of our nation's system of voluntary tax compliance. Laws governing the use or disclosure of tax return information and preparer penalties rely on the definition of a return preparer for their application. Changes in technology and business practices have made existing definitions of a return preparer outdated. Computer hardware and software, and electronic filing technology, were not commonly used when the existing definition of a tax return preparer was developed. Innovative sales and marketing techniques, including the preparation of a tax return in exchange for use of the tax refund as a down payment for a product or service, recently have become more commonplace.

The Committee believes that the definition of a return preparer should be updated to reflect current technology and business practices so that the confidentiality of taxpayer information is secure and to promote voluntary tax compliance. The definition of a return preparer should include preparers of returns other than income tax returns, those who do not charge a fee, and those for whom tax return preparation is not a sole business activity. Those who develop software, electronic return originators/authorized IRS e-file providers, and contractors performing services in connection with tax return preparation, also should be included in the definition of a tax return preparer.

Explanation of Provision

The provision expands the return preparer penalties beyond income tax returns to other tax returns, including estate and gift tax returns, employment tax, and excise tax returns.

The provision modifies the regulatory definition of tax return preparer to include any person who assists in preparing tax returns for compensation or holds himself out to tax return preparers or taxpayers as a person who prepares or assists in preparing tax returns, regardless of whether tax return preparation is the person's sole business activity and regardless of whether the person charges a fee for tax return preparation services. The provision also specifically includes as a tax return preparer, a person who develops software that is used to prepare or file a tax return, electronic return originators/authorized IRS e-file providers, as well as contractors of the tax return preparer performing services in connection with tax return preparation.

Effective Date

The provision is effective returns prepared after the date of enactment.

L. Restrict the Use and Disclosure of Taxpayer Information by Return Preparers for Nontax Purposes and Offshore Disclosures (sec. 512 of the bill and sec. 7216 of the Code)

Present Law

Section 7216 imposes criminal penalties on return preparers of income tax returns who knowingly or recklessly make unauthorized disclosures or use information furnished to them in connection with the preparation of an income tax return. The criminal penalties do not apply to disclosures authorized by the Code or made pursuant to an order of a court. The penalties also do not apply to the use of information in the preparation of State and local tax returns and declarations of estimated tax of the person to whom the information relates. Finally, the penalties do not apply to any disclosure or use permitted under the applicable Treasury regulations.

The Treasury regulations set forth circumstances under which a tax return preparer may disclose or use a taxpayer's tax return information without first obtaining the taxpayer's consent and those circumstances for which the formal consent of the taxpayer is required.

Disclosure or use without formal consent of taxpayer

Disclosure or use of information in the case of related taxpayers

Taxpayer consent is not required for the disclosure or use of information in the case of related taxpayers. A tax return preparer may use, in preparing a tax return of a second taxpayer, and may disclose to such second taxpayer in the form in which it appears on such return, any tax return information which the preparer obtained from a first taxpayer if

- The second taxpayer is related to the first taxpayer,
- The first taxpayer's tax interest in such information is not adverse to the second taxpayer's tax interest in such information, and
- The first taxpayer has not expressly prohibited such disclosure or use.

One taxpayer is related to another taxpayer if they have any one of the following relationships: husband and wife, child and parent, grandchild and grandparent, partner and partnership, trust or estate and fiduciary, corporation and shareholder, or members of a controlled group of corporations.

Other permissible disclosures without consent

- Consent of the taxpayer also is not required for the following disclosures:
- Disclosures pursuant to an order of a court or a Federal or State agency.
- Disclosures for use in revenue investigations or court proceedings. Disclosure for use in revenue investigations or court proceedings in connection with investigations of the return preparer by the IRS or for use in connection with proceedings involving such return preparer before a court or grand jury.

- Certain disclosures by lawyers and accountants to other members or employees of the firm.137
- Corporate fiduciaries. A trust company, trust department of a bank or other corporate fiduciary which prepares a tax return for a taxpayer to or for who it renders fiduciary, investment, or other custodial or management services may (1) disclose or use the tax return information in the ordinary course of rendering services to or for the taxpayer or (2) with the express or implied consent of the taxpayer, make such information available to the taxpayer's attorney, accountant, or investment advisor.
- Disclosure to the taxpayer's fiduciary. If the taxpayer dies, becomes incompetent, insolvent or bankrupt, or his assets are placed in conservatorship or receivership after furnishing tax return information to a tax return preparer, the tax return preparer may disclosure such information to the duly appointed fiduciary of the taxpayer or his estate, or to the duly authorized agent of such fiduciary.
- Disclosure by tax return preparer to tax return processor. A tax return preparer may disclose tax return information to another tax return preparer for the purpose of having the second tax return preparer transfer that information to and compute the tax liability on, a tax return of such taxpayer by means of electronic, mechanical, or other form of tax return processing service.
- Disclosure by one officer, employee or member to another. Transfers of tax return information between officers, employees and members of the same firm for the purpose of performing services which assist in the preparation of, or assist in providing auxiliary services in connection with the preparation of, the tax return of a taxpayer by or for whom the information was furnished.
- Identical information obtained from other sources. No restrictions are placed on identical tax return information if obtained other than in connection with the preparation of, or providing auxiliary services in connection with the preparation of, a tax return.
- Disclosure or use of information in the preparation or audit of State returns.
- Retention of records. A tax return preparer may retain tax return information of the taxpayer and may use such information in connection with the preparation of other

[137] Tax return preparers who are lawyers or accountants may disclose such information to another member or employee of the preparer's firm who may use it to render other legal or accounting services to the taxpayer; and may (1) take such return information into account and may act upon it in the course of performing legal or accounting services for a client other than the taxpayer or (2) disclose such information to another employee or member of the preparer's law or accounting firm to enable that other employee or member to take information into account and act upon it in the course of performing legal or accounting services for a client other than the taxpayer when such information is or may be relevant to the subject matter of such legal or accounting services for the other client and its consideration by those performing the services is necessary for the proper performance by them of such services. However, such information may not be disclosed to a person who is not a member or employee of the law or accounting firm unless such disclosure is authorized by another provision.

returns of the taxpayer or in connection with an audit by the IRS of any tax return.

- Lists for solicitation of tax return business. A tax return preparer may compile and maintain a list of client taxpayer names and addresses for the sole purpose of contacting the taxpayers on the list for the purpose of offering tax information or additional tax return preparation services to such taxpayers. The compiler of the list may not transfer such list except in conjunction with the sale or other disposition of the tax return preparation business of such compiler.
- Disclosures to report a crime. Disclosures to report a commission of a crime to the proper Federal, State or local official does not require consent.
- Disclosure or use of information for quality or peer reviews. Tax return information may be disclosed for the purpose of a quality or peer review to the extent necessary to accomplish the review.
- Disclosure of tax return information due to a tax return preparer's incapacity or death. In the event of incapacity or death of a tax return preparer, disclosure of tax return information may be made for the purpose of assisting the tax return preparer or his legal representative (or the representative of a deceased preparer's estate) in operating the business.

<u>Disclosure or use requiring the consent of the taxpayer</u>

<u>Use of tax return information by an affiliated group</u>

Present law Treasury regulations allow a tax return preparer to solicit a taxpayer's consent to use tax return information for services or facilities (unrelated to tax preparation) currently offered by the tax return preparer or member of the tax return preparer's affiliated group. The consent may not be made later than the time the taxpayer receives his completed tax return from the tax return preparer. A tax return preparer may not request a consent again after a taxpayer has once before refused to provide such consent.

The form of the consent is prescribed in the regulations. A separate written consent, signed by the taxpayer or his duly authorized agent or fiduciary, must be obtained for each separate use or disclosure and must contain:

- The name of the tax return preparer,
- The name of the taxpayer,
- The purpose for which the consent is being furnished,
- The date on which such consent is signed,
- A statement that the tax return information may not be disclosed or used by the tax return preparer for any purpose other than that stated in the consent, and
- A statement by the taxpayer, or his agent or fiduciary that he consents to the disclosure or use of such information.

<u>Consent to disclose tax return information to any third party</u>

Under the Treasury regulations, if a tax return preparer has obtained from a taxpayer a consent in the form described above, the tax return preparer may disclose the tax return information of such taxpayer to such third persons as the taxpayer may direct.

Present law does not require a tax return preparer to obtain the written consent of the taxpayer before disclosing such information to another tax return preparer located outside of the United States.

Reasons for Change

The use of tax return information as a source of clients or data for use in non-tax preparation lines of business is troubling to the Committee. The Committee is concerned that tax return preparers are exploiting their position of trust to market products and services unrelated to the preparation of a tax return. There has been considerable publicity regarding sales of refund anticipation loans and other financial products purchased from tax preparers, largely by low-income taxpayers, for excessive fees or low rates of return. Taxpayers may not understand how the products work, or even that they are giving consent to these products or services as part of the stack of forms they sign during the tax preparation process. As a result, the Committee believes it is appropriate to prohibit the use or disclosure of tax return information for a non-tax preparation purpose.

The Committee also is concerned with the transmission of tax return information to tax return prepares located overseas. The Committee believes it is important for a taxpayer to knowingly consent to such disclosures as the IRS may have limited ability to enforce the restrictions on the disclosure and use of tax return information should a tax return preparer located outside of the United States violate those rules. The Committee recognizes that some taxpayers with multi-national dealings may require the use of tax return preparers located in multiple countries, nevertheless, obtaining the taxpayer's consent should not be an obstacle to the performance of those services.

Explanation of Provision

The provision permits disclosure by consent only for tax preparation purposes (regardless of whether the disclosure or use is by an affiliate of the tax return preparer or a third party). Under the provision, taxpayer consents to use or disclose tax return information other than for tax purposes are not permitted. For this purpose, "use" of tax return information includes any circumstance in which a tax return preparer refers to, or relies upon, tax return information as the basis to take or permit an action. For example, if upon preparing the return, the return preparer determines that the taxpayer is due a refund and asks the taxpayer desires a refund anticipation loan, the tax return preparer is using that taxpayer's tax return information.

The provision also prohibits the sale of taxpayer return information except in conjunction with the sale of the taxpayer's business. The renting of client taxpayer lists also is prohibited under the provision. The provision does not alter the circumstances under which a taxpayer's return information may be disclosed or used without consent.

The provision also requires that a tax return preparer notify a taxpayer and obtain the taxpayer's consent before providing the taxpayer's tax return information to a person located outside of the United States. The provision directs the Secretary to prescribe a consent form that provides, among other information deemed appropriate by the Secretary, a clear statement that the taxpayer's tax return information will be disclosed to a tax return preparer located outside of the United States and that Federal tax law may not protect the taxpayer from unauthorized use or disclosure by such persons.

Effective Date

The provision is effective for disclosures and uses made after the date of enactment.

M. Disclosure to State Officials of Proposed Actions Related to Certain Section 501(c) Organizations (secs. 6103, 6104, 7213, 7213A, and 7431 of the Code)

Present Law[138]

In the case of organizations that are described in section 501(c)(3) and exempt from tax under section 501(a) or that have applied for exemption as an organization so described, present law (sec. 6104(c)) requires the Secretary to notify the appropriate State officer of (1) a refusal to recognize such organization as an organization described in section 501(c)(3), (2) a revocation of a section 501(c)(3) organization's tax-exempt status, and (3) the mailing of a notice of deficiency for any tax imposed under section 507, chapter 41, or chapter 42.[139] In addition, at the request of such appropriate State officer, the Secretary is required to make available for inspection and copying, such returns, filed statements, records, reports, and other information relating to the above-described disclosures, as are relevant to any State law determination. An appropriate State officer is the State attorney general, State tax officer, or any State official charged with overseeing organizations of the type described in section 501(c)(3).

In general, returns and return information (as such terms are defined in section 6103(b)) are confidential and may not be disclosed or inspected unless expressly provided by law.[140] Present law requires the Secretary to keep records of disclosures and requests for inspection[141] and requires that persons authorized to receive returns and return information maintain various safeguards to protect such information against unauthorized disclosure.[142] Willful unauthorized disclosure or inspection of returns or return information is subject to a fine and/or imprisonment.[143] The knowing or negligent unauthorized inspection or disclosure of returns or return information gives the taxpayer a right to bring a civil suit.[144] Such present-law protections

[138] Present law refers to the law in effect on the date of Committee action on the bill. It does not reflect the changes made by the Pension Protection Act of 2006, Pub. L. No. 109-280 (August 17, 2006).

[139] The applicable taxes include the termination tax on private foundations; taxes on public charities for certain excess lobbying expenses; taxes on a private foundation's net investment income, self-dealing activities, undistributed income, excess business holdings, investments that jeopardize charitable purposes, and taxable expenditures (some of these taxes also apply to certain non-exempt trusts); taxes on the political expenditures and excess benefit transactions of section 501(c)(3) organizations; and certain taxes on black lung benefit trusts and foreign organizations.

[140] Sec. 6103(a).

[141] Sec. 6103(p)(3).

[142] Sec. 6103(p)(4).

[143] Secs. 7213 and 7213A.

[144] Sec. 7431.

against unauthorized disclosure or inspection of returns and return information do not apply to the disclosures or inspections, described above, that are authorized by section 6104(c).

Reasons for Change

The Committee believes that State officials that are charged with oversight of certain organizations described in section 501(c) have an important and legitimate interest in receiving certain information about such organizations' tax-exempt status and tax filings, in some cases before the IRS has made a final determination with respect to an organization's tax-exempt status or liability for tax. By providing appropriate State officials with earlier access to information about the activities of certain section 501(c) organizations, State officials will be able to monitor such organizations more effectively and better protect the public's interest in assuring that organizations that have been given the benefit of tax-exemption operate consistently with their exempt purposes.

The Committee stresses the importance of maintaining the confidentiality of taxpayer return and return information and believes it is important to extend existing protections against unauthorized disclosure or inspection of return and return information to disclosures made or inspections allowed by the Secretary of return and return information regarding such section 501(c) organizations.

Explanation of Provision

[The bill does not include the provision as approved by the Committee because an identical or substantially similar provision was enacted into law in the Pension Protection Act of 2006 (Pub. L. No. 109-280, sec. 1224) subsequent to Committee action on the bill. The following discussion describes the provision as approved by the Committee.]

The provision provides that upon written request by an appropriate State officer, the Secretary may disclose: (1) a notice of proposed refusal to recognize an organization as a section 501(c)(3) organization; (2) a notice of proposed revocation of tax-exemption of a section 501(c)(3) organization; (3) the issuance of a proposed deficiency of tax imposed under section 507, chapter 41, or chapter 42; (4) the names, addresses, and taxpayer identification numbers of organizations that have applied for recognition as section 501(c)(3) organizations; and (5) returns and return information of organizations with respect to which information has been disclosed under (1) through (4) above.[145] Disclosure or inspection is permitted for the purpose of, and only to the extent necessary in, the administration of State laws regulating section 501(c)(3) organizations, such as laws regulating tax-exempt status, charitable trusts, charitable solicitation, and fraud. Such disclosure or inspection may be made only to or by an appropriate State officer or to an officer or employee of the State who is designated by the appropriate State officer, and may not be made by or to a contractor or agent. The Secretary also is permitted to disclose or open to inspection the returns and return information of an organization that is recognized as tax-

[145] Such returns and return information also may be open to inspection by an appropriate State officer.

exempt under section 501(c)(3), or that has applied for such recognition, to an appropriate State officer if the Secretary determines that disclosure or inspection may facilitate the resolution of Federal or State issues relating to the tax-exempt status of the organization. For this purpose, appropriate State officer means the State attorney general, the State tax officer, and any other State official charged with overseeing organizations of the type described in section 501(c)(3).

In addition, the provision provides that upon the written request by an appropriate State officer, the Secretary may make available for inspection or disclosure returns and return information of an organization described in section 501(c)(2) (certain title holding companies), 501(c)(4) (certain social welfare organizations), 501(c)(6) (certain business leagues and similar organizations), 501(c)(7) (certain recreational clubs), 501(c)(8) (certain fraternal organizations), 501(c)(10) (certain domestic fraternal organizations operating under the lodge system), and 501(c)(13) (certain cemetery companies). Such returns and return information are available for inspection or disclosure only for the purpose of, and to the extent necessary in, the administration of State laws regulating the solicitation or administration of the charitable funds or charitable assets of such organizations. Such disclosure or inspection may be made only to or by an appropriate State officer or to an officer or employee of the State who is designated by the appropriate State officer, and may not be made by or to a contractor or agent. For this purpose, appropriate State officer means the State attorney general, the State tax officer, and the head of an agency designated by the State attorney general as having primary responsibility for overseeing the solicitation of funds for charitable purposes of such organizations.

In addition, the provision provides that any returns and return information disclosed under section 6104(c) may be disclosed in civil administrative and civil judicial proceedings pertaining to the enforcement of State laws regulating the applicable tax-exempt organization in a manner prescribed by the Secretary. Returns and return information are not to be disclosed under section 6104(c), or in such an administrative or judicial proceeding, to the extent that the Secretary determines that such disclosure would seriously impair Federal tax administration. The provision makes disclosures of returns and return information under section 6104(c) subject to the disclosure, recordkeeping, and safeguard provisions of section 6103, including the requirements that the Secretary maintain a permanent system of records of requests for disclosure,[146] and that the appropriate State officer maintain various safeguards that protect against unauthorized disclosure.[147] The provision provides that the willful unauthorized disclosure of returns or return information described in section 6104(c) is a felony subject to a fine of up to $5,000 and/or imprisonment of up to five years,[148] the willful unauthorized inspection of returns or return information described in section 6104(c) is subject to a fine of up to $1,000 and/or imprisonment of up to one year,[149] and provides the taxpayer the right to bring a

[146] Sec. 6103(p)(3).

[147] Sec. 6103(p)(4).

[148] Sec. 7213(a)(2).

[149] Sec. 7213A.

civil action for damages in the case of knowing or negligent unauthorized disclosure or inspection of such information.[150]

Effective Date

The provision is effective on the date of enactment but does not apply to requests made before such date.

[150] Sec. 7431(a)(2).

TITLE VI − UNITED STATES TAX COURT MODERNIZATION

A. Appointment of Tax Court Employees (sec. 601 of the bill and sec. 7471(a) of the Code)

Present Law

The Tax Court is a legislative court established by the Congress pursuant to Article I of the U.S. Constitution (an "Article I" court).[151] The Tax Court is authorized to appoint employees, subject to the rules applicable to employment with the Executive Branch of the Federal Government (generally referred to as "competitive service"), as administered by the Office of Personnel Management.[152]

Employment with the Federal Executive Branch is governed by certain general statutory principles, such as recruitment of qualified individuals, fair and equitable treatment of employees and applicants, maintenance of high standards of employee conduct, and protection of employees against arbitrary action. The rules for employment in the Federal Executive Branch address various aspects of such employment, including: (1) procedures for the appointment of employees in the competitive service, including preferences for certain individuals (e.g., veterans); (2) compensation, benefits, and leave programs for employees; (3) appraisals of employee performance; (4) disciplinary actions; and (5) employee rights, including appeal rights. In addition, employees are protected from certain personnel practices (referred to as "prohibited personnel practices"), such as discrimination on the basis of race, color, religion, age, sex, national origin, political affiliation, marital status, or handicapping condition.

