[JOINT COMMITTEE PRINT]

# GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1998

PREPARED BY THE STAFF

OF THE

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# INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation in consultation with the staffs of the House Committee on Ways and Means and Senate Committee on Finance, provides an explanation of tax legislation enacted in 1998.

A committee report on legislation issued by a Congressional committee sets forth the committee's explanation of the bill as it was reported by that committee. In some instances, a committee report does not serve as an explanation of the final provisions of the legislation as enacted. This is because the version of the bill adopted by the conference committee may differ significantly from the versions of the bill reported by committee or passed by the House and the Senate. The material contained in this pamphlet is prepared so that Members of Congress, tax practitioners, and other interested parties can have a detailed explanation of the final tax legislation enacted in 1998 in one publication.

Part One of the pamphlet is an explanation of the provisions of the Surface Transportation Revenue Act of 1998 (Title IX of H.R. 2400, P.L. 105–178) relating to the extension and revision of the Highway Trust Fund excise taxes. Part Two is an explanation of the Internal Revenue Service Restructuring and Reform Act of 1998 (H.R. 2676, P.L. 105–206). Part Three is an explanation of the revenue provisions of the Tax and Trade Relief Act of 1998 (Division J of the Omnibus Consolidated and Emergency Supplemental Appropriations Act, 1999, H.R. 4328, P.L. 105–277). Part Four is an explanation of the revenue provision in the Ricky Ray Hemophilia Relief Fund Act of 1998 (sec. 103(h) of H.R. 1023, P.L. 105–369). The Appendix provides estimates of the budget effects of revenue legislation enacted in 1998 for the fiscal year period, 1999–2007.

The first footnote in each part gives the legislative history of each of the 1998 Acts.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1998* (JCS–6–98), November 24, 1998.

## PART ONE: SURFACE TRANSPORTATION REVENUE ACT OF 1998 (TITLE IX OF H.R. 2400) [2]

### A. Extension of Highway Trust Fund, Aquatic Resources Trust Fund, and National Recreational Trails Trust Fund Excise Taxes and Expenditure Authority (secs. 9002–9005, 9008, 9009, and 9011 of the Act and secs. 4041–4042, 4051–4053, 4071–4073, 4081–4084, 4101, 4481–4484, 9503, 9504, and 9511 of the Code)

#### *Present and Prior Law*

#### *Highway and related transportation excise taxes*

*Overview*

The present and prior law highway transportation excise taxes consist of:

(1) taxes on gasoline, diesel fuel, kerosene, and special motor fuels;

(2) a retail sales tax imposed on tractors, trucks, and trailers having gross vehicle weights in excess of prescribed thresholds;

(3) a tax on manufacturers of tires designed for use on heavy highway vehicles; and

(4) an annual use tax imposed on trucks and tractors having taxable gross weights in excess of prescribed thresholds.

Special motor fuels include liquefied natural gas ("LNG"), benzol, naphtha, liquefied petroleum gas (e.g., propane), natural gasoline, and any other liquid (e.g., ethanol and methanol) other than gasoline or diesel fuel. Compressed natural gas ("CNG") also is subject to tax as a special motor fuel, but at a lower rate than other special motor fuels.

With the exception of 4.3 cents per gallon of the motor fuels excise tax rates, these taxes were scheduled to expire after September 30, 1999.

*Highway motor fuels taxes*

*Tax rates.*—The present and prior law highway motor fules excise tax rates are shown in Table 1.

[2] Title IX of H.R. 2400 ("Surface Transportation Revenue Act of 1998"); P.L. 105–178. The revenue provisions (Title IX) of H.R. 2400 were reported by the House Committee on Ways and Means on March 27, 1998 (H. Rept. 105–467, Part II). H.R. 2400 was passed by the House on April 1, 1998.

The Senate passed H.R. 2400, as amended with the provisions of S. 1173, on April 2, 1998. The conference report was filed on the bill on May 22, 1998 (H. Rept. 105–550), and was passed by the House and the Senate on May 22, 1998. H.R. 2400 was signed by the President on June 9, 1998.

**Table 1. —Federal Highway Trust Fund Motor Fuels Excise Tax Rates, as of October 1, 1998[1]**

[Rates shown in cents per gallon]

| Highway fuel | Tax rate[2] |
|---|---|
| Gasoline[3] | 18.3 |
| Diesel Fuel[4] | 24.3 |
| Special Motor Fuels Generally | [5] 18.3 |
| CNG | [6] 4.3 |

[1] The rates shown include the 4.3-cents-per-gallon tax rate which was transferred to the Highway Trust Fund beginning on October 1, 1997, pursuant to the Taxpayer Relief Act of 1997.
[2] Excludes an additional 0.1-cent-per-gallon rate imposed on these motor fuels to finance the Leaking Underground Storage Tank Trust Fund.
[3] Gasoline used in motorboats and in certain off-highway recreational vehicles and small engines is subject to tax in the same manner and at the same rates as gasoline used in highway vehicles. 6.8 cents per gallon of the revenues from the tax on gasoline used in these uses was retained in the General Fund under prior law; the remaining 11.5 cents per gallon was deposited in the Aquatic Resources Trust Fund (motorboat and small engine gasoline), the Land and Water Conservation Fund ($1 million of motorboat gasoline tax revenues), and the National Recreational Trails Trust Fund (off-highway recreational vehicles).
[4] Kerosene is taxed at the same rate as diesel fuel.
[5] The rate is 13.6 cents per gallon for propane, 11.9 cents per gallon for liquefied natural gas, and 11.3 cents per gallon for methanol fuel from natural gas. In each case the tax rate is based on the relative energy equivalence of the fuel to gasoline.
[6] The statutory rate is 48.54 cents per thousand cubic feet ("MCF").

*Administration of highway motor fuels excise taxes.*—The gasoline, diesel fuel, and kerosene excise taxes are imposed on removal of the fuel from a refinery or on importation, unless the fuel is transferred by pipeline or barge to a registered terminal facility. In such a case, tax is imposed on removal of the fuel from the terminal facility (i.e., at the "terminal rack").[3] A large majority of these taxes is imposed at the terminal rack. The special motor fuels tax, which accounts for a relatively small portion of motor fuels tax revenues, is imposed at the retail level. Present law imposes tax on *all* gasoline, diesel fuel, and kerosene that is removed from a terminal facility, except diesel fuel and kerosene that is destined for nontaxable use (including a partially taxable use in an intercity bus or a train) and that is indelibly dyed in accordance with Treasury Department regulations.[4] Effective after June 30, 1998, prior law provided that as a condition of holding untaxed fuel, terminals that sold diesel fuel were required to offer both dyed and undyed fuel to their customers and terminals that sold kerosene were required to offer both dyed and undyed kerosene. The person holding an inventory position in the terminal at the time the fuel is removed

[3] Gasoline, diesel fuel, and kerosene may be removed from a refinery without payment of tax only if the party removing the fuel and all subsequent parties before its removal from a terminal facility are registered with the Internal Revenue Service. If fuel is sold to an unregistered party before leaving the terminal facility, tax immediately is imposed. This tax does not preclude imposition of a second tax at the terminal rack; however, the second tax may be refunded upon request. This dual tax regime was enacted in 1990 in response to reports that gasoline was being removed without payment of tax from terminals upon a claim that tax had already been paid, when in fact it had not been paid.
[4] Undyed kerosene also may be removed from terminals without payment of tax if the fuel is destined for use as aviation fuel or for certain nonfuel industrial purposes.

from that facility (the "position holder") is liable for payment of the tax.

Under prior law, gasoline, diesel fuel, and kerosene excise tax refunds were administered separately, subject to separate quarterly minimum filing thresholds. For gasoline, the minimum refund claim was $1,000 in the calendar quarter to which the claim relates. Certain diesel fuel claims were subject to this same standard; certain other diesel and aviation fuel claims could be filed in any of the first three calendar quarters in which the aggregate year-to-date refund equals $750. Fourth quarter refunds were required to be claimed as income tax credits regardless of amount.

*Highway fuels tax exemptions.*—Prior law and present law include numerous exemptions (including partial exemptions for specified uses of taxable fuels or for specified fuels), typically for governments or for uses not involving use of (and thereby damage to) the highway system. Because the gasoline, diesel fuel, and kerosene taxes generally are imposed before the end use of the fuel is known, many of these exemptions are realized through refunds to end users of tax paid by a party that processed the fuel earlier in the distribution chain. These exempt uses and fuels include:

(1) use in State and local government and nonprofit educational organization vehicles;

(2) use in buses engaged in transporting students and employees of schools;

(3) use in private local mass transit buses having a seating capacity of at least 20 adults (not including the driver) when the buses operate under contract with (or are subsidized by) a State or local governmental unit;

(4) use in private intercity buses serving the general public along scheduled routes (totally exempt from the gasoline tax and exempt from 17 cents per gallon of the diesel tax); and

(5) use in off-highway uses such as farming.

LNG, propane, CNG, and methanol derived from natural gas are subject to reduced tax rates based on the energy equivalence of these fuels to gasoline.