Reasons for Change

The Tax Court was established as an Article I court in part because of its need for independence from the Executive Branch and its responsibility for reviewing determinations of a Federal Executive Branch agency (i.e., the Internal Revenue Service).[153] Accordingly, the Committee believes that the Tax Court should have the authority to establish its own personnel system, rather than being subject to the rules administered by the Federal Executive Branch. Similar authority has previously been provided to other Article I courts and to courts established under Article III of the U.S. Constitution ("Article III" courts). Currently, the Tax Court is the only Federal court (Article I or III) that does not have its own personnel system. Authority to establish its own personnel system will also provide the Tax Court with greater flexibility in meeting its staffing needs, thus enabling the court to operate more effectively. The Committee also believes that a personnel system established by the Tax Court should be consistent with the general principles that govern other employment with the Federal Government and should provide certain protections to employees.

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[151] Sec. 7441.

[152] Sec. 7471.

[153] See, e.g., S. Rep. No. 91-552, at 302 (1969).

Explanation of Provision

The provision extends to the Tax Court authority to establish its own personnel management system. Any personnel management system adopted by the Tax Court must: (1) include the merit system principles that govern employment with the Federal Executive Branch; (2) prohibit personnel practices that are prohibited in the Federal Executive Branch; and (3) in the case of an individual eligible for preference for employment in the Federal Executive Branch, provide preference for that individual in a manner and to an extent consistent with preference in the Federal Executive Branch.

The provision requires the Tax Court to prohibit discrimination on the basis of race, color, religion, age, sex, national origin, political affiliation, marital status, or handicapping condition. The Tax Court is also required to promulgate procedures for resolving complaints of discrimination by employees and applicants for employment.

The provision allows the Tax Court to appoint a clerk without regard to the Federal Executive Branch rules regarding appointments in the competitive service. Under the provision, the clerk serves at the pleasure of the Tax Court.

The provision also allows the Tax Court to appoint other necessary employees without regard to the Federal Executive Branch rules regarding appointments in the competitive service. Under the provision, these employees are subject to removal by the Tax Court.

The provision allows judges and special trial judges of the Tax Court to appoint law clerks and secretaries, in such numbers as the Tax Court may approve, without regard to the Federal Executive Branch rules regarding appointments in the competitive service. Under the provision, a law clerk or secretary serves at the pleasure of the appointing judge.

The provision exempts law clerks from the sick leave and annual leave provisions applicable to employees of the Federal Executive Branch. Any unused sick or annual leave to the credit of a law clerk as of the effective date of the provision remains credited to the individual and is available to the individual upon separation from the Federal Government, or upon transfer to a position subject to such sick leave and annual leave provisions.

The provision allows the Tax Court to fix and adjust the compensation of the clerk and other employees without regard to the Federal Executive Branch rules regarding employee classifications and pay rates. To the maximum extent feasible, Tax Court employees are to be compensated at rates consistent with those of employees holding comparable positions in the Federal Judicial Branch. The Tax Court may also establish programs for employee evaluations, incentive awards, flexible work schedules, premium pay, and resolution of employee grievances.

In the case of an individual who is an employee of the Tax Court on the day before the effective date of the provision, the provision preserves certain rights that the employee is entitled to as of that day. The provision preserves the right to: (1) appeal a reduction in grade or removal; (2) appeal an adverse action; (3) appeal a prohibited personnel practice; (4) make an allegation of a prohibited personnel practice; or (5) file an employment discrimination appeal. These rights are preserved for as long as the individual remains an employee of the Tax Court.

Under the provision, a Tax Court employee who completes at least one year of continuous service under a nontemporary appointment with the Tax Court acquires competitive service status for appointment to any position in the Federal Executive Branch competitive service for which the employee possesses the required qualifications.

The provision also allows the Tax Court to procure the services of experts and consultants in accordance with Federal Executive Branch rules.

Effective Date

The provision is effective on the date the Tax Court adopts a personnel management system after the date of enactment of the provision.

B. Consolidate Review of Collection Due Process Cases in the Tax Court (sec. 6330 of the Code)

Present Law[154]

In general, the Internal Revenue Service ("IRS") is required to notify taxpayers that they have a right to a fair and impartial hearing before levy may be made on any property or right to property.[155] Similar rules apply with respect to liens.[156] The hearing is held by an impartial officer from the IRS Office of Appeals, who is required to issue a determination with respect to the issues raised by the taxpayer at the hearing. The taxpayer is entitled to appeal that determination to a court. The appeal must be brought to the United States Tax Court (the "Tax Court"), unless the Tax Court does not have jurisdiction over the underlying tax liability. If that is the case, then the appeal must be brought in the district court of the United States.[157] If a court determines that an appeal was not made to the correct court, the taxpayer has 30 days after such determination to file with the correct court.

The Tax Court is established under Article I of the United States Constitution[158] and is a court of limited jurisdiction.[159] The Tax Court only has the jurisdiction that is expressly conferred on it by statute.[160] For example, the jurisdiction of the Tax Court includes the authority to hear disputes concerning notices of income tax deficiency, certain types of declaratory judgment, and worker classification status, among others, but does not include jurisdiction over most excise taxes imposed by the Internal Revenue Code. Thus, the Tax Court may not have jurisdiction over the underlying tax liability with respect to an appeal of a due process hearing relating to a collections matter. As a practical matter, many cases involving appeals of a due process hearing (whether within the jurisdiction of the Tax Court or a district court) do not involve the underlying tax liability.

Reasons for Change

The Tax Court does not have jurisdiction over all of the tax issues underlying collection due process cases (such as issues involving most excise taxes). The judicial appeals structure of

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[154] Present law refers to the law in effect on the date of Committee action on the bill. It does not reflect the changes made by the Pension Protection Act of 2006, Pub. L. No. 109-280 (August 17, 2006).

[155] Sec. 6330(a).

[156] Sec. 6320.

[157] Sec. 6330(d).

[158] Sec. 7441.

[159] Sec. 7442.

[160] Sec. 7442.

present law was designed in recognition of these jurisdictional limitations; however, in many cases the underlying taxes are not involved in determining the due process issue. The present-law structure can lead to confusion over which court is the proper court in which to file an appeal. Some believe that this confusion may also be used by some taxpayers seeking to delay the collection process. Accordingly, the Committee believes that the Tax Court should have jurisdiction over all appeals of collection due process determinations. The simplification provided will both benefit the taxpayers involved and the IRS by eliminating confusion over which court is the proper venue for appeal and will reduce the period of time before judicial review. This provision will also eliminate the opportunity to use the present-law rules in unintended ways to delay or defeat the collection process.

Explanation of Provision

[The bill does not include the provision as approved by the Committee because an identical or substantially similar provision was enacted into law in the Pension Protection Act of 2006 (Pub. L. No. 109-280, sec. 855) subsequent to Committee action on the bill. The following discussion describes the provision as approved by the Committee.]

The provision modifies the jurisdiction of the Tax Court by providing that all appeals of collection due process determinations are to be made to the United States Tax Court.

Effective Date

The provision applies to determinations made after the date which is 60 days after the date of enactment.

C. Confirmation of Tax Court Authority to Apply Equitable Recoupment (sec. 6214 of the Code)

Present Law[161]

Equitable recoupment is a common-law equitable principle that permits the defensive use of an otherwise time-barred claim to reduce or defeat an opponent's claim if both claims arise from the same transaction. U.S. District Courts and the U.S. Court of Federal Claims, the two Federal tax refund forums, may apply equitable recoupment in deciding tax refund cases.[162] In *Estate of Mueller v. Commissioner*,[163] the Court of Appeals for the Sixth Circuit held that the United States Tax Court (the "Tax Court") may not apply the doctrine of equitable recoupment. More recently, the Court of Appeals for the Ninth Circuit, in *Branson v. Commissioner*,[164] held that the Tax Court may apply the doctrine of equitable recoupment.

Reasons for Change

The Committee believes that it is important to resolve the conflict among the circuit courts by eliminating the uncertainty or confusion of differing results in differing circuits. The Committee also believes that the provision will provide simplification benefits to both taxpayers and the IRS.

Explanation of Provision

[The bill does not include the provision as approved by the Committee because an identical or substantially similar provision was enacted into law in the Pension Protection Act of 2006 (Pub. L. No. 109-280, sec. 858) subsequent to Committee action on the bill. The following discussion describes the provision as approved by the Committee.]

The provision confirms that the Tax Court may apply the principle of equitable recoupment to the same extent that it may be applied in Federal civil tax cases by the U.S. District Courts or the U.S. Court of Claims. No implication is intended as to whether the Tax Court has the authority to continue to apply other equitable principles in deciding matters over which it has jurisdiction.

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[161] Present law refers to the law in effect on the date of Committee action on the bill. It does not reflect the changes made by the Pension Protection Act of 2006, Pub. L. No. 109-280 (August 17, 2006).

[162] *See Stone v. White*, 301 U.S. 532 (1937); *Bull v. United States*, 295 U.S. 247 (1935).

[163] 153 F.3d 302 (6th Cir.), *cert. den.*, 525 U.S. 1140 (1999).

[164] 264 F.3d 904 (9th Cir.), *cert. den.*, 2002 U.S. LEXIS 1545 (U.S. Mar. 18, 2002).

Effective Date

The provision is effective for any action or proceeding in the Tax Court with respect to which a decision has not become final as of the date of enactment.

D. Extend Authority for Special Trial Judges to Hear and Decide Certain Employment Status Cases (sec. 7443A of the Code)

Present Law[165]

In connection with the audit of any person, if there is an actual controversy involving a determination by the IRS as part of an examination that (1) one or more individuals performing services for that person are employees of that person or (2) that person is not entitled to relief under section 530 of the Revenue Act of 1978, the Tax Court has jurisdiction to determine whether the IRS is correct and the proper amount of employment tax under such determination.[166] Any redetermination by the Tax Court has the force and effect of a decision of the Tax Court and is reviewable.

An election may be made by the taxpayer for small case procedures if the amount of the employment taxes in dispute is $50,000 or less for each calendar quarter involved.[167] The decision entered under the small case procedure is not reviewable in any other court and should not be cited as authority.

The chief judge of the Tax Court may assign proceedings to special trial judges. The Code enumerates certain types of proceedings that may be so assigned and may be decided by a special trial judge. In addition, the chief judge may designate any other proceeding to be heard by a special trial judge.[168]

Reasons for Change

The Committee believes that clarifying that special trial judges may decide proceedings involving a determination of employment status in which the amount of employment taxes in dispute is $50,000 or less for each calendar quarter involved will improve the operations and internal functioning of the Tax Court.

Explanation of Provision

[The bill does not include the provision as approved by the Committee because an identical or substantially similar provision was enacted into law in the Pension Protection Act of 2006 (Pub. L. No. 109-280, sec. 857) subsequent to Committee action on the bill. The following discussion describes the provision as approved by the Committee.]

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165 Present law refers to the law in effect on the date of Committee action on the bill. It does not reflect the changes made by the Pension Protection Act of 2006, Pub. L. No. 109-280 (August 17, 2006).

166 Sec. 7436.

167 Sec. 7436(c).

168 Sec. 7443A.

The provision clarifies that the chief judge of the Tax Court may assign to special trial judges any employment tax cases that are subject to the small case procedure and may authorize special trial judges to decide such small tax cases.

Effective Date

The provision is effective for any action or proceeding in the Tax Court with respect to which a decision has not become final as of the date of enactment.

E. Tax Court Filing Fee (sec. 7451 of the Code)

Present Law[169]

The Tax Court is authorized to impose a fee of up to $60 for the filing of any petition for the redetermination of a deficiency or for declaratory judgments relating to the status and classification of 501(c)(3) organizations, the judicial review of final partnership administrative adjustments, and the judicial review of partnership items if an administrative adjustment request is not allowed in full.[170] The statute does not specifically authorize the Tax Court to impose a filing fee for the filing of a petition for review of the IRS's failure to abate interest or for failure to award administrative costs and other areas of jurisdiction for which a petition may be filed. The practice of the Tax Court is to impose a $60 filing fee in all cases commenced by petition.[171]

Reasons for Change

The Committee believes it is appropriate to clarify that the Tax Court filing fee applies to any case commenced by the filing of a petition.

Explanation of Provision

[The bill does not include the provision as approved by the Committee because an identical or substantially similar provision was enacted into law in the Pension Protection Act of 2006 (Pub. L. No. 109-280, sec. 859) subsequent to Committee action on the bill. The following discussion describes the provision as approved by the Committee.]

The provision provides that the Tax Court is authorized to charge a filing fee of up to $60 in all cases commenced by the filing of a petition. No negative inference should be drawn as to whether the Tax Court has the authority under present law to impose a filing fee for any case commenced by the filing of a petition.

Effective Date

The provision is effective on the date of enactment.

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[169] Present law refers to the law in effect on the date of Committee action on the bill. It does not reflect the changes made by the Pension Protection Act of 2006, Pub. L. No. 109-280 (August 17, 2006).

[170] Sec. 7451.

[171] *See* Rule 20(b) of the Tax Court Rules of Practice and Procedure.

TITLE VII − MISCELLANEOUS PROVISIONS

A. Expensing of Broadband Internet Access Expenditures (sec. 701 of the bill and sec. 191 of the Code)

Present Law

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").[172] Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods. The recovery periods applicable to most tangible personal property (generally tangible property other than residential rental property and nonresidential real property) range from 3 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 depreciation deduction would be maximized.

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct (or "expense") such costs.[173] Present law provides that the maximum amount a taxpayer may expense, for taxable years beginning in 2003 through 2009, is $100,000 of the cost of qualifying property placed in service for the taxable year. The $100,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $400,000. The $100,000 and $400,000 amounts are indexed for inflation for taxable years beginning after 2003 and before 2010. In general, under section 179, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. Additional section 179 incentives are provided with respect to a qualified property used by a business in the New York Liberty Zone,[174] an empowerment zone,[175] a renewal community,[176] or the Gulf Opportunity Zone.[177] Recapture rules generally apply with respect to property that ceases to be qualified property.

[172] Sec. 168.

[173] Sec. 179.

[174] Sec. 1400L(f).

[175] Sec. 1397A.

[176] Sec. 1400J.

[177] Sec. 1400N.

Reasons for Change

The Committee believes that it is appropriate to provide the tax incentive of expensing to encourage the provision of broadband services through new or upgraded equipment. In particular, the Committee believes that the provision of such services should be encouraged in rural areas and areas in which residents tend to have incomes significantly lower than the median. Because some such areas may be served by current-generation broadband services, the tax incentive is provided with respect to current generation broadband services for residential subscribers if the area is not a saturated market. The expensing incentive is provided without regard to whether the local market is saturated, in the case of next generation broadband service, because of the Committee's desire to encourage wider availability of faster broadband service.

Explanation of Provision

The provision provides an election to treat any qualified broadband expenditure paid or incurred by the taxpayer as not chargeable to capital account, but rather, as a deduction. The deduction is allowed in the first taxable year in which either current generation, or next generation, broadband services are provided through qualified equipment to qualified subscribers.[178] Expenditures are eligible for this election only for qualified equipment, the original use of which commences with the taxpayer. The provision applies for qualified broadband expenditures incurred after June 30, 2006, and before January 1, 2011.

"Current generation broadband services" are defined as the transmission of signals at a rate of at least 5 million bits per second to the subscriber and at a rate of at least 1 million bits per second from the subscriber. Next generation broadband services are defined as the transmission of signals at a rate of at least 50 million bits per second to the subscriber and at a rate of at least 10 million bits per second from the subscriber.

"Qualified broadband expenditures" means the direct or indirect costs properly taken into account for the taxable year for the purchase or installation of qualified equipment (including upgrades) and the connection of the equipment to a qualified subscriber. The term does not include costs of launching satellite equipment.

Qualified broadband expenditures include only the portion of the purchase price paid by the lessor, in the case of leased equipment, that is attributable to otherwise qualified broadband expenditures by the lessee. In the case of property that is originally placed in service by a person and that is sold to the taxpayer and leased back to such person by the taxpayer within three months after the date that the property was originally placed in service, the property is treated as originally placed in service by the taxpayer not earlier than the date that the property is used under the leaseback.

[178] An allocation rule is provided in the event that such services could be provided both to qualified subscribers and to others by means of the equipment.

A qualified subscriber, with respect to current generation broadband services, means any nonresidential subscriber maintaining a permanent place of business in a rural area or underserved area, or any residential subscriber residing in a rural area or underserved area that is not a saturated market. A qualified subscriber, with respect to next generation broadband services, means any nonresidential subscriber maintaining a permanent place of business in a rural area or underserved area, or any residential subscriber.

For this purpose, a rural area means any census tract not within 10 miles of an incorporated or census-designated place with more than 25,000 people and not within a county or county equivalent with overall population density of more than 500 people per square mile. An underserved area means a census tract located in an empowerment zone or enterprise community designated under section 1391 or the District of Columbia Enterprise Zone, or any census tract the poverty level of which is at least 30 percent and the median family income of which does not exceed (1) for a tract in a metropolitan statistical area, 70 percent of the greater of the metropolitan area median family income or the statewide median family income, and (2) for a tract that is not in a metropolitan statistical area, 70 percent of the nonmetropolitan statewide median family income.

A saturated market, for this purpose, means any census tract in which, as of the date of enactment, current generation broadband services have been provided by a single provider to 85 percent or more of the total potential residential subscribers. The services must be usable at least a majority of the time during periods of maximum demand, and usable in a manner substantially the same as services provided through equipment not eligible for the deduction under this provision.

If current, or next, generation broadband services can be provided through qualified equipment to both qualified subscribers and to other subscribers, the provision provides that the expenditures with respect to the equipment are allocated among subscribers to determine the amount of qualified broad broadband expenditures that may be deducted under the provision.

Qualified equipment means equipment that provides current, or next, generation broadband services at least a majority of the time during periods of maximum demand to each subscriber, and in a manner substantially the same as such services are provided by the provider to subscribers through equipment with respect to which no deduction is allowed under the provision. Limitations are imposed under the provision on equipment depending on where it extends, and on certain packet switching equipment, and on certain multiplexing and demultiplexing equipment.

Expenditures generally are not taken into account for purposes of the deduction under the provision with respect to property used predominantly outside the United States, used predominantly to furnish lodging, used by a tax-exempt organization (other than in a business whose income is subject to unrelated business income tax), or used by the United States or a political subdivision or by a possession, agency or instrumentality thereof or by a foreign person or entity. The basis of property is reduced by the cost of the property that is taken into account as a deduction under the provision. Recapture rules are provided. No business credit under section 38 is allowed with respect to any amount allowed as a deduction under the provision.

Effective Date

The provision is effective on the date of enactment and applies to expenditures incurred after June 30, 2006, and before January 1, 2011.