Ethanol and methanol derived from renewable sources (e.g., biomass) are eligible for income tax benefits (the "alcohol fuels credit") equal, under prior law, to 54 cents per gallon (ethanol) and 60 cents per gallon (methanol).[5] In addition, small ethanol producers are eligible for a separate 10-cents-per-gallon production credit.[6] The 54-cents-per-gallon ethanol and 60-cents-per-gallon renewable source methanol tax credits may be claimed through reduced excise taxes paid on gasoline and special motor fuels as well as through credits against income tax.[7]

### *Non-fuel Highway Trust Fund excise taxes*

In addition to the highway motor fuels excise tax revenues, the Highway Trust Fund receives revenues produced by three excise

[5] Under prior law, the alcohol fuels credit was scheduled to expire after December 31, 2000, or earlier, if the Highway Fund excise taxes actually expired before that date.

[6] The small ethanol producer credit is available on up to 15 million gallons of ethanol produced by persons whose annual production capacity does not exceed 30 million gallons.

[7] Authority to claim the ethanol and renewable source methanol tax benefits through excise tax reductions was scheduled to expire after September 30, 2000 (or earlier, if the underlying excise taxes actually expire before September 30, 2000) under prior law.

taxes imposed exclusively on heavy highway vehicles or tires. Under prior law and present law, these taxes are:

(1) A 12-percent excise tax imposed on the first retail sale of highway vehicles, tractors, and trailers (generally, trucks having a gross vehicle weight in excess of 33,000 pounds and trailers having such a weight in excess of 26,000 pounds);

(2) An excise tax imposed at graduated rates on highway tires weighing more than 40 pounds; and

(3) An annual use tax imposed on highway vehicles having a taxable gross weight of 55,000 pounds or more. (The maximum rate for this tax is $550 per year, imposed on vehicles having a taxable gross weight over 75,000 pounds.)

### *Aquatic Resources Trust Fund and National Recreational Trails Trust Fund taxes*

Gasoline and special motor fuels used in motorboats and in certain off-highway recreational vehicles and in small engines are subject to tax in the same manner and the same rates as gasoline and special motor fuels used in highway vehicles. Of the tax revenues from these uses, 6.8 cents per gallon was retained in the General Fund under prior law; the remaining 11.5 cents per gallon was deposited in the Aquatic Resources Trust Fund ("Aquatic Fund") (motorboat gasoline and special motor fuels and small-engine gasoline), the Land and Water Conservation Fund ("Land and Water Fund") (limited to $1 million of motorboat fuels tax revenues), and the National Recreational Trails Trust Fund (the "Trails Fund") (fuels used in off-highway recreational vehicles). Transfers to these Funds were scheduled to terminate after September 30, 1998 under prior law. Transfers to the Trails Fund were contingent on appropriations from that Fund; no appropriations from the Trails Fund were enacted under prior law.

### *Highway Trust Fund expenditure authority provisions*

#### *In general*

Dedication of excise tax revenues to the Highway Trust Fund and expenditures from the Highway Trust Fund are governed by provisions of the Code (sec. 9503).[8] Under prior law, revenues from the highway excise taxes, as imposed through September 30, 1999, were dedicated to the Highway Trust Fund. Also, the Highway Trust Fund earned interest on its cash balances each year from investments in Treasury securities under prior law (sec. 9602). Further, the Code authorized expenditures (subject to appropriations) from the Highway Trust Fund through September 30, 1998, for the purposes provided in authorizing legislation, as in effect on the date of enactment of Public Law 105–130.

Highway Trust Fund provisions also governed transfer of 11.5 cents per gallon of the revenues from the tax imposed on gasoline used in motorboats, small engines, and off-highway recreational vehicles. Those revenues were transferred from the Highway Trust Fund to the Aquatic Fund, the Land and Water Fund, and the Trails Fund, respectively, through September 30, 1998.

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[8] The Highway Trust Fund statutory provisions were placed in the Internal Revenue Code in 1982.

### *Prior-law Highway Trust Fund expenditure purposes*

The Highway Trust Fund is divided into two accounts: a Highway Account and a Mass Transit Account, each of which is the funding source for specific programs.

Highway and Mass Transit Account expenditure purposes have been revised with passage of each authorization Act enacted since establishment of the Highway Trust Fund in 1956. In general, expenditures authorized under those Acts (as the Acts were in effect on the date of enactment of the most recent of such authorizing Acts) are approved Highway Trust Fund expenditure purposes.[9] Authority to make expenditures from the Highway Trust Fund was scheduled to expire after September 30, 1998. Thus, no Highway Trust Fund monies could be spent for a purpose not already approved by the tax-writing committees of Congress. Further, no Highway Trust Fund expenditures could occur after September 30, 1998, without such approval.

Under prior law and present law, Highway Trust Fund spending further is limited by two anti-deficit provisions which are internal to the Highway Fund. The first of these provisions limits the unfunded Highway Account authorizations at the end of any fiscal year to amounts not exceeding the unobligated balance plus revenues projected to be collected for that Account by the dedicated excise taxes during the two following fiscal years. Under prior law, the second anti-deficit provision similarly limited unfunded Mass Transit Account authorizations to the dedicated excise taxes expected to be collected during the next fiscal year. Because of these two provisions, the highway transportation excise taxes typically have been scheduled to expire at least two years after current authorizing Acts. If either of these provisions is violated, spending for specified programs funded by the relevant Trust Fund Account is reduced proportionately, in much the same manner as would occur under a general Budget Act sequester.

*Highway Account.*—The Highway Trust Fund's Highway Account receives revenues from all non-fuel highway transportation excise taxes and under prior law, revenues from all but 2.85 cents per gallon (2.0 cents before October 1, 1997) of the highway motor fuels excise taxes. Programs financed from the Highway Account included expenditures for the following general purposes:

(1) Federal-aid highways, including the Interstate System, National Highway System, forest and public lands highways, scenic highways, and certain overseas highways (includes construction and planning and traffic control projects);

(2) Interstate highway resurfacing and repair;

(3) Bridge replacement and repair;

(4) Surface transportation programs;

(5) Congestion mitigation and air quality improvement;

(6) Highway safety programs and research and development, including a share of the cost of National Highway Traffic Safety Administration ("NHTSA") programs and university research centers;

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[9] The authorizing Acts which were referenced in the Highway Trust Fund (for the Highway Account) under prior law were the Highway Revenue Act of 1956, Titles I and II of the Surface Transportation Assistance Act of 1982, the Surface Transportation and Uniform Relocation Act of 1987, the Intermodal Surface Transportation Efficiency Act of 1991, and Public Law 105-130.

(7) Transportation research, technology, and training;

(8) Intermodal urban projects and mass transit (including carpool and vanpool) grants;

(9) Intelligent transportation systems;

(10) Transportation enhancements (including transportation-related historic restoration, scenic beautification, removal of billboards);

(11) Construction of ferry boats and ferry terminal facilities;

(12) Certain administrative costs of the Federal Highway Administration and NHTSA;

(13) Grants to the Internal Revenue Service for motor fuels tax and highway use tax enforcement activities; and

(14) Certain other highway and transit-related programs (including bicycle pathways and pedestrian walkways).

*Mass Transit Account.*—Under prior law, the Highway Fund's Mass Transit Account received revenues equivalent to 2.85 cents per gallon (2.0 cents before October 1, 1997) of the highway motor fuels excise taxes. Mass Transit Account monies were available through September 30, 1998, for capital and capital-related expenditures under sections 5338(a)(1) and (b)(1) of Title 49, United States Code, or the Intermodal Surface Transportation Efficiency Act of 1991.

The capital and capital-related mass transit programs included new rail or busway facilities, rail rolling stock, buses, improvement and maintenance of existing rail and other fixed guideway systems, and upgrading of bus systems.

***Aquatic Fund and Land and Water Fund provisions***

Under prior law, transfers of recreational motorboat gasoline and special fuels tax revenues from the Highway Trust Fund to the Boat Safety Account of the Aquatic Fund were limited to a maximum of $70 million per fiscal year. Any excess motorboat fuels tax revenues were transferred to the Land and Water Fund (limited to $1 million per year) and to the Sport Fish Restoration Account of the Aquatic Fund.[10] The authority to transfer revenues to the Aquatic Fund was scheduled to expire after September 30, 1998.

Expenditures from the Boat Safety Account and Land and Water Fund were subject to appropriation Acts. The Sport Fish Restoration Account has a permanent appropriation, and all moneys transferred to that Account are automatically appropriated in the fiscal year following the fiscal year of receipt.

Under prior law, expenditures were authorized from the Boat Safety Account, as follows:

(1) One-half of the amount allocated to the Account for State boating safety programs; and

(2) One-half of the amount allocated to the Account for operating expenses of the Coast Guard to defray the cost of services provided for recreational boating safety.

[10] Under prior law, the maximum balance that could accumulate in the Boat Safety Account was $70 million.