B. Modification of Refunds for Kerosene Used in Aviation (sec. 702 of the bill and sec. 6427 of the Code)

Present Law

Nontaxable uses of kerosene

In general, if kerosene on which tax has been imposed is used by any person for a nontaxable use, a refund in an amount equal to the amount of tax imposed may be obtained either by the purchaser, or in specific cases, the registered ultimate vendor of the kerosene.[179] However, the 0.1 cent per gallon representing the Leaking Underground Storage Tank Trust Fund financing rate generally is not refundable, except for exports.[180]

A nontaxable use is any use which is exempt from the tax imposed by section 4041(a)(1) other than by reason of a prior imposition of tax.[181] Nontaxable uses of kerosene include:

- Use on a farm for farming purposes;[182]
- Use in foreign trade or trade between the United States and any of its possessions;[183]
- Use as a fuel in vessels and aircraft owned by the United States or any foreign nation and constituting equipment of the armed forces thereof;[184]
- Exclusive use of a state or local government;[185]
- Export or shipment to a possession of the United States;[186]
- Exclusive use of a nonprofit educational organization;[187]

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179 Sec. 6427(l).

180 Sec. 6430.

181 Sec. 6427(l)(2).

182 Sec. 4041(f).

183 Sec. 4041(g)(1).

184 Id.

185 Sec. 4041(g)(2).

186 Sec. 4041(g)(3).

187 Sec. 4041(g)(4).

- Use as a fuel in an aircraft museum for the procurement, care, or exhibition of aircraft of the type used for combat or transport in World War II;[188] and

- Use as a fuel in (a) helicopters engaged in the exploration for or the development or removal of hard minerals, oil, or gas and in timber (including logging) operations if the helicopters neither take off from nor land at a facility eligible for Airport Trust Fund assistance or otherwise use federal aviation services during flights or (b) any air transportation for the purpose of providing emergency medical services (1) by helicopter or (2) by a fixed-wing aircraft equipped for and exclusively dedicated on that flight to acute care emergency medical services.[189]

- Off-highway business use.

Since 4041(a) is limited to the delivery into the fuel supply tank of a diesel-powered highway vehicle or train, kerosene delivered into the fuel supply tank of aircraft is a nontaxable use for purposes of section 4041(a).

Claims for refund of kerosene used in aviation

"Commercial aviation" is the use of an aircraft in a business of transporting persons or property for compensation or hire by air, with certain exceptions.[190] All other aviation is noncommercial aviation.

For fuel not removed directly into the wing of an airplane, the Safe, Accountable, Flexible, Efficient, Transportation Equity Act: A Legacy for Users ("SAFETEA") changed the rate of taxation for aviation-grade kerosene from 21.8 cents per gallon to the general kerosene and diesel rate of 24.3 cents per gallon.[191] In order to preserve the aviation rate for fuel actually used in aviation, the 21.8 cent rate of taxation (or as the case may be, the 4.3 cent commercial aviation rate, or the nontaxable use rate) is achieved through a refund when the fuel is used in aviation (a refund of 2.5 cents for taxable noncommercial aviation, 20 cents in the case of commercial aviation, and 24.3 cents for nontaxable uses).[192] These changes became effective on October 1, 2005.

Prior to October 1, 2005, if fuel that was previously taxed was used in noncommercial aviation for a nontaxable use, generally, the ultimate purchaser of such fuel (other than for the

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[188] Sec. 4041(h).

[189] Secs. 4041(l), 4261(f) and (g).

[190] "Commercial aviation" does not include aircraft used for skydiving, small aircraft on nonestablished lines or transportation for affiliated group members.

[191] Sec. 11161 of Pub. L. No. 109-59 (2005).

[192] Sec. 6427(l)(1), (4) and (5).

exclusive use of a State or local government, or for use on a farm for farming purposes) could claim a refund for the tax that was paid. SAFETEA eliminated the ability of a purchaser to file for a refund with respect to fuel used in noncommercial aviation. Instead, the registered ultimate vendor is the exclusive party entitled to a refund with respect to kerosene used in noncommercial aviation.[193] An ultimate vendor is the person who sells the kerosene to an ultimate purchaser for use in noncommercial aviation. If the fuel was used for a nontaxable use, the vendor may make a claim for 24.3 cents per gallon, otherwise, the vendor is permitted to claim 2.5 cents per gallon for kerosene sold for use in noncommercial aviation.[194]

For commercial aviation, the ultimate purchaser has the option of filing a claim itself, or waiving the right to refund to its ultimate vendor, if the vendor agrees to file on behalf of the purchaser.[195]

A separate special rule also applies to kerosene sold to a State or local government, regardless of whether the kerosene was sold for aviation or other purposes.[196] In general, this rule makes the registered ultimate vendor the appropriate party for filing refund claims on behalf of a State or local government. Special rules apply for credit card sales.[197]

Reasons for Change

It has come to the Committee's attention that some ultimate vendors are refusing to register with the IRS and to file for refunds on behalf of their customers that would be entitled to a full refund of the tax imposed on the fuel (excluding the Leaking Underground Storage Tank Trust Fund tax). Instead, the vendors are passing along the full amount of the tax to these purchasers. Because the registered ultimate vendor is the only person allowed to file a claim with the IRS, these purchasers are left without a method for obtaining the refund of tax to which

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[193] Sec. 6427(l)(5)(B).

[194] Sec. 6427(l)(5)(A). Under this provision, of the 24.4 cents of tax imposed on kerosene used in taxable noncommercial aviation, the 0.1 cent for the Leaking Underground Storage Tank Trust Fund financing rate and 21.8 cents of the tax imposed on kerosene cannot be refunded. The limitations of sec. 6427(l)(5)(A) on the amount that cannot be refunded do not apply to uses exempt from tax. However, sec. 6430 prevents a refund of the Leaking Underground Storage Tank Trust Fund financing rate in all cases except export. Sec. 6427(l)(5)(B) requires that all amounts that would have been paid to the ultimate purchaser pursuant to sec. 6427(l)(1) are to paid to the ultimate registered vendor, therefore the ultimate registered vendor is the only claimant for both nontaxable and taxable use of kerosene in noncommercial aviation.

[195] Sec. 6427(l)(4)(B).

[196] Sec. 6427(l)(6).

[197] If certain conditions are met, a registered credit card issuer may make the claim for refund in place of the ultimate vendor. If the diesel fuel or kerosene is purchased with a credit card issued to a State but the credit card issuer is not registered with the IRS (or does not meet certain other conditions) the credit card issuer must collect the amount of the tax and the State is the proper claimant.

they are entitled. This causes significant hardship for smaller entities, who may not have a significant relationship with the vendor, or purchase sufficient quantities to influence the vendor to file on their behalf. The Committee believes it is appropriate to give these exempt purchasers the option of filing the claim themselves or having a vendor file on their behalf.

Explanation of Provision

In general

The provision allows purchasers that use kerosene for an exempt aviation purpose (other than in the case of a State or local government) to make a claim for refund of the tax that was paid on such fuel or waive their right to claim a refund to their registered ultimate vendors. As a result, under the provision, crop-dusters, air ambulances, aircraft engaged in foreign trade and other exempt users may either make the claim for refund of the 24.3 cents per gallon themselves or waive the right to their vendors.

General noncommercial aviation use (which is entitled to a refund of 2.5-cents per gallon) remains an exclusive ultimate vendor rule. The rules for State and local governments also are unchanged.

Special rule for purchases of kerosene used in aviation on a farm for farming purposes

For kerosene used in aviation on a farm for farming purposes that was purchased after December 31, 2004, and before October 1, 2005, the Secretary is to pay to the ultimate purchaser (without interest) an amount equal to the aggregate amount of tax imposed on such fuel, reduced by any payments made to the ultimate vendor of such fuel. Such claims must be filed within three months of the date of enactment and may not duplicate claims filed under section 6427(l).

Effective Date

In general

The provision is effective for kerosene sold after September 30, 2005. For kerosene used for an exempt aviation purpose eligible for the waiver rule created by the provision, the ultimate purchaser is treated as having waived the right to payment and as having assigned such right to the ultimate vendor if the vendor meets the requirements of subparagraph (A), (B) or (D) of section 6416(a)(1). The rule of the preceding sentence applies to kerosene sold after September 30, 2005, and before the date of enactment.

Special rule for kerosene used in aviation on a farm for farming purposes

The special rule for kerosene used in aviation on a farm for farming purposes is effective on the date of enactment.

C. Declarations on Federal Corporate Income Tax Returns (sec. 703 of the bill and sec. 6062 of the Code)

Present Law

The Code requires[198] that the income tax return of a corporation must be signed by either the president, the vice-president, the treasurer, the assistant treasurer, the chief accounting officer, or any other officer of the corporation authorized by the corporation to sign the return.

The Code also imposes[199] a criminal penalty on any person who willfully signs any tax return under penalties of perjury that that person does not believe to be true and correct with respect to every material matter at the time of filing. If convicted, the person is guilty of a felony; the Code imposes a fine of not more than $100,000[200] ($500,000 in the case of a corporation) or imprisonment of not more than three years, or both, together with the costs of prosecution.

Reasons for Change

The Committee believes that the filing of accurate tax returns is essential to the proper functioning of the tax system. The Committee believes that requiring a corporation to have processes and procedures to ensure the corporate income tax return complies with the Internal Revenue Code will elevate both the level of care given to the preparation of those returns and the level of compliance with the Code's requirements, which will in turn help ensure that the proper amount of tax is being paid.

Explanation of Provision

The provision requires that a corporation's Federal income tax return include a declaration signed under penalties of perjury that the corporation has in place processes and procedures to ensure that the return complies with the Internal Revenue Code and that the chief executive officer was provided reasonable assurance of the accuracy of all material aspects of the return.

Effective Date

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

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[198] Sec. 6062.

[199] Sec. 7206.

[200] Pursuant to 18 U.S.C. sec. 3571, the maximum fine for an individual convicted of a felony is $250,000.

D. Treatment of Professional Employer Organizations as Employers (sec. 704 of the bill and new secs. 3511 and 7705 of the Code)

Present Law

In general

Employment taxes generally consist of the taxes under the Federal Insurance Contributions Act ("FICA"), the taxes under the Railroad Retirement Tax Act ("RRTA"), 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").[201]

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 for the calendar year ($94,200 for 2006). 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.

RRTA taxes consist of tier 1 taxes and tier 2 taxes. Tier 1 taxes parallel the OASDI and HI taxes applicable to employers and employees. Tier 2 taxes consist of employer and employee taxes on railroad compensation up to the tier 2 wage base for the calendar year. For 2006, the tier 2 employer rate is 12.6 percent, the employee rate is 4.4 percent, and the tier 2 wage base is $69,900.

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 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.

[201] Secs. 3101-3128 (FICA), 3201-3241 (RRTA), 3301-3311 (FUTA), and 3401-3404 (income tax withholding). Sections 3501-3510 provide additional rules.

Wages paid to employees, and FICA, RRTA, and income taxes withheld from the wages, are required to be reported on employment tax returns and on Forms W-2.[202]

Employment taxes generally apply to all remuneration paid by an employer to an employee. However, various exclusions apply to certain types of remuneration or certain types of services, which may depend on the type of employer for whom an employee performs services.[203] For example, remuneration (subject to a dollar limit) paid to an employee by a tax-exempt organization is excluded from wages for FICA purposes, and services performed in the employ of certain tax-exempt organizations are excluded from employment for FUTA purposes.[204] In addition, various definitions and special rules apply to certain types of employers.[205]

As discussed above, certain employment taxes apply only on amounts up to a specified wage base. If an employee works for multiple employers during a year, separate wage bases generally apply to each employer. However, a single OASDI, RRTA tier 1 or tier 2, or FUTA wage base applies in certain cases in which an employer (a "successor" employer) takes over the business of another employer (the "predecessor" employer) and employs the employees of the predecessor employer.

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.[206] 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 often arises in determining whether a worker is an

[202] Secs. 6011 and 6051.

[203] See, e.g., secs. 3121(a) and (b), 3231(e), 3306(b) and (c), and 3401(a).

[204] Secs. 3121(a)(16) and 3306(c)(8).

[205] See, e.g., secs. 3121, 3122, 3125, 3126, 3127, 3231, 3306, 3308, 3309, 3401(a), 3404, 3506, and 3510.

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

employee or an independent contractor. However, the same test applies in determining whether a worker is an employee of one person or another.[207]

In some cases, a person other than the common-law employer (a "third party") may be liable for employment taxes. For example, if wages are paid to an employee by a third party and the third party, rather than the employer, has control of the payment of the wages, the third party is the statutory employer responsible for complying with applicable employment tax requirements.[208] In addition, an employer may designate a reporting agent to be responsible for FICA tax and income tax withholding compliance,[209] including filing employment tax returns and issuing Forms W-2 to employees.[210] In that case, the reporting agent and the employer are jointly and severally liable for compliance.[211]

Professional employer organizations

A professional employer organization (sometimes called an employee leasing company) provides employees to perform services in the businesses of the professional employer organization's customers, generally small and medium-sized businesses. In many cases, before the professional employer organization arrangement is entered into, the employees already work in the customer's business as employees of the customer. The terms of a typical professional employer organization arrangement provide that the professional employer organization is the employer of the employees and is responsible for paying the employees and for the related

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[207] Issues relating to the classification of workers as employees or independent contractors are 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.

[208] 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); *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 of the wages. Rather, control depends on the facts and circumstances. See, e.g., *Consolidated Flooring Services v. United States*, 38 Fed. Cl. 450 (1997), and *Winstead v. United States*, 109 F. 2d 989 (4th Cir. 1997).

[209] The designated reporting agent rules do not apply for purposes of FUTA compliance.

[210] Sec. 3504. Form 2678 is used to designate a reporting agent.

[211] For administrative convenience, an employer may also use a payroll service to handle payroll and employment tax filings on its behalf, but the employer, not the payroll service, continues to be responsible for employment tax compliance.

employment tax compliance. The customer typically pays the professional employer organization a fee based on payroll costs plus an additional amount.[212]

In some cases, the employees provided to work in the customer's business are legally the employees of the customer, and the customer is legally responsible for employment tax compliance. Nonetheless, customers generally rely on the professional employer organization for employment tax compliance (without designating the professional employer organization as a reporting agent) and treat the employees as employees of the professional employer organization.

Income tax credits based on wages for employment tax purposes

The Code provides various income tax credits to employers under which the amount of the credit is determined by reference to the amount of wages for employment tax purposes.[213] For example, the amount of an employer's work opportunity credit is based on a portion of FUTA wages paid by the employer to employees who are members of certain targeted groups.[214] In addition, the credit for employer FICA tax paid on tips is based on the employer share of FICA tax paid by the employer with respect to certain tips treated as wages for FICA purposes.[215]

Reporting by large food and beverage establishments

Certain reporting requirements relating to tips apply to large food or beverage establishments.[216] In the case of such an establishment, an employer is generally required to report the following information to the IRS each calendar year: (1) the gross receipts of the establishment from the provision of food and beverages (other than certain receipts); (2) the aggregate amount of charge receipts (other than certain receipts); (3) the aggregate amount of charged tips on the charge receipts; (4) the sum of the aggregate amount of tips reported to the employer by employees and certain amounts required to be reported by the employer on employees' Form W-2s; and (5) with respect to each employee, the amount of tips allocated to the employee based on the receipts of the establishment. The employer must also provide

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[212] A professional employer organization may also provide employees with employee benefit coverage, such as under a pension plan or a health plan, even if the customer does not maintain such a plan. In such a case, the fee paid by the customer also covers employee benefit costs.

[213] See, e.g., secs. 41 (credit for research expenses), 45A (Indian employment credit), 45B (credit for employer FICA tax paid on tips), 45C (credit for clinical drug testing expenses), 51 (work opportunity credit), 51A (welfare-to-work credit), 1396 (empowerment zone employment credit), 1400(d) (DC Zone employment credit), and 1400H (renewal community employment credit). Some of these credits are temporary credits that expired at the end of 2005.

[214] Sec. 51(c)(1).

[215] Sec. 45B(b)(1).

[216] Sec. 6053(c).

employees with written statements showing certain information each calendar year, including the amount of tips allocated to the employee for the year.

User fees

User fees apply to requests to the IRS for ruling letters, opinion letters, determination letters, and similar requests.[217] The user fees that apply are determined by the IRS and are generally required to be determined after taking into account the average time and difficulty involved in a request.

Reasons for Change

The IRS estimates that the portion of the 2001 tax gap attributable to FICA and FUTA taxes is $15 billion.[218] An additional portion of the tax gap is attributable to income taxes due on unreported wages.

Professional employer organizations specialize in providing employees and employment-related services, including employment tax compliance, to their customers, which are generally small and medium-sized businesses. In addition, a professional employer organization can obtain economies of scale not available to its individual customers. As a result, professional employer organizations may improve employment tax compliance.

Under present law, responsibility for employment tax compliance generally rests with the employer. Uncertainty may exist as to whether a professional employer organization or its customer is the employer of the employees provided to the customer, making it unclear which party bears employment tax responsibility. In the case of noncompliance, the IRS may have difficulty establishing either party's liability for unpaid employment taxes. The Committee believes that improved employment tax compliance can be achieved by providing rules under which a professional employer organization that meets certain standards and follows certain procedures is treated for employment tax purposes as the employer of employees provided to customers, and thus is responsible for employment tax compliance, rather than the customers.

Explanation of Provision

Treatment of certified professional employer organization as employer for employment tax purposes

Under the provision, if certain requirements are met, for purposes of employment taxes and other obligations under the employment tax rules, a certified professional employer organization is treated as the employer of any work site employee performing services for any

[217] Sec. 7528.

[218] Internal Revenue Service, *IRS Updates Tax Gap Estimates,* IR-2006-28, and attachment (Feb. 14, 2006). The tax gap is the amount of tax that is imposed by law for a given tax year but is not paid voluntarily and timely.

customer of the certified professional employer organization, but only with respect to remuneration remitted to the work site employee by the certified professional employer organization. In addition, no other person is treated as the employer for employment tax purposes with respect to remuneration remitted by the certified professional employer organization to a work site employee.

Under the provision, exclusions, definitions, and special rules that are based on the type of employer and that would apply if the certified professional employer organization were not treated as the employer under the provision continue to apply. Thus, for example, if services performed in the employ of a customer that is a tax-exempt organization would be excluded from employment for FUTA purposes, the fact that a certified professional employer organization is treated as the employer for employment tax purposes does not affect the application of the exclusion.

The provision provides rules under which, on entering into a service contract with a customer with respect to a work site employee, a certified professional employer organization is treated as a successor employer and the customer is treated as the predecessor employer. Similarly, on termination of a service contract with respect to a worksite employee, the customer is treated as a successor employer and the certified professional employer organization is treated as a predecessor employer. Thus, wages paid by the customer and the certified professional employer organization to a work site employee during a calendar year are subject to a single OASDI, RRTA tier 1 or tier 2, or FUTA wage base.

The provision does not apply in the case of a customer who is related to the certified professional employer organization.[219] In addition, an individual with net earnings from self-employment derived from a customer's trade or business (i.e., a self-employed individual), including a customer who is a sole proprietor or a partner of a customer that is a partnership, is not a work site employee for employment tax purposes with respect to remuneration paid by a certified professional employer organization.

As discussed more fully below, a work site employee is an individual who performs services (1) for a customer pursuant to a contract between the customer and the certified professional employer organization that meets certain requirements and (2) at a work site that meets certain requirements. Thus, if the contract or work site fails to meet these requirements, the individual is not a work site employee. The provision applies also in the case of an individual (other than a self-employed individual) who is not a work site employee, but who performs services under a contract the meets the specified requirements. In this case, solely for purposes of a certified professional employer organization's liability for employment taxes and other obligations under the employment tax rules, a certified professional employer organization is treated as the employer of the individual, but only with respect to remuneration remitted to the

[219] Whether a customer and a certified professional employer organization are related is determined under the rules of section 267(b) (relating to transactions between related taxpayers) or 707(b) (relating to transactions between a partner and partnership). However, rules based on more than 50 percent ownership are applied by substituting 10 percent for 50 percent.

individual by the certified professional employer organization. Exclusions, definitions, and special rules that are based on the type of employer and that would apply if the certified professional employer organization were not treated as the employer under the provision continue to apply.

A certified professional employer organization is eligible for the FUTA credit with respect to contributions made to a State unemployment fund with respect to a work site employee by the certified professional employer organization or a customer. An additional FUTA credit may be claimed by a certified professional employer organization if, under State law, a certified professional employer organization is permitted to collect and remit contributions with respect to a work site employee to the State unemployment fund.

Except to the extent necessary for purposes of the provision treating a certified professional employer organization as the employer for employment tax purposes, nothing in the provision is to be construed to affect the determination of who is an employee or employer for purposes of the Code.

Certified professional employer organization

A certified professional employer organization is a person who has been certified by the Secretary, for purposes of being treated as the employer for employment tax purposes under the provision, as meeting certain requirements. These requirements are met if the person--

- demonstrates that the person (and any owner, officer, and such other persons as may be specified in regulations) meets requirements established by the Secretary with respect to tax status, background, experience, business location, and annual financial audits;
- computes its taxable income using an accrual method of accounting unless the Secretary approves another method;
- agrees to satisfy the bond and independent financial review requirements (described below) on an ongoing basis;
- agrees to satisfy any reporting obligations imposed by the Secretary;
- agrees to verify on such periodic basis as prescribed by the Secretary that it continues to meet the requirements for certification; and
- agrees to notify the Secretary in writing within such time as prescribed by the Secretary of any change that materially affects whether it continues to meet the requirements for certification.

Under the bond requirement, a certified professional employer organization must post a bond for the payment of employment taxes in a minimum amount and in a form acceptable to the Secretary. The minimum amount is determined for the period April 1 of any calendar year through March 31 of the following calendar year and is the greater of (1) five percent of the employment taxes for which the certified professional employer organization is liable under the provision during the preceding calendar year (but not to exceed $1,000,000), or (2) $50,000.

Under the independent financial review requirements, a certified professional employer organization must: (1) have, as of the most recent review date (i.e., six months after the completion of the certified professional employer organization's fiscal year), caused to be prepared and provided to the Secretary an opinion of an independent certified public accountant that the certified professional employer organization's financial statements are presented fairly in accordance with generally accepted accounting principles; and (2) provide to the Secretary, not later than the last day of the second month beginning after the end of each calendar quarter, from an independent certified public accountant an assertion regarding Federal employment tax payments and an examination level attestation on the assertion. The assertion must state that the certified professional employer organization has withheld and made deposits of all required FICA, RRTA, and withheld income taxes for the calendar quarter, and the attestation must state that the assertion is fairly stated in all material respects. If a certified professional employer organization fails to file the required assertion and attestation with respect to any calendar quarter, the independent financial review requirements are treated as not satisfied for the period beginning on the due date for the attestation.

For purposes of the bond and independent financial review requirements, all professional employer organizations that are members of a controlled group of corporations or under common control are treated as a single organization.[220] The Secretary may suspend or revoke the certification of a person's certified professional employer organization status if the Secretary determines that the person does not satisfy the representations or other requirements for certification or fails to satisfy the applicable accounting, reporting, payment, or deposit requirements.

Work site employee

A work site employee is an individual who: (1) performs services for a customer of a certified professional employer organization pursuant to a contract between the customer and the certified professional employer organization that meets certain requirements (described below); and (2) performs services at a work site meeting certain requirements (described below).[221]

The contract between the customer and the certified professional employer organization must be in writing and, with respect to an individual performing services for the customer, must provide that the certified professional employer organization will--

- assume responsibility for payment of wages to the individual, without regard to the receipt or adequacy of payment from the customer;
- assume responsibility for reporting, withholding, and paying any employment taxes with respect to the individual's wages, without regard to the receipt or adequacy of payment from the customer;

[220] Whether entities are members of a controlled group of corporations or under common control is determined under the rules of section 414(b) and (c).

[221] As discussed above, a self-employed individual is not a work site employee.

- assume responsibility for any employee benefits that the contract may require the certified professional employer organization to provide, without regard to the receipt or adequacy of payment from the customer;
- assume responsibility for hiring, firing, and recruiting workers in addition to the customer's responsibility for hiring, firing and recruiting workers;
- maintain employee records relating to the individual; and
- agree to be treated as a certified professional employer organization for employment tax purposes with respect to such individual.

For purposes of whether an individual is a work site employee, the work site where the individual performs services meets the applicable requirements if at least 85 percent of the individuals performing services for the customer at the work site are subject to one or more contracts with the certified professional employer organization that meet the above requirements.[222]

Regulations

The Secretary of Treasury ("Secretary") is directed to prescribe such regulations as may be necessary or appropriate to carry out the purposes of the provision. The Secretary is also directed to develop reporting and recordkeeping rules, regulations, and procedures to ensure compliance with the provision with respect to entities applying for and receiving certification as certified professional employer organizations. These are to be designed in a manner to streamline, to the extent possible, the application of the requirements of the provision, the exchange of information between a certified professional employer organization and its customers, and the reporting and recordkeeping obligations of a certified professional employer organization.

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[222] For this purpose, excluded employees under section 414(q)(5), such as employees who are under age 21 or have not completed six months of service, are not taken into account.

Other rules

Income tax credits based on wages for employment tax purposes

Under the provision, for purposes of various income tax credits[223] under which the amount of the credit is determined by reference to the amount of employment tax wages or employment taxes: (1) the credit with respect to a worksite employee performing services for a customer applies to the customer (not to the certified professional employer organization); (2) the customer (and not the certified professional employer organization) is to take into account wages and employment taxes paid by the certified professional employer organization with respect to the worksite employee and for which the certified professional employer organization receives payment from the customer; and (3) the certified professional employer organization is required to furnish the customer with any information necessary for the customer to claim the credit.[224]

Reporting by large food and beverage establishments

Under the provision, if a certified professional employer organization is treated for employment tax purposes as the employer of a work site employee, the customer for whom the work site employee performs services is the employer for purposes of the reporting required with respect to a large food or beverage establishment. The certified professional employer organization is required to furnish the customer with any information necessary to complete the required reporting.

User fees

Under the provision, the user fee charged under the program for certifying a professional employer organization may not exceed $500.

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[223] Secs. 41 (credit for research expenses), 45A (Indian employment credit), 45B (credit for employer FICA tax paid on tips), 45C (credit for clinical drug testing expenses), 51 (work opportunity credit), 51A (welfare-to-work credit), 1396 (empowerment zone employment credit), 1400(d) (DC Zone employment credit), 1400H (renewal community employment credit), and any other provision as provided by the Secretary. Some of these credits are temporary credits that expired at the end of 2005.

[224] Present law provides a deduction from taxable income (or, in the case of an individual, adjusted gross income) that is equal to a portion of the taxpayer's qualified production activities income (sec. 199). The deduction for a taxable year is limited to 50 percent of the wages deducted in arriving at qualified production activities income. To be taken into account, wages must be paid by the taxpayer to its employees and reported on Form W-2. For this purpose, wages means wages subject to income tax withholding, as well as elective deferrals and certain other amounts. Under regulations dealing with wages paid by an entity other than the common-law employer, a taxpayer may take into account wages paid by another entity and reported by the other entity on Form W-2 (with the other entity listed as the employer on the Form W-2), provided that the wages were paid to employees of the taxpayer for employment by the taxpayer. Treas. Reg. sec. 1.199-2(a)(2). The provision does not affect the application of these rules.

No inference as to effect of provision

Nothing contained in the provision or the amendments made by the provision is to be construed to create any inference with respect to the determination of who is an employee or employer (1) for Federal tax purposes (other than the purposes set forth in the provision), or (2) for purposes of any other provision of law.

Effective Date

The provision is effective with respect to wages paid for services performed on or after January 1 of the first calendar year beginning more than 12 months after the date of enactment of the provision. The Secretary is directed to establish the certification program for professional employer organizations not later than six months before the provision becomes effective.

E. Study on Collecting Estimated Tax Payments Through the Electronic Fund Transfer System (sec. 705 of the bill and sec. 6302 of the Code)

Present Law

To the extent that tax is not collected through withholding, taxpayers are required to make quarterly estimated payments of tax. If an individual fails to make the required estimated tax payments under the rules, a penalty is imposed under section 6654. The amount of the penalty is determined by applying the underpayment interest rate to the amount of the underpayment for the period of the underpayment.

The Code imposes a penalty on employers who fail to deposit employment taxes within the required time and in the proper manner. The Code also requires the IRS to collect at least 94 percent of these taxes through the Electronic Funds Transfer Payment System (EFTPS).[225] The Code does not require the IRS to collect estimated tax payments through EFTPS.

Reasons for Change

In 2004, the IRS received 61 percent of all employment tax payments (and 95 percent of all employment tax dollars) through EFTPS. In contrast, the IRS received less than one percent of all estimated tax payments (and less than one percent of all estimated tax dollars) through EFTPS in 2004.

Making estimated tax payments can be cumbersome, particularly for self-employed taxpayers who are juggling many different duties. The Committee believes it is important to simplify the process for making estimated tax payments. The Committee believes EFTPS has the potential to alleviate some of these estimated tax payment problems because it is convenient and relatively easy to use. One feature to EFTPS that is beneficial to taxpayers is the ability to schedule automatic payments from a taxpayer's bank account. A taxpayer can use this feature to make more frequent automatic estimated payments. Using EFTPS in this way could make estimated tax payments almost as automatic as one's monthly automobile or mortgage payment. The Committee believes that increased use of EFTPS for estimated tax payments will reduce the administrative burdens associated with making such payments.

Explanation of Provision

The provision requires the Secretary to study increased collection of estimated tax payments through the EFTPS. The provision requires the Secretary to report the results of such study within one year of the date of enactment.

Effective Date

The provision is effective on the date of enactment.

[225] Sec. 6302(h).

F. Study of Use of Voluntary Withholding Agreements (sec. 706 of the bill)

Present Law

Employment taxes generally consist of the taxes under the Federal Insurance Contributions Act ("FICA"), the tax under the Federal Unemployment Tax Act ("FUTA"), and the requirement that employers withhold income taxes from wages paid to employees ("income tax withholding").[226] Income tax 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.

Reasons for Change

The Committee believes that independent contractors may benefit by entering into voluntary withholding agreements with their payors. The Committee believes that voluntary withholding agreements may be less burdensome than making estimated tax payments. Even though withholding is not required on payments to independent contractors, some independent contractors may wish to enter into withholding agreements with their payors to avoid the burdens of saving and making quarterly estimated tax payments. Payors may be willing to do this as a convenience to their independent contractors, particularly where such payors already withhold and remit employment taxes on their own employees.

The Committee believes that increased use of voluntary withholding agreements between independent contractors and their payors would facilitate tax compliance. Moreover, independent contractors entering into such agreements with their payors would be relieved of the burden of making quarterly estimated tax payments.

Explanation of Provision

The provision requires the Secretary to study the use of voluntary withholding agreements between independent contractors and service recipients. The provision requires the Secretary to report the results of such study, including any necessary statutory changes, within one year of the date of enactment.

Effective Date

The provision is effective on the date of enactment.

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[226] Secs. 3101-3128 (FICA), 3301-3311 (FUTA), and 3401-3404 (income tax withholding). FICA taxes consist of an employer share and an employee share, which the employer withholds from employees' wages.

G. Offset of Tax Refunds Against State Judicial Debts (sec. 707 of the bill and sec. 6402 of the Code)

Present Law

Overpayments of Federal tax may be used to pay past-due child support and debts owed to Federal agencies, without the consent of the taxpayer.[227] Overpayments of Federal tax may also be used to pay specified past-due, legally enforceable State income tax debts, provided that the person making the Federal tax overpayment has shown on the Federal tax return for the taxable year of the overpayment an address that is within the State seeking the tax offset.

Reasons for Change

The Committee understands that the current refund procedure has proven an effective collection tool for State governments. The Committee believes that States will benefit by expanding the refund offset procedures to outstanding court-ordered debts.

Explanation of Provision

The provision permits State courts to use overpayments of Federal tax to pay past-due court-ordered debts. The State court debts would have lower priority than other debts that may be offset under present law.

Effective Date

The provision applies to refunds payable for taxable years ending after the date of enactment.

[227] Sec. 6402.

H. Clarification of Responsibilities of United States Marshals Attending the Tax Court (sec. 708 of the bill and sec. 7456 of the Code)

Present Law

The Tax Court is established under Article I of the United States Constitution[228] and is a court of limited jurisdiction.[229]

The primary role and mission of the U.S. Marshals Service is to provide for the security and to obey, execute, and enforce orders of the U.S. District Courts, the U.S. Courts of Appeals, and the Court of International Trade.[230] The United States marshal for a district in which the Tax Court is sitting is required, when requested by the Chief Judge, to attend any session of the Court in such district.[231]

Reasons for Change

The Committee believes that the security needs of the Tax Court, including protective services, are the same as those of other Federal courts and wishes to clarify the U.S. Marshal's Service responsibility to provide security to the Tax Court.

Explanation of Provision

The provision requires the U. S. Marshal's Service to provide protective services to the Tax Court, including protective services for the security of judges and other threatened persons beyond courthouse premises, similar to those provided to other Federal courts.

Effective Date

The provision is effective on the date of enactment.

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[228] Sec. 7441.

[229] Sec. 7442.

[230] 28 U.S.C. sec. 566(a).

[231] Sec. 7456(c).

I. Authorization of Appropriations to Combat the Tax Gap and for Tax Law Enforcement (sec. 709 of the bill)

Present Law

There is no explicit authorization of appropriations to the IRS to be used to combat the tax gap.

Reasons for Change

The IRS estimates that the gross annual tax gap, the difference between the taxes legally owed and the taxes timely paid, is $345 billion. With a voluntary compliance rate of 83.7 percent, 16.3 percent of American taxpayers do not fully comply with our nation's tax laws. The Committee believes that the sizable tax gap has the potential to undermine our voluntary tax compliance system. Moreover, it is unfair to honest taxpayers to allow tax cheats to ignore our nation's tax laws. The Committee believes that this authorization provides a good first step in renewed IRS efforts to combat the tax gap.

Explanation of Provision

The bill includes an authorization of $732 million dollars to the IRS to be used to combat the tax gap, $300 million of which is to be used to combat tax avoidance transactions, including the use of offshore accounts to conceal taxable income. Amounts appropriated shall remain available until expended.

Effective Date

The provisions are effective on the date of enactment.

J. Annual Tax Gap Study
(sec. 710 of the bill)

Present Law

There is no requirement that the Department of the Treasury produce a study for the tax-writing committees on its activities to close the tax gap.

Reasons for Change

The IRS estimates that the gross annual tax gap, the difference between the taxes legally owed and the taxes timely paid, is $345 billion. With a voluntary compliance rate of 83.7 percent, 16.3percent of American taxpayers do not comply with our nation's tax laws. The Committee believes that the sizable tax gap has the potential to undermine our voluntary tax compliance system. Moreover, it is unfair to honest taxpayers to allow tax cheats to ignore our nation's tax laws. The Committee believes that a comprehensive and credible plan, submitted annually, is an important part of an effective strategy to close the tax gap.

Description of Proposal

The provision requires the Department of the Treasury to submit an annual report to the tax-writing committees not later than September 30 of each year on activities the Treasury Department is undertaking to close the tax gap. The report should include a comprehensive set of strategies to: simplify the administration of the tax Code, including ways that resources can be used more efficiently; achieve more complete income reporting; improve tax-law enforcement; and improve customer service. The report should also include a detailed analysis of the elements of the tax gap, a list of measures designed to reduce the tax gap, goals for reducing the tax gap, and timelines to achieve those goals. Finally, the report should include specific administrative actions taken to reduce the tax gap and the results of such actions, and proposed legislative recommendations to improve voluntary compliance.

Effective Date

The provision is effective on the date of enactment.

K. Authorization of Appropriations for Tax Law Enforcement Relating to the Hiring and Continued Employment of Undocumented Workers (sec. 711 of the bill)

Present Law

IRS undercover operations are statutorily exempt from the generally applicable restrictions controlling the use of Government funds (which generally provide that all receipts must be deposited in the general fund of the Treasury and all expenses be paid out of appropriated funds). In general, the Code permits the IRS to use proceeds from an undercover operation to pay additional expenses incurred in the undercover operation, through 2006. The IRS is required to conduct a detailed financial audit of large undercover operations in which the IRS is churning funds and to provide an annual audit report to the Congress on all such large undercover operations.

There is no explicit authorization of appropriations to the IRS to be used to prosecute employers for the violations of tax laws relating to the hiring and continued employment of undocumented workers.

Reasons for Change

The Committee believes that additional resources are necessary to combat noncompliance by employers of undocumented workers. The Committee believes that this is a serious compliance issue and warrants the creation of an office in IRS Criminal Investigation.

Explanation of Provision

The bill authorizes the IRS to use $2 million toward the establishment of an office in IRS Criminal Investigation to prosecute employers for the violations of tax laws relating to the hiring and continued employment of persons not authorized to work in the United States. The Committee expects the office to work closely with other divisions within the IRS and understands that non-CI personnel may be assigned to the office.

For fiscal years 2007 and 2008, the provision also authorizes and appropriates to the office for the administration of such office an amount equal to the income tax, interest, and civil and criminal penalties collected by the IRS as a result of the actions of the office.

The provision requires the Secretary to report to Congress within one year of the date of enactment on enforcement activities of the office.

Effective Date

The provision is effective on the date of enactment.

L. Repeal of Dollar Limit on Contributions to Qualified Funeral Trusts (sec. 712 of the bill and sec. 685 of the Code)

Present Law

A qualified funeral trust is a taxable trust that arises as a result of a contract with a person engaged in the trade or business of providing funeral or burial services or property necessary to provide such services, and which meets certain other requirements.[232] A qualified funeral trust must have as its sole purpose holding, investing, and reinvesting funds in the trust, and using such funds solely to make payments for the above-described services or property for the benefit of the beneficiaries of the trust. A qualified funeral trust may have as beneficiaries only individuals with respect to whom the above-described services or property are to be provided at death, and the trust may only accept contributions by or for the benefit of such beneficiaries. In addition, to qualify, the trust must be one that, but for the making of a required election, would be treated under the grantor trust rules as owned by the purchaser of the funeral or burial contract. Because a qualified funeral trust is not treated as a grantor trust, the trust (rather than the purchaser of the contract) is taxed on income from the trust at the tax rates applicable to non-grantor trusts.

A trust is not a qualified funeral trust if it accepts aggregate contributions by or for the benefit of an individual in excess of a statutory dollar limit, which is $8,500 for 2006 (and which periodically is adjusted for inflation).