***Recreational Trails Trust Fund provisions***

The Trails Fund was established in the Intermodal Surface Transportation Act of 1991 ("1991 Act"). Amounts are authorized to be transferred from the Highway Trust Fund into the Trails Fund equivalent to revenues received from "nonhighway recreational fuel taxes" (not to exceed $30 million per year under an obligational ceiling set in the 1991 Act), subject to amounts actually being appropriated from the Trails Fund. No monies were ever transferred because no amounts were appropriated from the Trails Fund. The authority to transfer revenues to the Trails Fund was scheduled to expire after September 30, 1998 under prior law.

Nonhighway recreational fuels taxes included the taxes imposed on (1) fuel used in vehicles and equipment on recreational trails or back country terrain, or (2) fuel used in camp stoves and other outdoor recreational equipment. Such revenues did not include small-engine gasoline tax revenues which are transferred to the Aquatic Fund.

Expenditures were authorized from the Trails Fund, subject to appropriations, for allocations to States for use on trails and trail-related projects as set forth in the 1991 Act. Authorized uses included (1) acquisition of new trails and access areas, (2) maintenance and restoration of existing trails, (3) State environmental protection education programs, and (4) program administrative costs.

### *Reasons for Change*

The Transportation Equity Act for the 21st Century (the "Act") authorized expenditures (through contract authority and discretionary spending subject to appropriations) for Highway Trust Fund and Aquatic Fund programs during fiscal years 1998 through 2003. The Act further provided that Highway Trust Fund spending and revenues would not be considered for certain budget calculations. The excise taxes which constitute a dedicated revenue source for these programs under prior law were scheduled to expire after September 30, 1999. Thus, absent an extension of these taxes, contemplated highway, mass transit, and boat safety programs would not have been funded. The Congress concluded that a separate Trails Fund was not necessary, because no revenues had been deposited in the Trust Fund since its inception and because similar expenditure programs are financed from the Highway Trust Fund under the Act.

### *Explanation of Provisions*

***Highway tax and trust fund provisions***

*Extension of existing Highway Trust Fund excise taxes*

The scheduled expiration date of the Highway Trust Fund excise taxes on motor fuels and on heavy highway vehicles and tires was extended, from September 30, 1999 through September 30, 2005.

*Extension and modification of renewable source alcohol tax provisions*

The prior-law tax benefits for ethanol and renewable source methanol were extended for seven years from their previously scheduled expiration dates; the ethanol benefits were modified to reduce the benefit levels during the extension period. The modified ethanol benefit levels are as follows: 2001 and 2002, 53 cents per gallon; 2003 and 2004, 52 cents per gallon; and, 2005 through 2007, 51 cents per gallon. The extension and the modifications apply to both the alcohol fuels credit and to the associated excise tax provisions.

*Motor fuels tax refund procedure*

The Act combined the quarterly excise tax refund procedures for all taxable motor fuels, allowing aggregation of quarterly amounts and filing of refund claims once a single $750 minimum amount is reached (determined on a year-to-date basis rather than an individual quarter basis). Fourth quarter refund claims are allowed under the same rules as applicable to the first three quarters.

*Requirement that motor fuels terminals offer dyed fuel*

As described under prior law, diesel fuel and kerosene (after June 30, 1998) are taxed on removal from a registered terminal facility unless the fuel is destined for a nontaxable use and is indelibly dyed. After June 30, 1998, prior law required terminals to offer dyed fuel as a condition of being allowed to store untaxed fuel. The Act delayed the effective date of the requirement that terminals offer dyed fuel for two years, to July 1, 2000.

*Extension and modification of Highway Trust Fund provisions*

The prior-law September 30, 1998 expiration date of authority to spend monies from the Highway Trust Fund was extended, from September 30, 1998 through September 30, 2003.

The Code provisions governing purposes for which monies in the Highway Trust Fund may be spent were updated to include the purposes provided in the Act, as of the date of enactment.

The anti-deficit provisions of the Mass Transit Account were conformed to those of the Highway Account so that permitted obligations will be determined by reference to two years of projected revenues.

Provisions were incorporated into the Highway Trust Fund clarifying that expenditures from the Highway Trust Fund may occur only as provided in the Code. Clarification was further provided that the expiration date for expenditures allowed from the Highway Trust Fund does not preclude disbursements to liquidate contracts which were validly entered into before the last date permitted under those provisions. Expenditures for contracts entered into or for amounts otherwise obligated after that date (or for other non-contract authority purposes permitted by non-Code provisions) are not permitted, notwithstanding the provisions of any subsequently enacted authorization or appropriations legislation. If any such subsequent non-tax legislation provided for expenditures not provided for in the Code, or if any executive agency authorized such expenditures in contravention of the Code restrictions, excise tax revenues otherwise to be deposited in the Highway Fund would be retained in the General Fund beginning on the date of any unauthorized expenditure (including an obligation of funds under contract authority) pursuant to such legislation or the date of such an action by an executive agency.[11]

A technical amendment to the Taxpayer Relief Act of 1997 was included clarifying that excise tax revenues attributable to LNG, CNG, propane, and methanol from natural gas (all of which are subject to reduced, energy equivalent rates, as indicated in Table 1) are divided between the Highway and Mass Transit Accounts of the Highway Trust Fund in the same proportions as gasoline tax revenues are divided between those two accounts.

A technical correction to the Taxpayer Relief Act of 1997 was included providing that the amount of gasoline and diesel fuel tax revenues deposited into the Mass Transit Account is 2.86 cents per gallon (rather than 2.85 cents per gallon as provided in that 1997 Act).

The Act provided that the Highway Trust Fund (including the Mass Transit Account) will no longer earn interest on unspent balances, effective after September 30, 1998. Further, the balance in excess of $8 billion in the Highway Account of the Highway Trust Fund was canceled on October 1, 1998.

***Aquatic Fund provisions***

The Act extends transfers of motorboat fuels tax revenues to the Boat Safety Account and Wetlands sub-Account of the Aquatic Fund through September 30, 2003. The Act further provided that an additional 1.5 cents per gallon of taxes imposed during fiscal years 2002 and 2003 (for a total of 13 cents), and an additional 2 cents per gallon thereafter (for a total of 13.5), will be transferred to the Aquatic Fund.

The Act extends the expenditure authority for the Boat Safety Account through September 30, 2003. The expenditure purposes of the Aquatic Fund (including those of the Sport Fish Restoration Account) are conformed to those purposes in effect in the authorizing provisions of the Act as of the date of enactment.

The Act further incorporated provisions into the Aquatic Fund clarifying that expenditures from the Fund may occur only as provided in the Code Trust Fund provisions.

***Repeal of Trails Fund***

The Act repealed the Trails Fund and the transfers of nonhighway recreational fuels taxes to that Trust Fund, effective on the date of the Act's enactment. (Under authorizing provisions of the Act, Highway Trust Fund expenditures are authorized for purposes similar to those of the prior-law Trails Fund.)

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[11] The Congress did not intend that tax deposits terminate as a result of inadvertent administrative errors provided those errors are corrected within a reasonable period and do not evidence a pattern of disregard of this provision.

### *Revenue Effect*

The highway tax and trust fund provisions (other than the provisions relating to dyed fuel and refund procedures) are estimated to increase Federal fiscal year budget receipts by $9 million in 2001, $12 million in 2002, $23 million in 2003, $27 million in 2004, $39 million in 2005, $44 million in 2006, and $44 million in 2007 above amounts already included in the baseline. (Excise taxes dedicated to trust funds are assumed to be imposed permanently notwithstanding statutory expiration dates.) The provision delaying the requirement that registered terminals offer dyed fuel is estimated to have a negligible effect on Federal fiscal year budget receipts. The provision modifying the refund procedures for fuels excise taxes is estimated to decrease Federal fiscal year budget receipts by $5 million in 1999 and by less than $500,000 in each of the years 2000–2007. The provisions transferring additional revenues to the Aquatic Resources Trust Fund and repealing the National Recreational Trails Trust Fund are estimated to have no revenue effect.

## B. Repeal of 1.25-Cents-Per-Gallon Tax Rate on Rail Fuel (sec. 9006)

### *Prior Law*

Under prior law, diesel fuel used in trains was subject to a 5.65-cents-per-gallon excise tax. (Of this amount, 0.1 cent per gallon is dedicated to the Leaking Underground Storage Tank Trust Fund; this rate is scheduled to expire after March 31, 2005.) The remaining 5.55 cents per gallon was a General Fund tax, with 4.3 cents per gallon being permanently imposed and 1.25 cents per gallon being scheduled to expire after September 30, 1999.

### *Reasons for Change*

The 1.25-cents-per-gallon rail fuel tax rate was repealed because the Congress believed it is inappropriate for railroads to pay a fuel tax for deficit reduction when most other transportation modes pay taxes only to support trust fund programs that benefit those industries.

### *Explanation of Provision*

The Act repeals the 1.25-cents-per-gallon rate on rail diesel fuel that was scheduled to expire after September 30, 1999, effective on November 1, 1998.

### *Revenue Effect*

The provision is estimated to reduce Federal fiscal year budget receipts by $24 million in 1999 and less than $500,000 in 2000.