Reasons for Change

The Committee believes that the current statutory dollar limit, in certain cases, is insufficient to cover the cost of a funeral and burial.

Description of Provision

The provision repeals the dollar limit on contributions to qualified funeral trusts.

Effective Date

The provision is effective for contributions made after December 31, 2006.

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[232] Sec. 685(b).

M. Permit Administrative Relief for Certain Late Qualified Terminable Interest Property Elections (sec. 713 of the bill and sec. 2523 of the Code)

Present Law

A 100-percent marital deduction generally is permitted for the value of property transferred between spouses. Transfers of "qualified terminable interest property" also are eligible for the marital deduction. "Qualified terminable interest property" (or "QTIP") is property: (1) that passes from the decedent, (2) in which the surviving spouse has a "qualifying income interest for life," and (3) with respect to which a timely election has been made. A "qualifying income interest for life" exists if: (1) the surviving spouse is entitled to all the income from the property (payable annually or at more frequent intervals) or has the right to use the property during the spouse's life, and (2) no person has the power to appoint any part of the property to any person other than the surviving spouse.

A QTIP transfer may occur by way of a lifetime gift (i.e., an *inter vivos* QTIP transfer) or at death. In the event of a QTIP transfer made at a decedent's death, the QTIP election must be made by the decedent's executor on the estate tax return. In the event of an *inter vivos* QTIP transfer, the QTIP election generally must be made on the gift tax return for the calendar year in which the interest is transferred, and the election must be made within the time prescribed for filing such return. A QTIP election, once made, is irrevocable.

Reasons for Change

The IRS, under certain circumstances, has granted relief for late QTIP elections for estate tax purposes by granting an extension of time to make such an election. In the event a taxpayer fails to make a QTIP election for an *inter vivos* QTIP transfer within the prescribed timeframe, the extent of the IRS's authority to grant similar relief is unclear.

Explanation of Provision

The provision directs the Secretary to issue regulations prescribing the circumstances and procedures under which extensions of time will be granted to make a QTIP election for an *inter vivos* QTIP transfer, including elections with respect to transfers that occurred prior to the effective date of the provision. For this purpose, the due date of the election is treated as if not prescribed by statute. In determining whether to grant an extension of time, it is intended that the Secretary shall take into account all circumstances the Secretary deems relevant.

Effective Date

The provision applies to requests for relief pending on or after the date of enactment with respect to transfers made before, on, or after such date.

N. Disclosure of Written Determinations (sec. 714 of the bill and sec. 6110 of the Code)

Present Law

In general

Three provisions of present law govern the disclosure of information relating to tax-exempt organizations. First, section 6103 provides a general rule that tax returns and return information generally are not subject to disclosure unless authorized by the Code.[233] Second, in order to allow the public to scrutinize the activities of tax-exempt organizations, section 6104 grants an exception to the confidentiality rule of section 6103 for certain categories of tax-exempt organization documents and information. Third, section 6110 provides that written determinations by the IRS and related background file documents generally are open to public inspection in redacted form. Section 6110 does not apply to any matter to which section 6104 applies.[234]

Disclosure of applications for recognition of tax exemption and annual information returns

Under present law, the IRS is required to make approved applications for recognition of tax-exempt status (and certain related documents)[235] and annual information returns (Form 990 or Form 990-PF) available for public inspection, except that the IRS is not authorized to disclose the names and addresses of contributors (other than contributors to a private foundation).

The Secretary may withhold disclosure of certain information described in an organization's application for tax-exempt status if disclosure would: (1) divulge a trade secret, patent, process, style of work, or apparatus of the organization, and the Secretary determines that such disclosure would harm the organization; or (2) that the Secretary determines would harm the national defense.[236] The organization must apply to the Commissioner for a determination that the disclosure would violate one of these criteria. The organization will be given 15 days to contest an adverse determination before the information is made available for public inspection.[237]

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[233] Sec. 6103(a).

[234] Sec. 6110(l)(1).

[235] Section 6104(a)(1)(A) provides that "any papers submitted in support of" an application for tax-exempt status must be available for inspection. Treasury regulations limit the definition of supporting documents to papers submitted by the organization. Treas. Reg. sec. 301.6104(a)-1(e).

[236] Sec. 6104(a)(1)(D).

[237] Treas. Reg. sec. 301.6104(a)-5(a)(1).

Disclosure of written determinations

Section 6110 provides that the text of any written determination by the IRS and related background file document is open to public inspection.[238] The term "written determination" means a ruling, determination letter, technical advice memorandum, or Chief Counsel advice. Closing agreements, which are final and conclusive written agreements entered into by the IRS and a taxpayer in order to settle the taxpayer's tax liability with respect to a taxable year, do not constitute written determinations.[239]

Before releasing any written determination or background file document, the IRS must delete identifying details of the person about whom the written determination pertains and certain other private information.[240]

The application of section 6110 to guidance relating to tax-exempt organizations is limited to written determinations unrelated to an organization's tax-exempt status. Section 6110(l)(1) provides, "this section shall not apply to any matter to which section 6104 applies." The regulations under section 6110 clarify which matters are within the ambit of section 6104 and, therefore, are not subject to disclosure under section 6110:

[a]ny application filed with the Internal Revenue Service with respect to the qualification or exempt status of an organization . . .; any document issued by the Internal Revenue Service in which the qualification or exempt status of an organization is . . . granted, denied or revoked or the portion of any document in which technical advice with respect thereto is given to a district director; . . . the portion of any document issued by the Internal Revenue Service in which is discussed the effect on the qualification or exempt status of an organization . . . of proposed transactions by such organization . . . ; and any document issued by the Internal Revenue Service in which is discussed the qualification or status of a [private foundation or private operating foundation].[241]

In addition, the regulations under section 6104 provide that some documents relating to tax exemption that are not open to public inspection under section 6104(a)(1)(A) are nevertheless "within the ambit" of section 6104 for purposes of the disclosure provisions of section 6110.[242]

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[238] Sec. 6110(a). A background file document includes the request for a written determination, any written material submitted by the taxpayer in support of the request, and any communications between the IRS and other persons in connection with the written determination received before issuance of the written determination. Sec. 6110(b)(2).

[239] Sec. 6103(b)(2)(D); sec. 6110(b)(1)(B).

[240] Sec. 6110(c).

[241] Treas. Reg. sec. 301.6110-1(a).

[242] Treas. Reg. sec. 301.6104(a)-1(i).

The regulation explains that the following documents are, therefore, not available for public inspection under either section 6104 or 6110:

- unfavorable rulings or determination letters issued in response to applications for tax exemption;
- rulings or determination letters revoking or modifying a favorable determination letter;
- technical advice memoranda relating to a disapproved application for tax exemption or the revocation or modification of a favorable determination letter;
- any letter or document filed with or issued by the IRS relating to whether a proposed or accomplished transaction is a prohibited transaction under section 503;
- any letter or document filed with or issued by the IRS relating to an organization's status as a private foundation or private operating foundation, unless the letter or document relates to the organization's application for tax exemption; and
- any other letter or document filed with or issued by the IRS which, although it relates to an organization's tax exempt status as an organization described in section 501(c), does not relate to that organization's application for tax exemption.[243]

Under the regulations, such written determinations relating to exempt status issues are not released, even in redacted form. Pursuant to a decision of the D.C. Circuit Court of Appeals, however, the IRS is required to disclose written determinations relating to denials and revocations of exempt status – a decision in which the IRS acquiesced.[244]

Reasons for Change

The Committee believes that written determinations and background file documents that ordinarily would be disclosed under section 6110 but for the nondisclosure provided by section 6104 should be disclosed in redacted form, and that such disclosure will provide additional guidance to taxpayers as to the views of the IRS on certain issues.

Explanation of Provision

The provision provides that the provisions of section 6110 apply to written determinations and related background file documents relating to an organization described in section 501(c) or (d) (including any written determination denying an organization exempt status under such subsection), or to a political organization described in section 527, that are not required to be disclosed by section 6104(a)(1)(A).

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[243] *Id.*

[244] *Tax Analysts v. Internal Revenue Service*, 350 F.3d 100 (D.C. Cir. 2003); A.O.D. 2004-02.

Effective Date

The provision is effective for written determinations issued after the date of enactment.

O. Disclosure of Internet Web Site and Name Under Which Organization Does Business (sec. 715 of the bill and sec. 6033 of the Code)

Present Law

Most types of tax-exempt organizations are required to file annually an information return.[245] The Internal Revenue Code does not specifically require an exempt organization to furnish on the applicable information return any name under which the organization operates or does business, if such name differs from the legal name of the organization, or the organization's Internet web site address, if any.[246]

Reasons for Change

Some tax-exempt organizations do business and solicit contributions under a name that is different from the organization's legal name. This can cause confusion to individuals and others seeking information about the organization. Further, although much information regarding the operations and activities of tax-exempt organizations is available on the Internet web sites of such organizations, some members of the public might experience difficulties obtaining access to an organization's web site if they do not know the organization's web site address. The Committee believes that reducing confusion and increasing public access to relevant information regarding a tax-exempt organization would be achieved by requiring a tax-exempt organization to report on its annual return any name under which such organization operates or does business, and the Internet web site address (if any) of such organization.

Explanation of Provision

The provision requires a tax-exempt organization subject to reporting requirements under section 6033(a) to include on its annual return any name under which such organization operates or does business, and the Internet web site address (if any) of such organization.

Effective Date

The provision applies to returns filed after December 31, 2006.

[245] Sec. 6033(a).

[246] The IRS requires disclosure of an organization's Internet web site address and business name on Forms 990 and 990-EZ but not on Form 990-PF.

P. Modification to Reporting of Capital Transactions (sec. 716 of the bill and secs. 6033 and 6104 of the Code)

Present Law

Private foundations are required to file an annual information return (Form 990-PF).[247] Part IV of the Form 990-PF requires that private foundations report detailed information regarding the gain or loss from the sale or other disposition of property, including a description of the property sold, how it was acquired (purchase or donation), the date acquired, the date sold, the gross sales price, the amount of depreciation allowed or allowable, and the cost or other basis plus expenses of the sale. Such information generally is required for the IRS to calculate the tax on the private foundation's net investment income. The Form 990-PF is required to be made available to the public.

Reasons for Change

Under present law, private foundations that engage in capital transactions must report detailed information about each transaction on Form 990-PF, which is filed with the IRS and available to the public. For some foundations, listing these transactions involves hundreds of pages. The Committee believes that automatic disclosure of such voluminous information does not necessarily benefit the public, and may in fact reduce the level of meaningful disclosure by obscuring other important information. The Committee believes that meaningful disclosure to the public will be increased if the version of the Form 990-PF that automatically is available to the public summarizes rather than lists the securities transactions that affect the calculation of the organization's net investment income. In order to preserve the public's access to more specific information regarding such securities transactions, the Committee believes that the more detailed information provided to the IRS on the Form 990-PF should be made available to those members of the public that explicitly request such information.

Explanation of Provision

The provision requires that any information regarding capital gains and losses from the sale or disposition of stock or securities that are listed on an established securities market that is required to be furnished by private foundations in order to calculate the tax on net investment income be furnished also in summary form.

In addition, information regarding capital gains and losses from the sale or disposition of stock or securities that are listed on an established securities market that is required to be filed with the IRS but that is not in summary form is not required to be made available to the public by the IRS or by the private foundation except by the explicit request of a member of the public to the IRS or to the foundation. A member of the public may request disclosure of such information from the Secretary, who shall prescribe the manner of making such request and the manner of disclosure. A member of the public also may request disclosure of the private

[247] Sec. 6033(a).

foundation, which must be made in person or in writing. If the request is made in person, the foundation shall provide a copy of the information immediately and, if the request is made in writing, the foundation shall provide the information within 30 days.

The provision also provides that private foundations are required to state on the furnished summary that the more detailed description is available upon request.

Effective Date

The provision applies to returns filed after December 31, 2006.

Q. Disclosure that Form 990 is Publicly Available (sec. 717 of the bill)

Present Law

Under present law, there is no requirement that the IRS notify the public that the Form 990 is publicly available.

Reasons for Change

The information provided on Forms 990 is useful to the public only to the extent that the public is aware that the forms are publicly available. The Committee believes that the availability of Forms 990 that have been filed by exempt organizations will be increased by requiring the IRS to inform the public regarding the availability of such forms.

Explanation of Provision

The provision requires the IRS to notify the public in appropriate publications and other materials of the extent to which Form 990, Form 990-EZ, or Form 990-PF are publicly available.

Effective Date

The provision applies to publications or other materials issued or revised after the date of enactment.

R. Expedited Review Process for Certain Tax-Exemption Applications (sec. 718 of the bill)

Present Law

Most organizations that seek tax-exempt status as a charitable organization are required to file an Application for Recognition of Exemption (Form 1023) with the IRS.[248] Organizations that are not required to file Form 1023 include churches, their integrated auxiliaries, and conventions or associations of churches, and any organization (other than a private foundation) that normally has gross receipts of $5,000 or less in a taxable year. Organizations that file Form 1023 within 15 months of the end of the month of the organization's formation will, if the application is approved, be recognized as tax-exempt from the date of formation. The IRS will automatically grant an organization's request for an additional 12-month extension of the 15-month period. Otherwise, exemption normally will be recognized as of the date the application was received by the IRS. In appropriate circumstances, upon written request, the IRS will expedite consideration of applications for tax-exemption. For example, organizations formed to provide relief to victims of disasters or other emergencies often receive expedited consideration.

Reasons for Change

Many social service organizations that want to apply for government funding through grants or contracts are required as a condition of application to have been recognized as an exempt charitable organization. The Committee wishes to facilitate the formation of charitable organizations that intend to work with Federal, State and local governments to provide vital social services to many of the neediest members of society by implementing an expedited review procedure for exempt status applications, and by waiving IRS user fees pertaining to such applications filed by smaller social service organizations.

Explanation of Provision

The provision provides that the Secretary or his delegate shall adopt procedures to expedite consideration of applications for exempt status by organizations that are organized and operated for the primary purpose of providing social services. To be eligible, the organization must: (1) be seeking a contract or grant under a Federal, State, or local program that provides funding for social service programs; (2) establish that tax-exempt status is a condition of applying for such contract or grant; (3) include a completed copy of the contract or grant application with the application for exemption; and (4) meet such other criteria as the Secretary may provide. Organizations that meet the eligibility requirements described above (except for the requirement that tax-exempt status is a condition of the contract or grant application), and that certify that the organization's average annual gross receipts over the four year period preceding the application was not more than $50,000 (or, in the case of an organization in existence less than four years, is not expected to be more than $50,000 during the organization's first four years) are entitled to a waiver of any fee for application of tax-exempt status.

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[248] Sec. 508(a).

For this purpose, social services is defined as services directed at helping people in need, reducing poverty, improving outcomes of low-income children, revitalizing low-income communities, and empowering low-income families and low-income individuals to become self-sufficient, including: (1) child care services, protective services for children and adults, services for children and adults in foster care, adoption services, services related to the management and maintenance of the home, day care services for adults, and services to meet the special needs of children, older individuals, and individuals with disabilities (including physical, mental, or emotional disabilities); (2) transportation services; (3) job training and related services, and employment services; (4) information, referral, and counseling services; (5) the preparation and delivery of meals, and services related to soup kitchens or food banks; (6) health support services; (7) literacy and mentoring programs; (8) services for the prevention and treatment of juvenile delinquency and substance abuse, services for the prevention of crime and the provision of assistance to the victims and the families of criminal offenders, and services related to the intervention in, and prevention of, domestic violence; and (9) services related to the provision of assistance for housing under Federal law. Social services does not include a program having the purpose of delivering educational assistance under the Elementary and Secondary Education Act of 1965 or under the Higher Education Act of 1965.

Effective Date

The provision applies to applications for tax-exempt status filed after December 31, 2006.

S. Extension of Declaratory Judgment Procedures to Non-501(c)(3) Tax-Exempt Organizations (sec. 719 of the bill and sec. 7428 of the Code)

Present Law

In order for an organization to be granted tax exemption as a charitable entity described in section 501(c)(3), it generally must file an application for recognition of exemption with the IRS and receive a favorable determination of its status. Similarly, for most organizations, a charitable organization's eligibility to receive tax-deductible contributions is dependent upon its receipt of a favorable determination from the IRS. In general, a section 501(c)(3) organization can rely on a determination letter or ruling from the IRS regarding its tax-exempt status, unless there is a material change in its character, purposes, or methods of operation. In cases in which an organization violates one or more of the requirements for tax exemption under section 501(c)(3), the IRS is authorized to revoke an organization's tax exemption, notwithstanding an earlier favorable determination.

In situations in which the IRS denies an organization's application for recognition of exemption under section 501(c)(3) or fails to act on such application, or in which the IRS informs a section 501(c)(3) organization that it is considering revoking or adversely modifying its tax-exempt status, present law authorizes the organization to seek a declaratory judgment regarding its tax status.[249] Section 7428 provides a remedy in the case of a dispute involving a determination by the IRS with respect to: (1) the initial qualification or continuing qualification of an organization as a charitable organization for tax exemption purposes or for charitable contribution deduction purposes; (2) the initial classification or continuing classification of an organization as a private foundation; (3) the initial classification or continuing classification of an organization as a private operating foundation; or (4) the failure of the IRS to make a determination with respect to (1), (2), or (3). A "determination" in this context generally means a final decision by the IRS affecting the tax qualification of a charitable organization, although it also can include a proposed revocation of an organization's tax-exempt status or public charity classification. Section 7428 vests jurisdiction over controversies involving such a determination in the U.S. District Court for the District of Columbia, the U.S. Court of Federal Claims, and the U.S. Tax Court.

Prior to utilizing the declaratory judgment procedure, an organization must have exhausted all administrative remedies available to it within the IRS. An organization is deemed to have exhausted its administrative remedies at the expiration of 270 days after the date on which the request for a determination was made if the organization has taken, in a timely manner, all reasonable steps to secure such determination.

If an organization (other than a section 501(c)(3) organization) files an application for recognition of exemption and receives a favorable determination from the IRS, the determination of tax-exempt status is usually effective as of the date of formation of the organization if its

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[249] Sec. 7428.

purposes and activities during the period prior to the date of the determination letter were consistent with the requirements for exemption. However, if the organization files an application for recognition of exemption and later receives an adverse determination from the IRS, the IRS may assert that the organization is subject to tax on some or all of its income for open taxable years. In addition, as with charitable organizations, the IRS may revoke or modify an earlier favorable determination regarding an organization's tax-exempt status.

Under present law, a non-charity (i.e., an organization not described in section 501(c)(3)) may not seek a declaratory judgment with respect to an IRS determination regarding its tax-exempt status. The only remedies available to such an organization are to petition the U.S. Tax Court for relief following the issuance of a notice of deficiency or to pay any tax owed and sue for refund in Federal district court or the U.S. Court of Federal Claims.

Reasons for Change

The Committee believes that it is important to provide certainty for organizations that have sought a determination of their tax-exempt status. Thus, the Committee finds it appropriate to extend the present-law declaratory judgment procedures to all organizations that apply for tax-exempt status as organizations described in section 501(c) or 501(d).

Explanation of Provision

The provision extends declaratory judgment procedures similar to those currently available only to charities under section 7428 to other section 501(c) and 501(d) determinations. The provision limits jurisdiction over controversies involving such other determinations to the United States Tax Court.[250]

Effective Date

The extension of the declaratory judgment procedures to organizations other than section 501(c)(3) organizations is effective for pleadings filed with respect to determinations (or requests for determinations) made after December 31, 2006.

[250] This limitation currently applies to declaratory judgments relating to tax qualification for certain employee retirement plans (sec. 7476).

T. Wireless Telecommunications Property Treated as Qualified Technological Equipment (sec. 720 of the bill and sec. 168 of the Code)

Present Law

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") (sec. 168). Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods. The recovery periods applicable to most tangible personal property (generally tangible property other than residential rental property and nonresidential real property) range from 3 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 depreciation deduction would be maximized.

Under MACRS, qualified technological equipment is depreciated over a five-year recovery period using the 200-percent declining balance method. Qualified technological equipment includes any computer or peripheral equipment, any technology station equipment installed on a customer's premises, and any high technology equipment.

The recovery periods under MACRS for various asset classes are prescribed by Revenue Procedure 87-56.[251] Under IRS guidance, assets used to provide cellular telephone service fall within asset classes 48.12 (Telephone Central Office Equipment, 10-year recovery period), 48.121 (Computer-based Telephone Central Office Switching Equipment, 5-year recovery period), 48.13 (Telephone Station Equipment, 7 year recovery period), and 48.14 (Telephone Distribution Plants, 15 year recovery period).[252] Switching, transmission, and reception equipment located at either the mobile telephone switching office (MTSO) or cell sites are described in asset class 48.12. Computer-based switching equipment located at either the MTSO or cell sites is described in asset class 48.121. Transmission and reception assets are qualified technology equipment with a 5-year recovery period if they qualify as computer or peripheral equipment.

Reasons for Change

The Committee believes that the application of the asset classes originally developed for wireline telecommunications to wireless telecommunications equipment has resulted in uncertainty and increased administrative costs for wireless telecommunication service providers and the IRS. In addition, the Committee is aware the wireless telecommunication equipment may rapidly depreciate and become obsolete as a result of technological advances in the industry.

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[251] 1987-2 C.B. 674.

[252] Technical Advice Memorandum 9825003 (Jan. 30, 1998).

Accordingly, the provision provides a statutory depreciable life for wireless equipment and eliminates the need for wireless telecommunication service providers to attempt to apply the wireline asset classes to their wireless equipment.

Explanation of Provision

Under the provision, wireless telecommunications equipment placed in service before January 1, 2011, is treated as qualified technological equipment and therefore is eligible for the five-year recovery period applicable to such property. Wireless telecommunications equipment is defined as equipment used in the transmission, reception, coordination, or switching of wireless telecommunications service. Wireless telecommunications equipment does not include towers, buildings, T-1 lines, or other cabling that connects cell sites to mobile switching centers.

For this purpose, wireless telecommunications service includes any commercial mobile radio service as defined in title 47 of the Code of Federal Regulations ("CFR").[253]

Effective Date

The provision applies to property placed in service after the date of enactment and before January 1, 2011.

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[253] Under the CFR, a commercial mobile radio service is "a mobile service that is: (a)(1) provided for profit, i.e., with the intent of receiving compensation or monetary gain; (2) an interconnected service; and (3) available to the public, or to such classes of eligible users as to be effectively available to a substantial portion of the public; or (b) the functional equivalent of such a mobile service described in paragraph (a) of this section." (47 C.F.R. sec. 20.3.)

Under the CFR, a mobile service is "a radio communication service carried on between mobile stations or receivers and land stations, and by mobile stations communicating among themselves, and includes: (a) Both one-way and two-way radio communications services; (b) A mobile service which provides a regularly interacting group of base, mobile, portable, and associated control and relay stations (whether licensed on an individual, cooperative, or multiple basis) for private one-way or two-way land mobile radio communications by eligible users over designated areas of operation; and (c) Any service for which a license is required in a personal communications service under part 24 of this chapter." (47 C.F.R. sec. 20.3.)

U. Permanent Extension of Internet Tax Moratorium (sec. 721 of the bill)

Present Law

The Internet Tax Freedom Act of 1998[254] imposed a three-year moratorium on State and local government taxes on Internet access, as well as on any multiple or discriminatory State and local taxes on Internet-based transactions. In 2001, the tax moratorium was extended through November 1, 2003.[255] The Internet Tax Nondiscrimination Act of 2004[256] extended the moratorium through November 1, 2007.

Reasons for Change

The Committee believes that the Internet Tax Freedom Act has successfully protected Internet users and online businesses from unfair and discriminatory taxation. The Committee believes that the moratorium on Internet access taxes and multiple and discriminatory taxes on electronic commerce should be permanent.

Explanation of Provision

The provision makes permanent the Internet Tax Freedom Act's moratorium on certain taxes.

Effective Date

The provision is effective on the date of enactment.

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[254] Pub. L. No. 105-277.

[255] Pub. L. No. 107–75 (2001).

[256] Pub. L. No. 108-435 (2004).

V. Simplification through Elimination of Inoperative Provisions (sec. 722 of the bill)

Present Law

The Internal Revenue Code of 1986 contains provisions that are no longer used in computing current taxes or are little used or of minor importance. These provisions are popularly referred to as “deadwood”.

Reasons for Change

The provision simplifies the Code by deleting “deadwood” without making substantive changes in the tax law.

Explanation of Provision

The provision contains numerous amendments to the Code repealing obsolete provisions to the Internal Revenue Code of 1986. No substantive changes are intended by the amendments.

Effective Date

The provision takes effect on the date of enactment.

W. Definition of Convention or Association of Churches (sec. 7701 of the Code)

Present Law[257]

Under present law, an organization that qualifies as a "convention or association of churches" (within the meaning of sec. 170(b)(1)(A)(i)) is not required to file an annual return,[258] is subject to the church tax inquiry and church tax examination provisions applicable to organizations claiming to be a church,[259] and is subject to certain other provisions generally applicable to churches.[260] The Internal Revenue Code does not define the term "convention or association of churches."

Reasons for Change

The term "convention or association of churches" was added to the Code to ensure that hierarchical churches and congregational churches would not be treated dissimilarly for Federal income tax purposes merely because of their organizational and governance structures. The Committee understands that some congregational church organizations have only churches as members, and that others have both churches and individuals as members. The Committee is concerned that an organization with the characteristics of a convention or association of churches, including having a substantial number of churches as members, might fail to be regarded as a convention or association of churches merely because it includes individuals in its membership. The Committee intends that a congregational church organization that otherwise constitutes a convention or association of churches not be denied recognition as such merely because its membership includes individuals as well as churches.

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[257] Present law refers to the law in effect on the date of Committee action on the bill. It does not reflect the changes made by the Pension Protection Act of 2006, Pub. L. No. 109-280 (August 17, 2006).

[258] Sec. 6033(a)(2)(A)(i).

[259] Sec. 7611(h)(1)(B).

[260] *See, e.g.*, Sec. 402(g)(8)(B) (limitation on elective deferrals); sec. 403(b)(9)(B) (definition of retirement income account); sec. 410(d) (election to have participation, vesting, funding, and certain other provisions apply to church plans); sec. 414(e) (definition of church plan); sec. 415(c)(7) (certain contributions by church plans); sec. 501(h)(5) (disqualification of certain organizations from making the sec. 501(h) election regarding lobbying expenditure limits); sec. 501(m)(3) (definition of commercial-type insurance); sec. 508(c)(1)(A) (exception from requirement to file application seeking recognition of exempt status); sec. 512(b)(12) (allowance of up to $1,000 deduction for purposes of determining unrelated business taxable income); sec. 514(b)(3)(E) (definition of debt-financed property); sec. 3121(w)(3)(A) (election regarding exemption from social security taxes); sec. 3309(b)(1) (application of federal unemployment tax provisions to services performed in the employ of certain organizations); sec. 6043(b)(1) (requirement to file a return upon liquidation or dissolution of the organization); and sec. 7702(j)(3)(A) (treatment of certain death benefit plans as life insurance).

Explanation of Provision

[The bill does not include the provision as approved by the Committee because an identical or substantially similar provision was enacted into law in the Pension Protection Act of 2006 (Pub. L. No. 109-280, sec. 1222) subsequent to Committee action on the bill. The following discussion describes the provision as approved by the Committee.]

The provision provides that an organization that otherwise is a convention or association of churches does not fail to so qualify merely because the membership of the organization includes individuals as well as churches, or because individuals have voting rights in the organization.

Effective Date

The provision is effective on the date of enactment.

TITLE VIII − REVENUE OFFSET PROVISIONS

A. Economic Substance Doctrine (secs. 801 and 802 of the bill)

1. Clarification of the economic substance doctrine (sec. 801 of the bill and new sec. 7701(o) of the Code)

Present Law

In general

The Code provides specific rules regarding the computation of taxable income, including the amount, timing, source, and character of items of income, gain, loss and deduction. These rules are designed to provide for the computation of taxable income in a manner that provides for a degree of specificity to both taxpayers and the government. Taxpayers generally may plan their transactions in reliance on these rules to determine the federal income tax consequences arising from the transactions.

In addition to the statutory provisions, courts have developed several doctrines that can be applied to deny the tax benefits of tax motivated transactions, notwithstanding that the transaction may satisfy the literal requirements of a specific tax provision. The common-law doctrines are not entirely distinguishable, and their application to a given set of facts is often blurred by the courts and the IRS. Although these doctrines serve an important role in the administration of the tax system, invocation of these doctrines can be seen as at odds with an objective, "rule-based" system of taxation. Nonetheless, courts have applied the doctrines to deny tax benefits arising from certain transactions.[261]

A common-law doctrine applied with increasing frequency is the "economic substance" doctrine. In general, this doctrine denies tax benefits arising from transactions that do not result in a meaningful change to the taxpayer's economic position other than a purported reduction in federal income tax.[262]

Economic substance doctrine

Courts generally deny claimed tax benefits if the transaction that gives rise to those benefits lacks economic substance independent of tax considerations − notwithstanding that the purported activity actually occurred. The Tax Court has described the doctrine as follows:

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[261] See, e.g., *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *aff'g* 73 T.C.M. (CCH) 2189 (1997), *cert. denied* 526 U.S. 1017 (1999).

[262] Closely related doctrines also applied by the courts (sometimes interchangeable with the economic substance doctrine) include the "sham transaction doctrine" and the "business purpose doctrine". See, e.g., *Knetsch v. United States*, 364 U.S. 361 (1960) (denying interest deductions on a "sham transaction" whose only purpose was to create the deductions).

The tax law . . . requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. The doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings.[263]

Business purpose doctrine

Another common law doctrine that overlays and is often considered together with (if not part and parcel of) the economic substance doctrine is the business purpose doctrine. The business purpose test is a subjective inquiry into the motives of the taxpayer − that is, whether the taxpayer intended the transaction to serve some useful non-tax purpose. In making this determination, some courts have bifurcated a transaction in which independent activities with non-tax objectives have been combined with an unrelated item having only tax-avoidance objectives in order to disallow the tax benefits of the overall transaction.[264]

Application by the courts

Elements of the doctrine

There is a lack of uniformity regarding the proper application of the economic substance doctrine.[265] Some courts apply a conjunctive test that requires a taxpayer to establish the presence of both economic substance (i.e., the objective component) and business purpose (i.e., the subjective component) in order for the transaction to survive judicial scrutiny.[266] A narrower approach used by some courts is to conclude that either a business purpose or economic substance is sufficient to respect the transaction).[267] A third approach regards economic

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[263] *ACM Partnership v. Commissioner*, 73 T.C.M. at 2215.

[264] *ACM Partnership v. Commissioner*, 157 F.3d at 256 n.48.

[265] "The casebooks are glutted with [economic substance] tests. Many such tests proliferate because they give the comforting illusion of consistency and precision. They often obscure rather than clarify." *Collins v. Commissioner*, 857 F.2d 1383, 1386 (9th Cir. 1988).

[266] See, e.g., *Pasternak v. Commissioner*, 990 F.2d 893, 898 (6th Cir. 1993) ("The threshold question is whether the transaction has economic substance. If the answer is yes, the question becomes whether the taxpayer was motivated by profit to participate in the transaction.").

[267] See, e.g., *Rice's Toyota World v. Commissioner*, 752 F.2d 89, 91-92 (4th Cir. 1985) ("To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and, second, that the transaction has no economic substance because no reasonable possibility of a profit exists."); *IES Industries v. United States,* 253 F.3d 350, 358 (8th Cir. 2001) ("In determining whether a transaction is a sham for tax purposes [under the Eighth Circuit test], a transaction will be characterized as a sham if it is not motivated by any economic purpose out of tax considerations (the business purpose test), and if it is without economic substance because no real potential for profit exists (the economic substance test)."). As noted earlier, the economic substance doctrine and the sham transaction doctrine are similar and sometimes are applied

substance and business purpose as "simply more precise factors to consider" in determining whether a transaction has any practical economic effects other than the creation of tax benefits.[268]

Recently, the Court of Federal Claims questioned the continuing viability of the doctrine That court also stated that "the use of the 'economic substance' doctrine to trump 'mere compliance with the Code' would violate the separation of powers" though that court also found that the particular case did not lack economic substance. The Court of Appeals for the Federal Circuit ("Federal Circuit Court") overruled the Court of Federal Claims decision, reiterating the viability of the economic substance doctrine and concluding that the transaction in questions violated that doctrine.[269] The Federal Circuit Court stated that "[w]hile the doctrine may well also apply if the taxpayer's sole subjective motivation is tax avoidance even if the transaction has economic substance, [footnote omitted], a lack of economic substance is sufficient to disqualify the transaction without proof that the taxpayer's sole motive is tax avoidance."[270]

Nontax economic benefits

There also is a lack of uniformity regarding the type of non-tax economic benefit a taxpayer must establish in order to satisfy economic substance. Some courts have denied tax benefits on the grounds that a stated business benefit of a particular structure was not in fact obtained by that structure.[271] Several courts have denied tax benefits on the grounds that the

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interchangeably. For a more detailed discussion of the sham transaction doctrine, see, e.g., Joint Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (including Provisions Relating to Corporate Tax Shelters)* (JCS-3-99) at 182.

[268] See, e.g., *ACM Partnership v. Commissioner*, 157 F.3d at 247; *James v. Commissioner*, 899 F.2d 905, 908 (10th Cir. 1995); *Sacks v. Commissioner*, 69 F.3d 982, 985 (9th Cir. 1995) ("Instead, the consideration of business purpose and economic substance are simply more precise factors to consider . . . We have repeatedly and carefully noted that this formulation cannot be used as a 'rigid two-step analysis'.").

[269] *Coltec Industries, Inc. v. United States*, 62 Fed. Cl. 716 (2004) (slip opinion at 123-124, 128); *vacated and remanded,* 454 F.3d 1340 (Fed. Cir. 2006).

[270] The Federal Circuit Court stated that "when the taxpayer claims a deduction, it is the taxpayer who bears the burden of proving that the transaction has economic substance." The Federal Circuit Court quoted a decision of its predecessor court, stating that "Gregory v. Helvering requires that a taxpayer carry an unusually heavy burden when he attempts to demonstrate that Congress intended to give favorable tax treatment to the kind of transaction that would never occur absent the motive of tax avoidance." The Court also stated that "while the taxpayer's subjective motivation.may be pertinent to the existence of a tax avoidance purpose, all courts have looked to the objective reality of a transaction in assessing its economic substance." *Coltec Industries, Inc. v. United States*, 454 F.3d 1340, at 1355,1356 (Fed. Cir. 2006).

[271] See, e,g, *Coltec Industries v. United States,* 454 F.3d 1340 (Fed. Cir. 2006). The court analyzed the transfer to a subsidiary of a note purporting to provide high stock basis in exchange for a

subject transactions lacked profit potential.[272] In addition, some courts have applied the economic substance doctrine to disallow tax benefits in transactions in which a taxpayer was exposed to risk and the transaction had a profit potential, but the court concluded that the economic risks and profit potential were insignificant when compared to the tax benefits.[273] Under this analysis, the taxpayer's profit potential must be more than nominal. Conversely, other courts view the application of the economic substance doctrine as requiring an objective determination of whether a "reasonable possibility of profit" from the transaction existed apart from the tax benefits.[274] In these cases, in assessing whether a reasonable possibility of profit exists, it is sufficient if there is a nominal amount of pre-tax profit as measured against expected net tax benefits.

Financial accounting benefits

In determining whether a taxpayer had a valid business purpose for entering into a transaction, at least one court has concluded that financial accounting benefits arising from tax savings do not qualify as a non-tax business purpose.[275] However, based on court decisions that recognize the importance of financial accounting treatment, taxpayers have asserted that financial accounting benefits arising from tax savings can satisfy the business purpose test.[276]

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purported assumption of liabilities, and held these transactions unnecessary to accomplish any business purpose of using a subsidiary to manage asbestos liabilities. The court also held that the purported business purpose of adding a barrier to veil-piercing claims by third parties was not accomplished by the transaction. 454 F.3d 1340 at pp 358-1360 (Fed. Cir. 2006).

[272] See, e.g., *Knetsch*, 364 U.S. at 361; *Goldste;in v. Commissioner*, 364 F.2d 734 (2d Cir. 1966) (holding that an unprofitable, leveraged acquisition of Treasury bills, and accompanying prepaid interest deduction, lacked economic substance).

[273] See, e.g., *Goldstein v. Commissioner*, 364 F.2d at 739-40 (disallowing deduction even though taxpayer had a possibility of small gain or loss by owning Treasury bills); *Sheldon v. Commissioner*, 94 T.C. 738, 768 (1990) (stating that "potential for gain . . . is infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions").

[274] See, e.g., *Rice's Toyota World v. Commissioner*, 752 F.2d at 94 (the economic substance inquiry requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits); *Compaq Computer Corp. v. Commissioner*, 277 F.3d at 781 (applied the same test, citing *Rice's Toyota World*); *IES Industries v. United States*, 253 F.3d 350, 354 (8th Cir. 2001).

[275] See, *American Electric Power, Inc. v. U.S.*, 136 F. Supp. 2d 762, 791-92 (S.D. Ohio 2001); *aff'd* 326 F.3d.737 (6th Cir. 2003).

[276] See, e.g., Joint Committee on Taxation, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations* (JSC-3-03) February, 2003 ("Enron Report"), Volume III at C-93, 289. Enron Corporation relied on *Frank Lyon Co. v. United States*, 435 U.S. 561, 577-78 (1978), and *Newman v. Commissioner*, 902 F.2d 159, 163 (2d

Reasons for Change

Recent tax avoidance transactions have relied upon the interaction of highly technical tax law provisions to produce tax consequences not contemplated by the Congress. When successful, taxpayers who engage in these transactions enlarge the tax gap by gaining unintended tax relief and by undermining overall respect for the tax system. Even in cases when taxpayers do not prevail, substantial resources are expended and resolutions of issues frequently are delayed for several years.