### C. Purposes for Which Amtrak NOL Monies May be Used in Non-Amtrak States (sec. 9007 of the Act, modifying sec. 977(e)(1)(B) of the Taxpayer Relief Act of 1997)

#### *Present and Prior Law*

The Taxpayer Relief Act of 1997 provided elective procedures that allow Amtrak to consider the tax attributes of its predecessors in the use of its net operating losses. The election was conditioned on Amtrak agreeing to make payments equal to one percent of the amount it receives as a result of the election to the States that do not receive Amtrak service. The non-Amtrak States are required to spend these monies for qualified purposes. Qualified purposes were limited to the capital costs connected with the provision of intercity passenger rail and bus service, or the purchase of intercity rail service from Amtrak. Any amounts not spent by the non-Amtrak States for qualified purposes by 2010 must be returned to the Treasury.

#### *Reasons for Change*

The Congress believed that all States, whether or not served by Amtrak, should share in the Federal income tax benefits provided Amtrak in the Taxpayer Relief Act of 1997. The Congress believed that each non-Amtrak State's share should be available for appropriate transportation projects within that State. Since enactment of the Taxpayer Relief Act of 1997, the Congress has become aware of additional appropriate transportation projects within the non-Amtrak States.

#### *Explanation of Provision*

The provision expands the list of qualified purposes to include (a) capital expenditures related to State owned rail operations, (b) projects eligible to receive funding under section 5309, 5310, or 5311 of Title 49, (c) projects that are eligible to receive funding under section 130 or 152 of Title 23, (d) upgrading and maintenance of intercity primary and rural air service facilities, including the purchase of air service between primary and rural airports and regional hubs, (e) the provision of passenger ferryboat service and (f) certain harbor and highway improvements that are eligible to receive funding under section 103, 133, 144, and 149 of Title 23.

#### *Effective Date*

The provision is effective on August 5, 1997, as if it had been included in the Taxpayer Relief Act of 1997.

#### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

### D. Exclusion from Income for Employer-Provided Transportation Benefits (sec. 9010 of the Act and sec. 132 of the Code)

#### *Present and Prior Law*

Qualified transportation fringe benefits provided by an employer are excluded from an employee's gross income. Qualified transportation fringe benefits include parking, transit passes, and vanpool benefits. In addition, in the case of employer-provided parking, no amount is includible in income of an employee merely because the employer offers the employee a choice between cash and employer-provided parking. Under prior law, transit passes and vanpool benefits were only excludable if provided in addition to, and not in lieu of, any compensation otherwise payable to an employee. Up to $175 per month of employer-provided parking is excludable from income. Under prior law, up to $65 per month of employer-provided transit and vanpool benefits were excludable from gross income. Under prior law, these dollar amounts were indexed annually for inflation, rounded to the nearest multiple of $5.

Under present and prior law, qualified transportation fringe benefits include a cash reimbursement by an employer to an employee. However, in the case of transit passes, a cash reimbursement is considered a qualified transportation fringe benefit only if a voucher or similar item which may be exchanged only for a transit pass is not readily available for direct distribution by the employer to the employee. The position of the Treasury Department is that a voucher or similar item is "readily available" if an employer can obtain it on terms no less favorable than those available to an individual employee and without incurring a significant administrative cost.[12]

Present and prior law impose limits on the amount of annual additions that can be made to a tax-qualified pension plan. In the case of defined contribution plans, the limit is the lesser of $30,000 or 25 percent of compensation. For this purpose, under section 415(c)(3), compensation is generally taxable compensation, plus salary reduction contributions under a qualified cash or deferred arrangement (a "section 401(k) plan"), a tax-sheltered annuity (a "section 403(b) annuity"), a SIMPLE plan, certain plans of deferred compensation for State and local government employees and employees of tax-exempt organizations (a "sec. 457 plan"), and a cafeteria plan. Tax-qualified pension plans are also subject to nondiscrimination rules designed to ensure that an employer's pension plans benefit a broad cross section of employees. For purposes of applying these rules, compensation is generally defined as under Code section 415(c)(3). However, an employer can elect not to include as compensation salary reduction contributions under a section 401(k) plan, 403(b) annuity, or cafeteria plan. In addition, as provided by the Secretary, an employer can use an alternative definition of compensation for nondiscrimination testing purposes. Any such alternative definitions must not discriminate in favor of highly compensated employees.

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[12] I.R.S. Notice 94–3, 1994 C.B. 327.

### *Explanation of Provision*

The Act permits employers to offer employees a choice between cash compensation or any qualified transportation benefit or a combination of any of such benefits. Thus, under the Act, no amount is includible in gross income or wages merely because the employee is offered the choice of cash in lieu of one or more qualified transportation benefits (up to the applicable dollar limit). Also, no amount is includible in income or wages merely because the employee is offered a choice among qualified transportation benefits. The amount of cash offered is includible in income and wages only to the extent the employee elects cash.

It is intended that salary reduction amounts used to provide qualified transportation benefits under the provision be treated for pension plan purposes the same as other salary reduction contributions. Thus, it is intended that such amounts be included for purposes of applying the limits on contributions and benefits, and that an employer may elect whether or not to include such amounts in compensation for nondiscrimination testing.[13] It is expected that the Secretary, in prescribing rules regarding the alternative definition of compensation, will treat salary reduction amounts under this provision the same as other salary reduction contributions.

The provision does not change the rules regarding when a cash reimbursement for transit passes is treated as a qualified transportation fringe benefit.

In addition, beginning in 2002, the Act increases the exclusion for transit passes and vanpooling to $100 per month. Beginning in 2003, the $100 amount is indexed as under prior law.

Further, the Act provides that there is no indexing of any qualified transportation benefit in 1999.

### *Effective Date*

The provision permitting a cash option for any transportation benefit is effective for taxable years beginning after December 31, 1997; the increase in the exclusion for transit passes and vanpooling to $100 per month is effective for taxable years beginning after December 31, 2001; and indexing on the $100 amount for transit passes and vanpooling is effective for taxable years beginning after December 31, 2002.

### *Revenue Effect*

The provision is estimated to increase Federal fiscal year budget receipts by $3 million in 1999, $3 million in 2000, $4 million in 2001, and to decrease Federal fiscal year budget receipts by $1 million in 2002, $3 million in 2003, $10 million in 2004, $7 million in 2005, $12 million in 2006, and $8 million in 2007.

[13] A technical correction may be necessary so that the statute reflects this intent.

## E. Identification of Limited Tax Benefits (sec. 9012 of the Act)

### *Present and Prior Law*

The Line Item Veto Act amended the Congressional Budget and Impoundment Act of 1974 to grant the President the limited authority to cancel specific dollar amounts of discretionary budget authority, certain new direct spending, and limited tax benefits. The Line Item Veto Act provides that the Joint Committee on Taxation is required to examine any revenue or reconciliation bill or joint resolution that amends the Internal Revenue Code of 1986 prior to its filing by a conference committee in order to determine whether or not the bill or joint resolution contains any limited tax benefits and to provide a statement to the conference committee that either (1) identifies each limited tax benefit contained in the bill or resolution, or (2) states that the bill or resolution contains no limited tax benefits. The Line Item Veto Act provides that the conferees determine whether or not to include the Joint Committee's statement in the conference report. If the conference report includes the information from the Joint Committee on Taxation identifying provisions that are limited tax benefits, then the President can cancel one or more of those, but only those, provisions that have been identified. If such a conference report contains a statement from the Joint Committee on Taxation that none of the provisions in the conference report are limited tax benefits, then the President has no authority to cancel any of the specific tax provisions, because there are no tax provisions that are eligible for cancellation under the Line Item Veto Act.

On June 25, 1998, the U.S. Supreme Court held that the cancellation procedures set forth in the Line Item Veto Act are unconstitutional. *Clinton v. City of New York*, 118 S. Ct. 2091 (June 25, 1998).

### *Explanation of Provision*

Pursuant to the provisions of the Line Item Veto Act as in effect at the time the Surface Transportation Revenue Act of 1998 was passed by the Congress, that Act included a provision stating that the Joint Committee on Taxation determined that the Act contains no provision involving limited tax benefits within the meaning of the Line Item Veto Act.

# PART TWO: INTERNAL REVENUE SERVICE RESTRUCTURING AND REFORM ACT OF 1998 (H.R. 2676)[14]

## TITLE I. REORGANIZATION OF STRUCTURE AND MANAGEMENT OF THE IRS

### A. IRS Restructuring and Creation of IRS Oversight Board

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

#### *Prior Law*

***IRS mission statement***

Under prior law, the Internal Revenue Service ("IRS") mission statement provided that:

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

***IRS organizational plan***

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

#### *Reasons for Change*

The Congress believed that a key reason for taxpayer frustration with the IRS is the lack of appropriate attention to taxpayer needs. Taxpayers should be able to receive from the IRS the same level

[14] P.L. 105–206. H.R. 2676 was reported by the House Committee on Ways and Means on October 31, 1997 (H. Rept. 105–364, Part I). The House passed the bill on November 5, 1997, and added (as new Title VI) the provisions of H.R. 2645 ("Tax Technical Corrections Act of 1997") as previously reported by the Committee on Ways and Means (H. Rept. 105–356, October 29, 1997).

H.R. 2676 was reported, as amended, by the Senate Committee on Finance on April 22, 1998 (S. Rept. 105–174), and was passed by the Senate, as amended, on May 7, 1998. The conference report on H.R. 2676 was filed on June 24, 1998 (H. Rept. 105–599). The House passed the conference report on June 25, 1998, and the Senate passed it on July 9, 1998.

H.R. 2676 was signed by the President on July 22, 1998.

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

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

The Congress believed that the former IRS organizational structure was one of the factors contributing to the inability of the IRS to properly serve taxpayers and the proposed structure would help enable the IRS to better serve taxpayers and provide the necessary level of services and accountability to taxpayers. The Congress supported the Commissioner in his efforts to modernize and update the IRS and believed it appropriate to provide statutory direction for the reorganization of the IRS.

### *Explanation of Provision*

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

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

### *Effective Date*

The provision is effective on the date of enactment.

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

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

### *Present and Prior Law*

The administration and enforcement of the internal revenue laws are performed by or under the supervision of the Secretary of the Treasury.[15] The Secretary has delegated the responsibility to administer and enforce the Internal Revenue laws to the Commissioner. The Commissioner has the final authority of the IRS concerning the substantive interpretation of the tax laws as reflected in legislative and regulatory proposals, revenue rulings, letter rulings, and technical advice memoranda. The duties of the Chief Counsel of the IRS are prescribed by the Secretary. Under prior law, the Secretary delegated authority over the Chief Counsel to General Counsel of the Treasury, and the General Counsel delegated authority to serve as the legal adviser to the Commissioner to the Chief Counsel.

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

Under the ethical conduct rules, all Federal Government employees (including special government employees) are precluded from participating in a matter in which the employee (or a related party)

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[15] Code section 7801(a).

has a financial interest. In addition, special government employees cannot represent a party (whether or not for compensation) or receive compensation for representation of a party[16] in relation to a matter (1) in which the employee has at any time participated personally and substantially, or (2) which is pending in the department or agency of the Government in which the special government employee is serving. In the case of a special government employee who has served in a department no more than 60 days during the immediately preceding 365 days, item (2) does not apply. Thus, for example, such an individual can receive compensation for representational services with respect to matters pending in the department in which the employee serves, as long as it is not a matter involving parties in which the employee personally and substantially participated.[17]

The conflict of interest rules also impose restrictions on what a Federal Government employee can do after leaving the Government. Under these rules, senior level officers and employees (including special government employees) who served at least 60 days cannot represent anyone other than the United States before the individual's former department or agency for 1 year after terminating employment. Whether an employee is a senior level officer or employee is determined by pay grade. The one-year post employment restriction does not apply to special government employees who serve less than 60 days during the 365-day period before termination of employment.[18]

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

### *Reasons for Change*

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

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

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

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

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

The Restructuring Commission concluded the following:

> "problems throughout the IRS cannot be solved without focus, consistency and direction from the top. The current structure, which includes Congress, the President, the Department of the Treasury, and the IRS itself, does not allow the IRS to set and maintain consistent long-term strategy and priorities, nor to develop and execute focused plans for improvement. Additionally, the structure does not ensure that the IRS budget, staffing and technology are targeted toward achieving organizational success."

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

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

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

### *Explanation of Provision*

#### *Duties, responsibilities, and powers of the IRS Oversight Board*

*General responsibilities of the Board*

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

*Specific responsibilities of the Board*

The Board has the following specific responsibilities: (1) to review and approve strategic plans of the IRS, including the establishment of mission and objectives (and standards of performance) and annual and long-range strategic plans; (2) to review the operational functions of the IRS, including plans for modernization of the tax administration system, outsourcing or managed competition, and training and education; (3) to review and approve the Commissioner's plans for major reorganization of the IRS; and (4) to review operations of the IRS in order to ensure the proper treatment of taxpayers. The Board also has the following specific responsibilities relating to management: (1) to recommend to the President candidates for Commissioner (and to recommend the removal of the Commissioner); and (2) to review the Commissioner's selection, evaluation, and compensation of IRS senior executives who have program management responsibility over significant functions of the IRS. The Congress expected that the Chair of the Board will consider establishing a financial management subcommittee to advise the Commissioner on financial management issues.

Consistent with the Board's responsibility to review and approve plans for major reorganizations, Congress intended for the Board to have the authority to review and approve the reorganization plan that is contained in Title I of the Act. However, to the extent that the Commissioner has already taken measures to develop and implement such a plan, Congress did not want to impede such efforts. Thus, Congress did not intend in any way that the Commissioner should be precluded from moving ahead with such planning and implementation prior to the appointment of the Board.

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

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

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

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

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

*Composition of the Board*

The Board is composed of 9 members. Six of the members are so-called "private-life" members who are not otherwise Federal officers or employees. These private-life members are appointed by the President, with the advice and consent of the Senate. The other members are: (1) the Secretary (or, if the Secretary so designates, the Deputy Secretary); (2) the Commissioner; and (3) an individual who is a full-time Federal employee or a representative of employees ("employee representative") and who is appointed by the President, with the advice and consent of the Senate.

*Section 6103 authority*

Board members have limited access to confidential tax return and return information under section 6103. This limited access permits the Board to receive such information (i.e., information that has not been redacted to remove confidential tax return and return information) from the Treasury IG for Tax Administration or the Commissioner in connection with reports made to the Board. This access to section 6103 information does not include the taxpayer's name, address, or taxpayer or employer identification number. The Board members are subject to the anti-browsing rules applicable to IRS employees under present law.[19]

*Qualifications of Board members*

The private-life members of the Board are appointed without regard to political affiliation and based solely on their expertise in the following areas: (1) management of large service organizations; (2) customer service; (3) the Federal tax laws, including administration and compliance; (4) information technology; (5) organization development; (6) the needs and concerns of taxpayers; and (7) the

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

needs and concerns of small businesses. In the aggregate, the private-life members of the Board should collectively bring to bear expertise in these enumerated areas.

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

### *Ethical standards for private-life members*

#### *Representational activities and compensation matters*

The ethical conduct rules applicable to private-life Board members depend on whether or not such members are determined to be "special government employees" under Federal law. It is expected that they generally will be.[20] In that case, they will be subject, at a minimum, to the ethical conduct rules applicable to special government employees. In addition, during their term as a Board member, a private-life Board member cannot represent any party (whether or not for compensation) with respect to (1) any matter before the Board or the IRS, (2) any tax-related matter before the Treasury Department or (3) any court proceeding with respect to a matter described in (1) or (2). Thus, for example, the day after appointment to the Board, a private-life Board member could not meet with representatives of the IRS or Treasury on behalf of a client or the Board member's corporate employer with respect to proposed tax regulations. On the other hand, the Board member could, for example, represent clients before the U.S. Customs Service. The special rules applicable to private-life Board members generally do not preclude the Board member from sharing in compensation from representation of clients by another person (e.g., a partner of the Board member) before the IRS or Treasury.[21]

#### *Post-employment restrictions*

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

#### *Financial disclosure reports*

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

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[20] If the Board members are determined not to be special government employees, then they will be subject to the ethical conduct rules relating to regular Federal Government employees.

[21] Certain limitations to this exception to the otherwise applicable ethical rules apply. For example, this exception does not apply if the matter was one in which the Board member personally and substantially participated.

### *Ethical standards for employee representative*

The same ethics rules applicable to the private-life members regarding the representational activities and compensation matters apply to the employee representative if the individual is a special government employee (i.e., the individual is not already an officer or employee of the Federal Government). In addition, the same post-employment restrictions and the financial disclosure requirements applicable to the private-life members apply to the employee representative.

The provision grants the President the authority to waive, at the time the President nominates the employee representative to the Board, for the term of the member, any appropriate provisions of chapter 11 of title 18 of the United States Code, to the extent such waiver is necessary to allow such member to participate in the decisions of the Board while continuing to serve as an employee representative. Any such waiver is not effective unless a written intent of waiver to exempt the member (and the actual waiver language) is submitted to the Senate with the nomination of the member. It is not intended that waiver of the restrictions on post-employment provided under the provision be necessary to allow such member to participate in the decisions of the Board while continuing to serve as an employee representative.

### *Administrative matters*

#### *Term of appointments*

The 6 private-life Board members and the employee representative are appointed for 5-year terms. The private-life members and the employee representative may serve no more than two 5-year terms. Board member terms are staggered, as a result of a special rule providing that some private-life members first appointed to the Board serve terms of less than 5 years. Under this rule, 2 private-life members first appointed have a term of 3 years, 2 private-life members have a term of 4 years, and 2 private-life members have a term of 5 years. The terms of the initial Board members run from the date of appointment. Subsequent terms will run from expiration of the previous term. A Board member appointed to fill a vacancy before the expiration of a term will be appointed to the remainder of the term. Such a member could be appointed to subsequent 5-year term.

#### *Chair of the Board*

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

#### *Meetings and quorum*

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

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

*Staffing*

The Chair is authorized to hire (and terminate) such personnel as the Chair finds necessary to enable the Board to carry out its duties. In addition, the Board will have such staff as detailed by the Commissioner or from another Federal agency at the request of the Chair of the Board. The Chair can procure temporary and intermittent services under section 3109(b) of title 5 of the U.S. Code. The Congress intended that the size of the staff be limited to a small number, and the Board is encouraged to use outside consultants whenever necessary.