A strictly rule-based tax system cannot efficiently prescribe the appropriate outcome of every conceivable transaction that might be devised and is, as a result, incapable of preventing all unintended consequences. Thus, many courts have long recognized the need to supplement tax rules with anti-tax avoidance standards, such as the economic substance doctrine, in order to assure the Congressional purpose is achieved. The Committee believes it is desirable to provide greater clarity and uniformity in the application of the economic substance doctrine in order to improve its effectiveness at deterring unintended consequences and to promote more effective utilization of resources.

Explanation of Provision

The provision clarifies and enhances the application of the economic substance doctrine. Under the provision, in a case in which a court determines that the economic substance doctrine is relevant to a transaction (or a series of transactions), such transaction (or series of transactions) has economic substance (and thus satisfies the economic substance doctrine) only if the taxpayer establishes that (1) the transaction changes in a meaningful way (apart from Federal income tax consequences) the taxpayer's economic position, and (2) the taxpayer has a substantial non-tax purpose for entering into such transaction and the transaction is a reasonable means of accomplishing such purpose.[277]

The provision does not change current law standards used by courts in determining when to utilize an economic substance analysis.[278] Also, the provision does not alter the court's ability to aggregate, disaggregate or otherwise recharacterize a transaction when applying the

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Cir. 1990) to argue that financial accounting benefits arising from tax savings constitutes a good business purpose.

[277] If the tax benefits are clearly contemplated and expected by the language and purpose of the relevant authority, it is not intended that such tax benefits be disallowed if the only reason for such disallowance is that the transaction fails the economic substance doctrine as defined in this provision.

[278] See, e.g., Treas. Reg. sec. 1.269-2, stating that characteristic of circumstances in which a deduction otherwise allowed will be disallowed are those in which the effect of the deduction, credit, or other allowance would be to distort the liability of the particular taxpayer when the essential nature of the transaction or situation is examined in the light of the basic purpose or plan which the deduction, credit, or other allowance was designed by the Congress to effectuate.

doctrine.[279] The provision provides a uniform definition of economic substance, but does not alter the flexibility of the courts in other respects.

Conjunctive analysis

The provision clarifies that the economic substance doctrine involves a conjunctive analysis − there must be an objective inquiry regarding the effects of the transaction on the taxpayer's economic position, as well as a subjective inquiry regarding the taxpayer's motives for engaging in the transaction. Under the provision, a transaction must satisfy both tests − i.e., it must change in a meaningful way (apart from Federal income tax consequences) the taxpayer's economic position, and the taxpayer must have a substantial non-tax purpose for entering into such transaction (and the transaction is a reasonable means of accomplishing such purpose) − in order to satisfy the economic substance doctrine. This clarification eliminates the disparity that exists among the circuits regarding the application of the doctrine, and modifies its application in those circuits in which either a change in economic position or a non-tax business purpose (without having both) is sufficient to satisfy the economic substance doctrine.

Non-tax business purpose

Under the provision, a taxpayer's non-tax purpose for entering into a transaction (the second prong in the analysis) must be "substantial," and the transaction must be "a reasonable means" of accomplishing such purpose. Under this formulation, the non-tax purpose for the transaction must bear a reasonable relationship to the taxpayer's normal business operations or investment activities.[280]

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[279] See, e.g., *Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938) ("A given result at the end of a straight path is not made a different result because reached by following a devious path.").

[280] See, e.g., Treas. Reg. sec. 1.269-2(b) (stating that a distortion of tax liability indicating the principal purpose of tax evasion or avoidance might be evidenced by the fact that "the transaction was not undertaken for reasons germane to the conduct of the business of the taxpayer"). Similarly, in *ACM Partnership v. Commissioner*, 73 T.C.M. (CCH) 2189 (1997), the court stated:

> Key to [the determination of whether a transaction has economic substance] is that the transaction must be rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions. Both the utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry. A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the nontax benefits would be at least commensurate with the transaction costs. [citations omitted]

See also Martin McMahon Jr., *Economic Substance, Purposive Activity, and Corporate Tax Shelters*, 94 Tax Notes 1017, 1023 (Feb. 25, 2002) (advocates "confining the most rigorous application of business purpose, economic substance, and purposive activity tests to transactions outside the ordinary course of the taxpayer's business − those transactions that do not appear to contribute to any business activity or objective that the taxpayer may have had apart from tax planning but are merely loss

In determining whether a taxpayer has a substantial non-tax business purpose, an objective of achieving a favorable accounting treatment for financial reporting purposes will not be treated as having a substantial non-tax purpose.[281] Furthermore, a transaction that is expected to increase financial accounting income as a result of generating tax deductions or losses without a corresponding financial accounting charge (i.e., a permanent book-tax difference)[282] should not be considered to have a substantial non-tax purpose unless a substantial non-tax purpose exists apart from the financial accounting benefits.[283]

By requiring that a transaction be a "reasonable means" of accomplishing its non-tax purpose, the provision reiterates the present-law ability of the courts to bifurcate a transaction in which independent activities with non-tax objectives are combined with an unrelated item having only tax-avoidance objectives in order to disallow the tax benefits of the overall transaction.[284]

<u>Profit potential</u>

Under the provision, a taxpayer may rely on factors other than profit potential to demonstrate that a transaction results in a meaningful change in the taxpayer's economic

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generators."); Mark P. Gergen, *The Common Knowledge of Tax Abuse,* 54 SMU L. Rev. 131, 140 (Winter 2001) ("The message is that you can pick up tax gold if you find it in the street while going about your business, but you cannot go hunting for it.").

[281] However, if the tax benefits are clearly contemplated and expected by the language and purpose of the relevant authority, such tax benefits should not be disallowed solely because the transaction results in a favorable accounting treatment. An example is the repealed foreign sales corporation rules.

[282] This includes tax deductions or losses that are anticipated to be recognized in a period subsequent to the period the financial accounting benefit is recognized. For example, FAS 109 in some cases permits the recognition of financial accounting benefits prior to the period in which the tax benefits are recognized for income tax purposes.

[283] Claiming that a financial accounting benefit constitutes a substantial non-tax purpose fails to consider the origin of the accounting benefit (i.e., reduction of taxes) and significantly diminishes the purpose for having a substantial non-tax purpose requirement. See, e.g., *American Electric Power, Inc. v. U.S.*, 136 F. Supp. 2d 762, 791-92 (S.D. Ohio, 2001) ("AEP's intended use of the cash flows generated by the [corporate-owned life insurance] plan is irrelevant to the subjective prong of the economic substance analysis. If a legitimate business purpose for the use of the tax savings 'were sufficient to breathe substance into a transaction whose only purpose was to reduce taxes, [then] every sham tax-shelter device might succeed,'") (citing *Winn-Dixie v. Commissioner*, 113 T.C. 254, 287 (1999)); *aff'd* 326 F3d 737 (6th Cir. 2003).

[284] See, e.g., *ACM Partnership v. Commissioner*, 157 F.3d at 256 n.48; see also *Coltec Industries, Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006) "the first asserted business purpose focuses on the wrong transaction--the creation of Garrison as a separate subsidiary to manage asbestos liabilities. . . . [W]e must focus on the transaction that gave the taxpayer a high basis in the stock and thus gave rise to the alleged benefit upon sale…" 454 F.3d 1340, 1358 (Fed. Cir. 2006).

position; the provision merely sets forth a minimum threshold of profit potential if that test is relied on to demonstrate a meaningful change in economic position. If a taxpayer relies on a profit potential, however, the present value of the reasonably expected pre-tax profit must be substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.[285] Moreover, the profit potential must exceed a risk-free rate of return. In addition, in determining pre-tax profit, fees and other transaction expenses and foreign taxes are treated as expenses.

In applying the profit potential test to a lessor of tangible property, depreciation, applicable tax credits (such as the rehabilitation tax credit and the low income housing tax credit), and any other deduction as provided in guidance by the Secretary are not taken into account in measuring tax benefits.

Transactions with tax-indifferent parties

The provision also provides special rules for transactions with tax-indifferent parties. For this purpose, a tax-indifferent party means any person or entity not subject to Federal income tax, or any person to whom an item would have no substantial impact on its income tax liability. Under these rules, the form of a financing transaction will not be respected if the present value of the tax deductions to be claimed is substantially in excess of the present value of the anticipated economic returns to the lender. Also, the form of a transaction with a tax-indifferent party will not be respected if it results in an allocation of income or gain to the tax-indifferent party in excess of the tax-indifferent party's economic gain or income or if the transaction results in the shifting of basis on account of overstating the income or gain of the tax-indifferent party.

Other rules

The Secretary may prescribe regulations which provide (1) exemptions from the application of the provision, and (2) other rules as may be necessary or appropriate to carry out the purposes of the provision.

No inference is intended as to the proper application of the economic substance doctrine under present law. In addition, except with respect to the economic substance doctrine, the provision shall not be construed as altering or supplanting any other common law doctrine (including the sham transaction doctrine), and the provision shall be construed as being additive to any such other doctrine.

Effective Date

The provision applies to transactions entered into after the date of enactment.

285 Thus, a "reasonable possibility of profit" will not be sufficient to establish that a transaction has economic substance.

2. Penalty for understatements attributable to transactions lacking economic substance, etc. (sec. 802 of the bill and new sec. 6662B of the Code)

Present Law

General accuracy-related penalty

An accuracy-related penalty under section 6662 applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. If the correct income tax liability exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 (or, in the case of corporations, by the lesser of (a) 10 percent of the correct tax (or $10,000 if greater) or (b) $10 million), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.[286] Except in the case of tax shelters,[287] the amount of any understatement 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. The Treasury Secretary may prescribe a list of positions which the Secretary believes do not meet the requirements for substantial authority under this provision.

The section 6662 penalty generally is abated (even with respect to tax shelters) in cases in which the taxpayer can demonstrate that there was "reasonable cause" for the underpayment and that the taxpayer acted in good faith.[288] The relevant regulations provide that reasonable cause exists where the taxpayer "reasonably relies in good faith on an opinion based on a professional tax advisor's analysis of the pertinent facts and authorities [that] . . . unambiguously concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged" by the IRS.[289]

Listed transactions and reportable avoidance transactions

In general

A separate accuracy-related penalty under section 6662A applies to "listed transactions" and to other "reportable transactions" with a significant tax avoidance purpose (hereinafter

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[286] Sec. 6662.

[287] A tax shelter is defined for this purpose as a partnership or other entity, an investment plan or arrangement, or any other plan or arrangement if a significant purpose of such partnership, other entity, plan, or arrangement is the avoidance or evasion of Federal income tax. Sec. 6662(d)(2)(C).

[288] Sec. 6664(c).

[289] Treas. Reg. sec. 1.6662-4(g)(4)(i)(B); Treas. Reg. sec. 1.6664-4(c).

referred to as a "reportable avoidance transaction"). The penalty rate and defenses available to avoid the penalty vary depending on whether the transaction was adequately disclosed.

Both listed transactions and reportable transactions are allowed to be described by the Treasury department under section 6707A(c), which imposes a penalty for failure adequately to report such transactions under section 6011. A reportable transaction is defined as one that the Treasury Secretary determines is required to be disclosed because it is determined to have a potential for tax avoidance or evasion.[290] A listed transaction is defined as a reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of the reporting disclosure requirements.[291]

<u>Disclosed transactions</u>

In general, a 20-percent accuracy-related penalty is imposed on any understatement attributable to an adequately disclosed listed transaction or reportable avoidance transaction.[292] The only exception to the penalty is if the taxpayer satisfies a more stringent reasonable cause and good faith exception (hereinafter referred to as the "strengthened reasonable cause exception"), which is described below. The strengthened reasonable cause exception is available only if the relevant facts affecting the tax treatment are adequately disclosed, there is or was substantial authority for the claimed tax treatment, and the taxpayer reasonably believed that the claimed tax treatment was more likely than not the proper treatment.

<u>Undisclosed transactions</u>

If the taxpayer does not adequately disclose the transaction, the strengthened reasonable cause exception is not available (i.e., a strict-liability penalty generally applies), and the taxpayer is subject to an increased penalty equal to 30 percent of the understatement.[293] However, a taxpayer will be treated as having adequately disclosed a transaction for this purpose if the IRS Commissioner has separately rescinded the separate penalty under section 6707A for failure to disclose a reportable transaction.[294] The IRS Commissioner is authorized to do this only if the failure does not relate to a listed transaction and only if rescinding the penalty would promote compliance and effective tax administration.[295]

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[290] Sec. 6707A(c)(1).

[291] Sec. 6707A(c)(2).

[292] Sec. 6662A(a).

[293] Sec. 6662A(c).

[294] Sec. 6664(d).

[295] Sec. 6707A(d).

A public entity that is required to pay a penalty for an undisclosed listed or reportable transaction must disclose the imposition of the penalty in reports to the SEC for such periods as the Secretary shall specify. The disclosure to the SEC applies without regard to whether the taxpayer determines the amount of the penalty to be material to the reports in which the penalty must appear; and any failure to disclose such penalty in the reports is treated as a failure to disclose a listed transaction. A taxpayer must disclose a penalty in reports to the SEC once the taxpayer has exhausted its administrative and judicial remedies with respect to the penalty (or if earlier, when paid).[296]

Determination of the understatement amount

The penalty is applied to the amount of any understatement attributable to the listed or reportable avoidance transaction without regard to other items on the tax return. For purposes of this provision, the amount of the understatement is determined as the sum of: (1) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer's treatment of the item and the proper treatment of the item (without regard to other items on the tax return);[297] and (2) the amount of any decrease in the aggregate amount of credits which results from a difference between the taxpayer's treatment of an item and the proper tax treatment of such item.

Except as provided in regulations, a taxpayer's treatment of an item shall not take into account any amendment or supplement to a return if the amendment or supplement is filed after the earlier of when the taxpayer is first contacted regarding an examination of the return or such other date as specified by the Secretary.[298]

Strengthened reasonable cause exception

A penalty is not imposed under the provision with respect to any portion of an understatement if it is shown that there was reasonable cause for such portion and the taxpayer acted in good faith. Such a showing requires: (1) adequate disclosure of the facts affecting the transaction in accordance with the regulations under section 6011;[299] (2) that there is or was substantial authority for such treatment; and (3) that the taxpayer reasonably believed that such treatment was more likely than not the proper treatment. For this purpose, a taxpayer will be treated as having a reasonable belief with respect to the tax treatment of an item only if such

[296] Sec. 6707A(e).

[297] For this purpose, any reduction in the excess of deductions allowed for the taxable year over gross income for such year, and any reduction in the amount of capital losses which would (without regard to section 1211) be allowed for such year, shall be treated as an increase in taxable income. Sec. 6662A(b).

[298] Sec. 6662A(e)(3).

[299] See the previous discussion regarding the penalty for failing to disclose a reportable transaction.

belief: (1) is based on the facts and law that exist at the time the tax return (that includes the item) is filed; and (2) relates solely to the taxpayer's chances of success on the merits and does not take into account the possibility that (a) a return will not be audited, (b) the treatment will not be raised on audit, or (c) the treatment will be resolved through settlement if raised. [300]

A taxpayer may (but is not required to) rely on an opinion of a tax advisor in establishing its reasonable belief with respect to the tax treatment of the item. However, a taxpayer may not rely on an opinion of a tax advisor for this purpose if the opinion (1) is provided by a "disqualified tax advisor" or (2) is a "disqualified opinion."

Disqualified tax advisor

A disqualified tax advisor is any advisor who: (1) is a material advisor[301] and who participates in the organization, management, promotion or sale of the transaction or is related (within the meaning of section 267(b) or 707(b)(1)) to any person who so participates; (2) is compensated directly or indirectly[302] by a material advisor with respect to the transaction; (3) has a fee arrangement with respect to the transaction that is contingent on all or part of the intended tax benefits from the transaction being sustained; or (4) as determined under regulations prescribed by the Secretary, has a disqualifying financial interest with respect to the transaction.

A material advisor is considered as participating in the "organization" of a transaction if the advisor performs acts relating to the development of the transaction. This may include, for example, preparing documents: (1) establishing a structure used in connection with the transaction (such as a partnership agreement); (2) describing the transaction (such as an offering memorandum or other statement describing the transaction); or (3) relating to the registration of the transaction with any federal, state or local government body.[303] Participation in the

[300] Sec. 6664(d).

[301] The term "material advisor" means any person who provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, or carrying out any reportable transaction, and who derives gross income in excess of $50,000 in the case of a reportable transaction substantially all of the tax benefits from which are provided to natural persons ($250,000 in any other case). Sec. 6111(b)(1).

[302] This situation could arise, for example, when an advisor has an arrangement or understanding (oral or written) with an organizer, manager, or promoter of a reportable transaction that such party will recommend or refer potential participants to the advisor for an opinion regarding the tax treatment of the transaction.

[303] An advisor should not be treated as participating in the organization of a transaction if the advisor's only involvement with respect to the organization of the transaction is the rendering of an opinion regarding the tax consequences of such transaction. However, such an advisor may be a "disqualified tax advisor" with respect to the transaction if the advisor participates in the management, promotion or sale of the transaction (or if the advisor is compensated by a material advisor, has a fee arrangement that is contingent on the tax benefits of the transaction, or as determined by the Secretary, has a continuing financial interest with respect to the transaction).

"management" of a transaction means involvement in the decision-making process regarding any business activity with respect to the transaction. Participation in the "promotion or sale" of a transaction means involvement in the marketing or solicitation of the transaction to others. Thus, an advisor who provides information about the transaction to a potential participant is involved in the promotion or sale of a transaction, as is any advisor who recommends the transaction to a potential participant.

Disqualified opinion

An opinion may not be relied upon if the opinion: (1) is based on unreasonable factual or legal assumptions (including assumptions as to future events); (2) unreasonably relies upon representations, statements, finding or agreements of the taxpayer or any other person; (3) does not identify and consider all relevant facts; or (4) fails to meet any other requirement prescribed by the Secretary.

Coordination with other penalties

To the extent a penalty on an understatement is imposed under section 6662A, that same amount of understatement is not also subject to the accuracy-related penalty under section 6662(a) or to the valuation misstatement penalties under section 6662(e) or 6662(h). However, such amount of understatement is included for purposes of determining whether any understatement (as defined in sec. 6662(d)(2)) is a substantial understatement as defined under section 6662(d)(1) and for purposes of identifying an underpayment under the section 6663 fraud penalty.

The penalty imposed under section 6662A does not apply to any portion of an understatement to which a fraud penalty is applied under section 6663.

Reasons for Change

The committee believes that a stronger penalty imposed on understatements attributable to non-economic substance transactions is desirable to improve compliance.

Explanation of Provision

The provision imposes a new, stronger penalty for an understatement attributable to any transaction that lacks economic substance (referred to in the statute as a "non-economic substance transaction understatement").[304] The penalty rate is 40 percent (reduced to 20 percent if the taxpayer adequately discloses the relevant facts in accordance with regulations prescribed under section 6011). No exceptions (including the reasonable cause or rescission rules) to the penalty are available (i.e., the penalty is a strict-liability penalty).

[304] Thus, unlike the present-law accuracy-related penalty under section 6662A (which applies only to listed and reportable avoidance transactions), the new penalty under the provision applies to any transaction that lacks economic substance.