*Claims against Board members*

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

*Compensation of Board members*

The private-life members of the Board are compensated at a rate of $30,000 per year, except that the Chair is compensated at a rate of $50,000 a year. The employee representative member of the Board is compensated at a rate of $30,000 per year unless the individual is already an officer or employee of the Federal Government. The other Board members will receive no compensation for their services as a Board member. The members of the Board are entitled to travel expenses for purposes of attending meetings of the Board. Travel expenses other than those incurred to attend Board meetings are allowed if approved in advance by the Chair, and the Board is to report annually to Congress the amount of travel expenditures incurred by the Board.

*Reports*

The Board is required to report each year regarding the conduct of its responsibilities, and information on travel expenditures incurred. The annual report is to be provided to the President and the House Committees on Ways and Means, Government Reform and Oversight, and Appropriations and the Senate Committees on Finance, Governmental Affairs, and Appropriations. In addition, the Board is required to report to the Ways and Means and Finance Committees if the IRS does not address problems identified by the Board.

### ***Effective Date***

The provisions relating to the Board are effective on the date of enactment (July 22, 1998). The President is directed to submit nominations for Board members to the Senate within 6 months of the date of enactment. Provisions relating to the Board are not to be construed to invalidate the actions and authority of the IRS prior to the appointment of members of the Board.

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

## B. Appointment and Duties of IRS Commissioner and Chief Counsel and Other Personnel

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

### *Present and Prior Law*

Within the Department of the Treasury is a Commissioner of Internal Revenue, who is appointed by the President, with the advice and consent of the Senate. Under prior law, the Commissioner had such duties and powers as were prescribed by the Secretary.[22] The Secretary has delegated to the Commissioner the administration and enforcement of the internal revenue laws.[23] The Commissioner generally does not have authority with respect to tax policy matters.[24]

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

### *Reasons for Change*

The Congress believed that the duties and responsibilities of the Commissioner are of such significance that the Commissioner should continue to be appointed by the President.[25] However, the frequency with which the Commissioner changes—the average tenure in office is under 3 years—is one of the factors contributing to lack of IRS management continuity. The Congress believed (as did the National Commission on Restructuring the IRS) that providing a statutory term for the Commissioner to serve would help ensure greater continuity of IRS management.

### *Explanation of Provision*

As under prior law, the Commissioner is appointed by the President, with the advice and consent of the Senate, and may be removed at will by the President. Under the provision, one of the qualifications of the Commissioner is demonstrated ability in management. The Commissioner is appointed to a 5-year term, begin-

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[22] Code section 7802(a).

[23] Treasury Order 150–10 (April 22, 1982).

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

[25] Retaining prior law also eliminates any constitutional issues that may arise if the Commissioner is appointed by someone other than the President, such as by the Board, as suggested by the National Commission on Restructuring the IRS.

ning with the date of appointment. The Commissioner may be reappointed for more than one 5-year term. The Board recommends candidates to the President for the position of Commissioner; however, the President is not required to nominate for Commissioner a candidate recommended by the Board. The Board has the authority to recommend the removal of the Commissioner.

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

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

### *Effective Date*

The provisions relating to the Commissioner are effective on the date of enactment (July 22, 1998). The provision relating to the 5-year term of office applies to the Commissioner in office on the date of enactment. The 5-year term runs from the date of appointment.

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

## 2. IRS Chief Counsel (sec. 1102(b) of the Act and sec. 7803 of the Code)

### *Present and Prior Law*

The President is authorized to appoint, by and with the consent of the Senate, an Assistant General Counsel of the Treasury, who is the Chief Counsel of the IRS. The Chief Counsel is the chief law officer for the IRS and has had such duties as may be prescribed by the Secretary. The Secretary has delegated authority over the Chief Counsel to the Treasury General Counsel. Under prior law, the Chief Counsel did not report to the Commissioner, but to the

Treasury General Counsel. As delegated by the Treasury General Counsel, the duties of the Chief Counsel included: (1) to be the legal advisor to the Commissioner and his or her officers and employees; (2) to furnish such legal opinions as may be required in the preparation and review of rulings and memoranda of technical advice and the performance of other duties delegated to the Chief Counsel; (3) to prepare, review, or assist in the preparation of proposed legislation, treaties, regulations and Executive Orders relating to laws affecting the IRS; (4) to represent the Commissioner in cases before the Tax Court; (5) to determine what civil actions should be brought in the courts under the laws affecting the IRS and to prepare recommendations to the Department of Justice for the commencement of such actions and to authorize or sanction commencement of such actions.

### *Explanation of Provision*

As under prior law, the Chief Counsel is appointed by the President, with the advice and consent of the Senate.

The Chief Counsel is to report directly to the Commissioner, with two exceptions. First, the Chief Counsel is to report to both the Commissioner and the General Counsel of the Treasury Department with respect to (1) legal advice or interpretation of the tax law not relating solely to tax policy, and (2) tax litigation. Under this rule, the Congress intended that the Chief Counsel's dual reporting to the Commissioner and to the General Counsel include reporting with respect to legal advice or interpretation of the tax law set forth in regulations, revenue rulings and revenue procedures, technical advice and other similar memoranda, private letter rulings, and published guidance not described in the foregoing.

Second, the Chief Counsel is to report to the General Counsel with respect to legal advice or interpretation of the tax law relating solely to tax policy. Under this rule, the Congress intended that the Chief Counsel's reporting to the General Counsel include proposed legislation and international tax treaties.

The provision provides that if there is any disagreement between the Commissioner and the General Counsel with respect to any matter on which the Chief Counsel has dual reporting to both the Commissioner and the General Counsel, the matter is to be submitted to the Secretary or the Deputy Secretary of the Treasury for resolution.

The Congress intended that under the general rule, the Chief Counsel's reporting directly to the Commissioner include reporting with respect to budget, organizational structure and reorganizations, mission and strategic plans. In addition, the Congress intended that the Chief Counsel's reporting directly to the Commissioner include reporting with respect to all matters relating to the day-to-day operations of the IRS, such as management of the IRS and procurement.

The provision provides that all personnel in the Office of the Chief Counsel are to report to the Chief Counsel (and not to any person at the IRS or elsewhere within the Treasury Department).

The Chief Counsel has such duties and powers as prescribed by the Secretary. Unless otherwise specified by the Secretary, these duties include the duties delegated under prior law to the Chief

Counsel as described above. If the Secretary determines not to delegate such specified duties to the Chief Counsel, such determination is subject to the same notice requirement applicable to changes in the delegation of authority with respect to the Commissioner.

### *Effective Date*

The provision is generally effective on the date of enactment (July 22, 1998). The provision providing that the Chief Counsel reports directly to the Commissioner is effective 90 days after the date of enactment (October 20, 1998).

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

## C. Structure and Funding of the Employee Plans and Exempt Organizations Division ("EP/EO") (sec. 1101 of the Act and former sec. 7802(b) of the Code)

### *Prior Law*

Prior to 1974, no one specific office in the IRS had primary responsibility for employee plans and tax-exempt organizations. As part of the reforms contained in the Employee Retirement Income Security Act of 1974 ("ERISA"), Congress statutorily created the Office of Employee Plans and Exempt Organizations ("EP/EO") under the direction of an Assistant Commissioner.[26] EP/EO was created to oversee deferred compensation plans governed by sections 401–414 of the Code and organizations exempt from tax under Code section 501(a).

In general, EP/EO was established in response to concern about the level of IRS resources devoted to oversight of employee plans and exempt organizations. The legislative history of Code section 7802(b) states that, with respect to administration of laws relating to employee plans and exempt organizations, "the natural tendency is for the Service to emphasize those areas that produce revenue rather than those areas primarily concerned with maintaining the integrity and carrying out the purposes of exemption provisions."[27]

To provide funding for the new EP/EO office, ERISA authorized the appropriation of an amount equal to the sum of the section 4940 excise tax on investment income of private foundations (assuming a rate of 2 percent) as would have been collected during the second preceding year plus the greater of the same amount or $30 million.[28] However, amounts raised by the section 4940 excise were never dedicated to the administration of EP/EO, but were transferred instead to general revenues. Thus, the level of EP/EO funding, like that of the rest of the IRS, has always been dependent on annual Congressional appropriations to the Treasury Department.

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

### *Reasons for Change*

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

### *Explanation of Provision*

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

In addition, the Act repeals the funding mechanism set forth in section 7802(b)(2). Thus, the appropriate level of funding for EP/EO is, consistent with current practice, subject to annual Congressional appropriations, as are other functions within the IRS. In this regard, however, the Congress noted that, given the magnitude of the sectors EP/EO is charged with regulating, as well as the unique nature of its mandate, an adequately funded EP/EO is extremely important to the efficient and fair administration of the Federal tax system. Accordingly, the Congress intended that financial resources for EP/EO should not be constrained on the basis that EP/EO is a "non-core" IRS function; rather, EP/EO, like all functions of the IRS, should be funded so as to promote the efficient and fair administration of the Federal tax system.

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

### *Effective Date*

The provision is effective on the date of enactment (July 22, 1998).

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

## D. Taxpayer Advocate (secs. 1102 (a), (c), and (d) of the Act and sec. 7803(c) of the Code)

### *Present and Prior Law*

#### *Taxpayer Advocate*

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

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

#### *Taxpayer assistance orders*

Under the rules enacted in TBOR 2, taxpayers could request that the Taxpayer Advocate issue a taxpayer assistance order ("TAO") if the taxpayer is suffering or about to suffer a significant hardship as a result of the manner in which the internal revenue laws are being administered. A TAO may require the IRS to release property of the taxpayer that has been levied upon, or to cease any action, take any action as permitted by law, or refrain from taking any action with respect to the taxpayer.

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

#### *Reports of the Taxpayer Advocate*

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

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

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

### *Reasons for Change*

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

In determining whether a taxpayer assistance order should be issued, the Taxpayer Advocate should consider certain factors as constituting a "significant hardship" for the taxpayer. In addition to providing relief if the taxpayer is about to suffer a significant hardship, the Taxpayer Assistance Order should be issued in other appropriate situations, such as if there is an immediate threat of adverse action, if there has been a delay of more than 30 days in resolving the taxpayer's account problems, the taxpayer will have to pay significant costs if relief is not granted, or the taxpayer will suffer irreparable injury, or long-term adverse impact, if relief is not granted.

### *Explanation of Provision*

#### *National Taxpayer Advocate*

The provision renames the Taxpayer Advocate the "National Taxpayer Advocate." The National Taxpayer Advocate is appointed by the Secretary after consultation with the Commissioner and the Board (without regard to the provisions of Title 5 of the U.S. Code, relating to appointments in the competitive service or the Senior Executive Service). An individual may be appointed as the National Taxpayer Advocate only if the individual was not an officer or employee of the IRS during the 2-year period ending with such appointment and the individual agrees not to accept employment with the IRS for at least 5 years after ceasing to be the National Taxpayer Advocate. Service as an officer or employee of the Office of the Taxpayer Advocate is not taken into account, for purposes of these 2-year and 5-year rules. The National Taxpayer Advocate's compensation is to be at the highest rate of basic pay established for the Senior Executive Service, or, if the Treasury Secretary so determines, at a rate fixed under 5 U.S. Code section 9503.

The provision replaces the prior-law problem resolution system with a system of local Taxpayer Advocates who report directly to the National Taxpayer Advocate and who will be employees of the Taxpayer Advocate's Office, independent from the IRS examination, collection, and appeals functions.

Each local taxpayer advocate reports to the National Taxpayer Advocate or his delegate. The Congress intended that a delegate mean the Taxpayer Advocate for the appropriate organizational unit. It is not intended that a local Taxpayer Advocate report to a District Director of the IRS, for example. Providing reporting to a delegate of the National Taxpayer Advocate under the provision was intended to provide reporting flexibility sufficient to take into account the necessities of any reorganization of the IRS.

The National Taxpayer Advocate has the responsibility to evaluate and take personnel actions (including dismissal) with respect to any local Taxpayer Advocate or any employee in the Office of the National Taxpayer Advocate. In conjunction with the Commissioner, the National Taxpayer Advocate is required to develop career paths for local Taxpayer Advocates. The Congress intended that the National Taxpayer Advocate's responsibility to appoint local Taxpayer Advocates and make available at least one local Taxpayer Advocate for each State means that a local Taxpayer Advocate will be available to taxpayers in each State. The Congress intended that the National Taxpayer Advocate be able to hire and consult counsel as appropriate.

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

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

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

#### *Taxpayer assistance orders*

The provision expands the circumstances under which a TAO may be issued. The provision provides that a "significant hardship" is deemed to occur if one of the following four factors exists: (1) there is an immediate threat of adverse action; (2) there has been a delay of more than 30 days in resolving the taxpayer's account problems; (3) the taxpayer will have to pay significant costs (including fees for professional services) if relief is not granted; or (4) the taxpayer will suffer irreparable injury, or a long-term adverse impact, if relief is not granted. The National Taxpayer Advocate may also issue a TAO if the taxpayer meets requirements set forth in regulations. It was intended that the circumstances set forth in regulations be based on considerations of equity.

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

#### *Reports of the National Taxpayer Advocate*

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

### *Effective Date*

The provision is generally effective on the date of enactment (July 22, 1998), except that in appointing the first National Taxpayer Advocate after date of enactment, the Treasury Secretary may not appoint anyone who was an officer or employee of the IRS at any time during the 2-year period ending on the date of appointment, and the Treasury Secretary need not consult with the Board if the Board has not been appointed.

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

## E. Treasury Office of Inspector General; IRS Office of the Chief Inspector (secs. 1102 and 1103 of the Act, sec. 7803(d) of the Code, and secs. 2, 8D, and 9 of the Inspector General Act of 1978)

### *Present and Prior Law*

#### *Treasury Inspector General*

*In general*

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

*Appointment and qualifications*

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

*Duties and responsibilities*

The Treasury IG generally is authorized to conduct, supervise and coordinate internal audits and investigations relating to the programs and operations of the Treasury, including all of its bureaus and offices.[29] Special rules apply, however, with respect to the Treasury IG's jurisdiction over ATF, Customs, the Secret Service and the IRS—the four so-called "law enforcement bureaus." Upon its establishment, the Treasury IG assumed the internal audit functions previously performed by the offices of internal affairs of ATF, Customs and the Secret Service. Although the Treasury IG was granted oversight responsibility for the internal investigations performed by the Office of Internal Affairs of ATF, the Office of Internal Affairs of Customs, and the Office of Inspections of the Secret Service, the internal investigation or inspection functions of these offices remained with the respective bureaus. The Treasury IG did not assume responsibility for either the internal audit or inspection functions of the IRS Office of the Chief Inspec-

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

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

The Commissioner and the Treasury IG have entered into two Memorandums of Understanding ("MOUs")[30] to clarify the respective roles of the IRS Office of the Chief Inspector and the Treasury IG in two primary areas: (1) the investigation of allegations of wrongdoing by IRS executives and employees in situations where the independence of the Office of the Chief Inspector could be questioned, and (2) oversight by the Treasury IG of the IRS Office of the Chief Inspector.[31] Pursuant to the 1990 MOU, the Commissioner agreed to transfer 21 FTEs and $1.9 million from the IRS appropriation to the Treasury IG appropriation to be used for the following purposes: (1) oversight of the operations of the Office of the Chief Inspector; (2) conduct of special reviews of IRS operations; (3) investigation of allegations of misconduct concerning the Commissioner, the Senior Deputy Commissioner, and employees of the IRS Office of the Chief Inspector; and (4) investigation of allegations of misconduct where the independence of the IRS Office of the Chief Inspector might be questioned. With respect to item (4), the Commissioner and Treasury IG agreed that all allegations of misconduct involving IRS executives and managers (Grade 15 and above), as well as any other allegation involving "significant or notorious" matters were to be referred to the Treasury IG, and that investigations arising out of such referrals generally would be conducted by the Treasury IG.

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

*Authority*

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

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

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

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

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

*Access to taxpayer returns and return information*

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

*Reporting requirements*

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

*Resources*

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

***IRS Office of Chief Inspector***

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

*Appointment of the Chief Inspector*

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

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

*Duties and responsibilities*

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

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

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

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

*Authority*

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

*Access to taxpayer returns and return information*

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

*Reporting requirements*

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

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

*Resources*

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

### ***Reasons for Change***

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

### *Explanation of Provision*

#### *In general*

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

#### *Appointment and qualifications of Treasury IG for Tax Administration*

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

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

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

#### *Duties and responsibilities of Treasury IG for Tax Administration*

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

Accordingly, the Treasury IG for Tax Administration is charged with conducting audits, investigations, and evaluations of IRS programs and operations (including the Board) to promote the economic, efficient and effective administration of the nation's tax laws and to detect and deter fraud and abuse in IRS programs and operations. In this regard, the Treasury IG for Tax Administration specifically is directed to evaluate the adequacy and security of IRS technology on an ongoing basis. The Treasury IG for Tax Administration is charged with investigating allegations of criminal misconduct (e.g., Code sections 7212, 7213, 7214, 7216 and new section 7217), as well as administrative misconduct (e.g., violations of the Taxpayer Bill of Rights and the Taxpayer Bill of Rights 2, the Office of Government Ethics Standards of Ethical Conduct and the IRS Supplemental Standards of Ethical Conduct). The Act provides, however, that the responsibility for (1) protecting IRS employees and (2) investigating the backgrounds of prospective IRS employees shall not be transferred to the Treasury IG for Tax Administration, but shall remain with the IRS.