A "non-economic substance transaction" means any transaction if (1) the transaction lacks economic substance (as defined in the Senate amendment provision regarding the clarification of the economic substance doctrine),[305] (2) the transaction was not respected under the rules relating to transactions with tax-indifferent parties (as described in the Senate amendment provision regarding the clarification of the economic substance doctrine),[306] or (3) any similar rule of law. For this purpose, a similar rule of law would include, for example, an understatement attributable to a transaction that is determined to be a sham transaction.

For purposes of the bill, the calculation of an "understatement" is made in the same manner as in the present law provision relating to accuracy-related penalties for listed and reportable avoidance transactions (sec. 6662A). Thus, the amount of the understatement under the provision would be determined as the sum of (1) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer's treatment of the item and the proper treatment of the item (without regard to other items on the tax return),[307] and (2) the amount of any decrease in the aggregate amount of credits which results from a difference between the taxpayer's treatment of an item and the proper tax treatment of such item. In essence, the penalty will apply to the amount of any understatement attributable solely to a non-economic substance transaction.

As in the case of the understatement penalty for reportable and listed transactions under present law section 6662A(e)(3), except as provided in regulations, the taxpayer's treatment of an item will not take into account any amendment or supplement to a return if the amendment or supplement is filed after the earlier of the date the taxpayer is first contacted regarding an examination of such return or such other date as specified by the Secretary.

As in the case of the understatement penalty for undisclosed reportable transactions under present law section 6707A, a public entity that is required to pay a penalty under the provision (but in this case, regardless of whether the transaction was disclosed) must disclose the imposition of the penalty in reports to the SEC for such periods as the Secretary shall specify. The disclosure to the SEC applies without regard to whether the taxpayer determines the amount

[305] That Senate amendment provision generally provides that in any case in which a court determines that the economic substance doctrine is relevant, a transaction has economic substance only if: (1) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (2) the taxpayer has a substantial non-tax purpose for entering into such transaction and the transaction is a reasonable means of accomplishing such purpose. Specific other rules also apply. See "Explanation of Provision" for the immediately preceding Senate amendment provision, "Clarification of the economic substance doctrine."

[306] That Senate amendment provision provides that the form of a transaction that involves a tax-indifferent party will not be respected in certain circumstances. See "Explanation of Provision" for the immediately preceding Senate amendment provision, "Clarification of the economic substance doctrine."

[307] For this purpose, any reduction in the excess of deductions allowed for the taxable year over gross income for such year, and any reduction in the amount of capital losses that would (without regard to section 1211) be allowed for such year, would be treated as an increase in taxable income.

of the penalty to be material to the reports in which the penalty must appear, and any failure to disclose such penalty in the reports is treated as a failure to disclose a listed transaction. A taxpayer must disclose a penalty in reports to the SEC once the taxpayer has exhausted its administrative and judicial remedies with respect to the penalty (or if earlier, when paid).

Regardless of whether the transaction was disclosed, once a penalty under the provision has been included in the first letter of proposed deficiency which allows the taxpayer an opportunity for administrative review in the IRS Office of Appeals, the penalty cannot be compromised for purposes of a settlement without approval of the Commissioner personally. Furthermore, the IRS is required to keep records summarizing the application of this penalty and providing a description of each penalty compromised under the provision and the reasons for the compromise.

Any understatement on which a penalty is imposed under the provision will not be subject to the accuracy-related penalty under section 6662 or under 6662A (accuracy-related penalties for listed and reportable avoidance transactions). However, an understatement under the provision is taken into account for purposes of determining whether any understatement (as defined in sec. 6662(d)(2)) is a substantial understatement as defined under section 6662(d)(1). The penalty imposed under the provision will not apply to any portion of an understatement to which a fraud penalty is applied under section 6663.

Effective Date

The provision applies to transactions entered into after the date of enactment.

B. Tax Treatment of Certain Inverted Corporate Entities (sec. 803 of the bill and sec. 7874 of the Code)

Present Law

Determination of corporate residence

The U.S. tax treatment of a multinational corporate group depends significantly on whether the parent corporation of the group is domestic or foreign. For purposes of U.S. tax law, a corporation is treated as domestic if it is incorporated under the law of the United States or of any State. Other corporations (i.e., those incorporated under the laws of foreign countries or U.S. possessions) generally are treated as foreign.

U.S. taxation of domestic corporations

The United States employs a "worldwide" tax system, under which domestic corporations generally are taxed on all income, whether derived in the United States or abroad. In order to mitigate the double taxation that may arise from taxing the foreign-source income of a domestic corporation, a foreign tax credit for income taxes paid to foreign countries is provided to reduce or eliminate the U.S. tax owed on such income, subject to certain limitations.

Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income generally is deferred, and U.S. tax is imposed on such income when repatriated. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F (secs. 951-964) and the passive foreign investment company rules (secs. 1291-1298). A foreign tax credit is generally available to offset, in whole or in part, the U.S. tax owed on this foreign-source income, whether such income is repatriated as an actual dividend or included under one of the anti-deferral regimes.

U.S. taxation of foreign corporations

The United States taxes foreign corporations only on income that has a sufficient nexus to the United States. Thus, a foreign corporation is generally subject to U.S. tax only on income that is "effectively connected" with the conduct of a trade or business in the United States. Such "effectively connected income" generally is taxed in the same manner and at the same rates as the income of a U.S. corporation. An applicable tax treaty may limit the imposition of U.S. tax on business operations of a foreign corporation to cases in which the business is conducted through a "permanent establishment" in the United States.

In addition, foreign corporations generally are subject to a gross-basis U.S. tax at a flat 30-percent rate on the receipt of interest, dividends, rents, royalties, and certain similar types of income derived from U.S. sources, subject to certain exceptions. The tax generally is collected by means of withholding by the person making the payment. This tax may be reduced or eliminated under an applicable tax treaty.

U.S. tax treatment of inversion transactions prior to the American Jobs Creation Act of 2004

Prior to the American Jobs Creation Act of 2004 ("AJCA"), a U.S. corporation could reincorporate in a foreign jurisdiction and thereby replace the U.S. parent corporation of a multinational corporate group with a foreign parent corporation. These transactions were commonly referred to as inversion transactions. Inversion transactions could take many different forms, including stock inversions, asset inversions, and various combinations of and variations on the two. Most of the known transactions were stock inversions. In one example of a stock inversion, a U.S. corporation forms a foreign corporation, which in turn forms a domestic merger subsidiary. The domestic merger subsidiary then merges into the U.S. corporation, with the U.S. corporation surviving, now as a subsidiary of the new foreign corporation. The U.S. corporation's shareholders receive shares of the foreign corporation and are treated as having exchanged their U.S. corporation shares for the foreign corporation shares. An asset inversion could be used to reach a similar result, but through a direct merger of the top-tier U.S. corporation into a new foreign corporation, among other possible forms. An inversion transaction could be accompanied or followed by further restructuring of the corporate group. For example, in the case of a stock inversion, in order to remove income from foreign operations from the U.S. taxing jurisdiction, the U.S. corporation could transfer some or all of its foreign subsidiaries directly to the new foreign parent corporation or other related foreign corporations.

In addition to removing foreign operations from U.S. taxing jurisdiction, the corporate group could seek to derive further advantage from the inverted structure by reducing U.S. tax on U.S.-source income through various earnings stripping or other transactions. This could include earnings stripping through payment by a U.S. corporation of deductible amounts such as interest, royalties, rents, or management service fees to the new foreign parent or other foreign affiliates. In this respect, the post-inversion structure could enable the group to employ the same tax-reduction strategies that are available to other multinational corporate groups with foreign parents and U.S. subsidiaries, subject to the same limitations (e.g., secs. 163(j) and 482).

Inversion transactions could give rise to immediate U.S. tax consequences at the shareholder and/or the corporate level, depending on the type of inversion. In stock inversions, the U.S. shareholders generally recognized gain (but not loss) under section 367(a), based on the difference between the fair market value of the foreign corporation shares received and the adjusted basis of the domestic corporation stock exchanged. To the extent that a corporation's share value had declined, and/or it had many foreign or tax-exempt shareholders, the impact of this section 367(a) "toll charge" was reduced. The transfer of foreign subsidiaries or other assets to the foreign parent corporation also could give rise to U.S. tax consequences at the corporate level (e.g., gain recognition and earnings and profits inclusions under secs. 1001, 311(b), 304, 367, 1248 or other provisions). The tax on any income recognized as a result of these restructurings could be reduced or eliminated through the use of net operating losses, foreign tax credits, and other tax attributes.

In asset inversions, the U.S. corporation generally recognized gain (but not loss) under section 367(a) as though it had sold all of its assets, but the shareholders generally did not recognize gain or loss, assuming the transaction met the requirements of a reorganization under section 368.

U.S. tax treatment of inversion transactions under AJCA

In general

AJCA added new section 7874 to the Code, which defines two different types of corporate inversion transactions and establishes a different set of consequences for each type. Certain partnership transactions also are covered.

Transactions involving at least 80 percent identity of stock ownership

The first type of inversion is a transaction in which, pursuant to a plan[308] or a series of related transactions: (1) a U.S. corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity in a transaction completed after March 4, 2003; (2) the former shareholders of the U.S. corporation hold (by reason of holding stock in the U.S. corporation) 80 percent or more (by vote or value) of the stock of the foreign-incorporated entity after the transaction; and (3) the foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50 percent ownership (i.e., the "expanded affiliated group"), does not have substantial business activities in the entity's country of incorporation, compared to the total worldwide business activities of the expanded affiliated group. The provision denies the intended tax benefits of this type of inversion ("80-percent inversion") by deeming the top-tier foreign corporation to be a domestic corporation for all purposes of the Code.[309]

In determining whether a transaction meets the definition of an inversion under the provision, stock held by members of the expanded affiliated group that includes the foreign incorporated entity is disregarded. For example, if the former top-tier U.S. corporation receives stock of the foreign incorporated entity (e.g., so-called "hook" stock), the stock would not be considered in determining whether the transaction meets the definition. Similarly, if a U.S. parent corporation converts an existing wholly owned U.S. subsidiary into a new wholly owned controlled foreign corporation, the stock of the new foreign corporation would be disregarded, with the result that the transaction would not meet the definition of an inversion under the provision. Stock sold in a public offering related to the transaction also is disregarded for these purposes.

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[308] Acquisitions with respect to a domestic corporation or partnership are deemed to be "pursuant to a plan" if they occur within the four-year period beginning on the date which is two years before the ownership threshold under the provision is met with respect to such corporation or partnership.

[309] Since the top-tier foreign corporation is treated for all purposes of the Code as domestic, the shareholder-level "toll charge" of sec. 367(a) does not apply to these inversion transactions.

Transfers of properties or liabilities as part of a plan a principal purpose of which is to avoid the purposes of the provision are disregarded. In addition, the Treasury Secretary is to provide regulations to carry out the provision, including regulations to prevent the avoidance of the purposes of the provision, including avoidance through the use of related persons, pass-through or other noncorporate entities, or other intermediaries, and through transactions designed to qualify or disqualify a person as a related person or a member of an expanded affiliated group. Similarly, the Treasury Secretary has the authority to treat certain non-stock instruments as stock, and certain stock as not stock, where necessary to carry out the purposes of the provision.

Transactions involving at least 60 percent but less than 80 percent identity of stock ownership

The second type of inversion is a transaction that would meet the definition of an inversion transaction described above, except that the 80-percent ownership threshold is not met. In such a case, if at least a 60-percent ownership threshold is met, then a second set of rules applies to the inversion. Under these rules, the inversion transaction is respected (i.e., the foreign corporation is treated as foreign), but any applicable corporate-level "toll charges" for establishing the inverted structure are not offset by tax attributes such as net operating losses or foreign tax credits. Specifically, any applicable corporate-level income or gain required to be recognized under sections 304, 311(b), 367, 1001, 1248, or any other provision with respect to the transfer of controlled foreign corporation stock or the transfer or license of other assets by a U.S. corporation as part of the inversion transaction or after such transaction to a related foreign person is taxable, without offset by any tax attributes (e.g., net operating losses or foreign tax credits). This rule does not apply to certain transfers of inventory and similar property. These measures generally apply for a 10-year period following the inversion transaction.

Other rules

Under section 7874, inversion transactions include certain partnership transactions. Specifically, the provision applies to transactions in which a foreign-incorporated entity acquires substantially all of the properties constituting a trade or business of a domestic partnership, if after the acquisition at least 60 percent (or 80 percent, as the case may be) of the stock of the entity is held by former partners of the partnership (by reason of holding their partnership interests), provided that the other terms of the basic definition are met. For purposes of applying this test, all partnerships that are under common control within the meaning of section 482 are treated as one partnership, except as provided otherwise in regulations. In addition, the modified "toll charge" rules apply at the partner level.

A transaction otherwise meeting the definition of an inversion transaction is not treated as an inversion transaction if, on or before March 4, 2003, the foreign-incorporated entity had acquired directly or indirectly more than half of the properties held directly or indirectly by the domestic corporation, or more than half of the properties constituting the partnership trade or business, as the case may be.

Reasons for Change

The Committee believes that the inversions regime should generally apply to companies that completed 80-percent inversion transactions after public notice was given that eventual legislation on this issue could be effective after March 20, 2002.

Explanation of Provision

The provision generally extends the 80-percent inversion regime of section 7874 to 80-percent inversions completed after March 20, 2002 but on or before March 4, 2003, with certain modifications as described below. A transaction otherwise meeting the definition of an 80-percent inversion under the provision (i.e., one completed after March 20, 2002 but on or before March 4, 2003) is not treated as an 80-percent inversion if, on or before March 20, 2002, the foreign-incorporated entity had acquired directly or indirectly more than half the properties held directly or indirectly by the domestic corporation, or more than half the properties constituting the partnership trade or business, as the case may be.

Under the provision, an 80-percent inversion that is completed after March 20, 2002 but on or before March 4, 2003 is respected until the end of the last day of the foreign-incorporated entity's taxable year that began in 2005. At the end of that day, the inverted foreign-incorporated entity that completed the 80-percent inversion (or if relevant, any successor entity) is deemed to have transferred all of its assets and liabilities to a domestic corporation in a transaction that is generally treated as a nontaxable inbound reorganization ("repatriation"). The basis of the assets of the foreign-incorporated entity generally remains the same in the hands of the domestic corporation, subject to any special adjustments for importing built-in losses (e.g., sec. 362(e)). Shareholders of the domestic corporation inherit the respective bases of their shares of the foreign-incorporated entity.

On the day of the repatriation, the earnings and profits of the inverted foreign-incorporated entity transfer over to the domestic corporation. The transfer of such earnings and profits is not a deemed dividend and does not result in a tax upon the domestic corporation or its shareholders. In addition, any foreign taxes attributable to such earnings and profits are not creditable. However, shareholders may be subject to tax on distributions of such earnings and profits.

Beginning on the day after the repatriation, the inverted foreign-incorporated entity is treated for all tax purposes as a domestic corporation. Thus, any income earned by the inverted foreign-incorporated entity after the date of repatriation is deemed to be earned by a domestic corporation, and therefore, is fully taxable at U.S. corporate income tax rates. As a further consequence of the repatriation of the inverted foreign-incorporated entity, foreign subsidiaries become controlled foreign corporations, subject to the rules of subpart F.

It is intended that the Secretary will prescribe regulations that are necessary or appropriate to carry out the provision, including, but not limited to, regulations to prevent the avoidance of the purposes of the provision.

Effective Date

The provision is effective for taxable years beginning after December 31, 2005.

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 statement is made concerning the estimated budget effects of the provisions of the bill as reported.

[INSERT TABLE]

B. Budget Authority and Tax Expenditures

Budget authority

In compliance with section 308(a)(1) of the Budget Act, the Committee states that the provisions of the bill as reported involve new or increased budget authority with respect to the following sections of the bill: section 320, relating to authorization of appropriations for tax law enforcement relating to human sex trafficking, section 709, relating to the authorization of appropriations to combat the tax gap and for tax law enforcement, and section 711, relating to authorization of appropriations for tax law enforcement relating to the hiring and continued employment of undocumented workers.

Tax expenditures

In compliance with section 308(a)(2) of the Budget Act, the Committee states that the revenue-reducing provisions of the bill involve increased tax expenditures (see revenue table in Part III.A., above). The revenue increasing provisions of the bill generally involve reduced tax expenditures (see revenue table in Part III.A., above).

C. Consultation with Congressional Budget Office

In accordance with section 403 of the Budget Act, the Committee advises that the Congressional Budget Office has not submitted a statement on the bill. The letter from the Congressional Budget Office has not been received, and therefore will be provided separately.

IV. VOTES OF THE COMMITTEE

Motion to report the bill

In compliance with paragraph 7(b) of rule XXVI of the Standing Rules of the Senate, the Committee states that, with a quorum present, S. 1321 as modified by the Chairman's mark and amended by the Committee, the "Telephone Excise Tax Repeal and Taxpayer Protection Act of 2006," was ordered favorably reported by a voice vote on June 28, 2006.

Votes on other amendments

The Committee accepted an amendment by Senator Wyden to make permanent the moratorium on State and local government taxes on Internet access and certain other Internet-based transactions imposed by the Internet Tax Freedom Act (Pub. L. No. 105-277).

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 amended.

Impact on individuals and businesses

The bill includes provisions to repeal the telephone excise tax, to provide improvements in tax administration and taxpayer safeguards, to reform the penalty and interest provisions of the Internal Revenue Code, to modernize the procedures and operation of the United States Tax Court, to improve the confidentiality of tax information, to simplify the tax laws, to curtail tax shelters, and to improve corporate governance.

The bill includes various other provisions that are not expected to impose additional administrative requirements or regulatory burdens on individuals or businesses.

Impact on personal privacy and paperwork

The provisions of the bill do not reduce personal privacy. Several provisions of the bill may improve personal privacy protections, such as the provision ensuring compliance by contractors with confidentiality safeguards (section 503) and the provision imposing higher standards for requests for and consents to disclosure (section 504).

B. Unfunded Mandates Statement

This information is provided in accordance with section 423 of the Unfunded Mandates Reform Act of 1995 (Pub. L. No. 104-4).

The Committee has determined that the tax provisions of the bill contain two private sector mandates: (1) codification of economic substance; and (2) corporate inversions. The cost required to comply with each Federal private sector mandate generally are no greater than the aggregate estimated budget effects of the provision. Benefits from the provisions include improved administration of the tax laws and a more accurate measurement of income for Federal income tax purposes.

The Committee has determined that the tax provisions of the reported bill contain no intergovernmental mandates within the meaning of Pub. L. No. 104-4, the Unfunded Mandates Reform Act of 1995.

C. Tax Complexity Analysis

Section 4022(b) of the Internal Revenue Service Reform and Restructuring Act of 1998 (the "IRS Reform Act") requires the Joint Committee on Taxation (in consultation with the Internal Revenue Service and the Department of the Treasury) to provide a tax complexity analysis. The complexity analysis is required for all legislation reported by the Senate

Committee on Finance, the House Committee on Ways and Means, or any committee of conference if the legislation includes a provision that directly or indirectly amends the Code and has widespread applicability to individuals or small businesses.

The staff of the Joint Committee on Taxation has determined that a complexity analysis is not required under section 4022(b) of the IRS Reform Act because the bill contains no provisions that amend the Code and that have "widespread applicability" to individuals or small businesses.