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

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

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

***Authority of Treasury IG for Tax Administration***

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

Under the Act, the Treasury IG for Tax Administration must provide to the Board all reports regarding IRS matters on a timely basis and conduct audits or investigations requested by the Board. The Treasury IG for Tax Administration also must, in a timely manner, conduct such audits or investigations and provide such reports as may be requested by the Commissioner. In addition, the Act provides that the Commissioner or the Board may request the Treasury IG for Tax Administration to conduct an audit or investigation relating to the IRS. If the Treasury IG for Tax Administration determines not to conduct an audit or investigation requested by the Commissioner or the Board, the Treasury IG for Tax Administration shall timely provide the requesting party with a written explanation of its determination. In this regard, it is intended that the Treasury IG for Tax Administration shall make all reasonable efforts to be responsive to the requests of the Commissioner and the Board.

In carrying out the duties and responsibilities described above, the Treasury IG for Tax Administration has the present-law authority generally granted to Inspectors General under the IG Act of 1978. The limitations on the authority of the Treasury IG under such Act do not apply to the Treasury IG for Tax Administration. In addition, the Treasury IG for Tax Administration has the authority granted to the IRS Office of the Chief Inspector under present-law Code section 7608, including the right to execute and serve search and arrest warrants, to serve subpoenas and summonses, to make arrests without warrant, to carry firearms, and to seize property subject to forfeiture under the Code.

***Resources***

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

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

***Access to taxpayer returns and return information***

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

***Reporting requirements***

The Treasury IG for Tax Administration is subject to the semiannual reporting requirements set forth in section 5 of the IG Act of 1978. As under prior law, reports are made to the Committees on Government Reform and Oversight and Ways and Means of the House and the Committees on Governmental Affairs and Finance of the Senate. The reports must contain the information that is required to be reported by the Treasury IG with respect to the IRS under present law, as well as information regarding the source, nature and status of taxpayer complaints and allegations of serious misconduct by IRS employees received by the IRS or by the Treasury IG for Tax Administration. In addition, the Treasury IG for

Tax Administration is required to report annually on certain additional information (e.g., regarding the use of enforcement statistics in evaluating IRS employees, the implementation of various taxpayer rights protections, and IRS employee terminations and mitigations) required by the Act.

***Treasury IG***

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

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

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

### *Effective Date*

The provision is effective 180 days after the date of enactment (January 18, 1999). [32]

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

[32] Division C, Title 1, sec. 101 of H.R. 4328, the Omnibus Consolidated and Emergency Supplemental Appropriations Act, 1999, provides for appointment by the President of an acting Treasury IG for Tax Administration to serve during the period beginning on the date of enactment of the provision (October 21, 1998) and ending on the earlier of April 30, 1999, or the date on which the first Treasury IG for Tax Administration takes office. The acting Treasury IG for Tax Administration is to, before January 18, 1999 (the date that is 180 days after the date of enactment of the Internal Revenue Service Restructuring and Reform Act of 1988), take only such actions as are necessary to begin operation of the office of Treasury IG for Tax Administration, including: (1) making interim arrangements for administrative support for the office; (2) establishing interim positions in the office into which personnel will be transferred upon the transfer of functions and duties to the office on January 18, 1999; (3) appointing such acting personnel on an interim basis as may be necessary upon the transfer of functions and duties to the office on January 18, 1999; and (4) providing guidance and input for the fiscal year 2000 budget process for the office. No person appointed as acting Treasury IG for Tax Administration may serve on or after January 19, 1999, unless on or before such date the President has submitted to the Senate his nomination of an individual to serve as the first Treasury IG for Tax Administration. A person who is appointed to the position of acting Treasury IG for Tax Administration may not serve concurrently as the Treasury IG or the acting Treasury IG. In addition, the acting Treasury IG for Tax Administration may not be employed by the IRS within the two years preceding and the five years following such individual's appointment.

### F. Prohibition on Executive Branch Influence Over Taxpayer Audits (sec. 1105 of the Act and new sec. 7217 of the Code)

#### *Present and Prior Law*

There was no prior-law explicit prohibition in the Code against high-level Executive Branch influence over taxpayer audits and collection activity.

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

#### *Reasons for Change*

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

#### *Explanation of Provision*

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

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

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

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

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

### *Effective Date*

The provision applies to violations occurring after the date of enactment (after July 22, 1998).

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

## G. IRS Personnel Flexibilities (secs. 1201–1205 of the Act and new chapter 95 of Title 5, U.S.C.)

### *Present and Prior Law*

Under present and prior law, the IRS is subject to the personnel rules and procedures set forth in title 5, United States Code, which regulate hiring, evaluating, promoting, and firing employees. Under these rules, IRS employees generally are classified under the General Schedule or the Senior Executive Service.

### *Reasons for Change*

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

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

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

### *Explanation of Provision*

#### *In general*

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

#### *Senior management and technical positions*

*Streamlined critical pay authority*

The Act provides a streamlined process for the Secretary of the Treasury, or his delegate, to fix the compensation of and appoint up to 40 individuals to designated critical technical and professional positions, provided that: (1) the positions require expertise of an extremely high level in a technical, administrative or professional field and are critical to the IRS; (2) exercise of the authority is necessary to recruit or retain an individual exceptionally well qualified for the position; (3) designation of such positions is approved by the Secretary; (4) the terms of such appointments are limited to no more than four years; (5) appointees to such positions were not IRS employees prior to June 1, 1998; and (6) the total annual compensation for any position (including performance bonuses) does not exceed the rate of pay of the Vice President (currently, $175,400).

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

The streamlined authority is limited to a period of 10 years after the date of enactment.

*Critical pay authority*

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

*Recruitment, retention and relocation incentives*

The Act authorizes the Secretary to vary from the pre-existing provisions governing recruitment, retention and relocation incentives. The authority is for a period of 10 years after the date of enactment and is be subject to OPM approval.

In addition, for a period of 10 years after the date of enactment, the provision authorizes the IRS to pay certain relocation expenses for individuals appointed to critical pay positions after June 1, 1998.

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

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

*Performance awards for senior executives*

The Act provides the Secretary with the authority to provide performance bonus awards to IRS senior executives of up to one-third of the individual's annual compensation. The bonus award is based on meeting preset performance goals established by the IRS. An individual's total annual compensation, including the bonus, cannot exceed the rate of pay of the Vice President. The authority is not subject to OPM approval. It is anticipated that the bonuses will not be available to more than 25 IRS senior executives annually.

***General workforce***

*Performance management system*

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

In addition, the performance management system is to provide for: (1) establishing goals or objectives for individual, group or organizational performance and taxpayer service surveys; (2) communicating such goals or objectives to employees; and (3) using such goals or objectives to make performance distinctions among employees or groups of employees. The Congress intends that in no event will performance measures be used which rank employees or groups of employees based solely on enforcement results, establish dollar goals for assessments or collections, or otherwise undermine fair treatment of taxpayers.

The Congress intends to give the IRS flexibility to establish a new performance management system. The Congress expects that this will refocus the IRS' personnel system on the overall mission of the IRS and how each employee's performance relates to that mission. Although the new performance standards are premised on the notion of retention, such standards should go beyond simply establishing a retention/non-retention or pass-fail performance system. At a minimum, the Congress believes that there should be at least one standard above the retention standard. This will enable managers to make meaningful distinctions among employees based on performance, to encourage employees to perform at a higher level and to reward superior performance.

*Awards*

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

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

*Workforce classification and pay banding*

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

*Workforce staffing*

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

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

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

***Voluntary separation incentives***

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

***Demonstration projects***

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

***Violations for which IRS employees may be terminated***

The Act requires the IRS to terminate an employee for certain proven violations committed by the employee in connection with the performance of official duties. The violations include: (1) 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.

The Act provides non-delegable authority to the Commissioner to determine that mitigating factors exist, that, in the Commissioner's sole discretion, mitigate against terminating the employee. The Act also provides that 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. The Treasury IG is required to track employee terminations and terminations that would have occurred had the Commissioner not determined that there were mitigation factors and include such information in the IG's annual report.

***Performance measures***

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

***IRS employee training program***

The Act requires the IRS to implement an employee training program no later than 180 days after enactment. The Act also requires the IRS to submit to Congressional tax writing committees within 180 days of the date of enactment an employee training plan which will: (1) detail a comprehensive employee training program to ensure adequate customer service training; (2) detail a schedule for training and the fiscal years during which the training will occur; (3) detail the funding of the program and relevant information to demonstrate the priority and commitment of resources to the plan; (4) review the organizational design of customer service; (5) provide for the implementation of a performance development system; and (6) provide for at least 16 hours of conflict management training in fiscal year 1999 for collection employees.

### ***Effective Date***

The provision is effective on the date of enactment (July 22, 1998).

### ***Revenue Effect***

The provision is estimated to have no effect on Federal fiscal year budget receipts.

# TITLE II. ELECTRONIC FILING

## A. Electronic Filing of Tax and Information Returns (sec. 2001 of the Act)

### *Present and Prior Law*

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

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

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

### *Reasons for Change*

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

### *Explanation of Provision*

The Act states that the policy of Congress is to promote paperless filing, with a long-range goal of providing for the filing of at least 80 percent of all tax returns in electronic form by the year 2007. The provision requires the Secretary of the Treasury to establish a strategic plan to eliminate barriers, provide incentives, and use competitive market forces to increase taxpayer use of electronic filing. The provision requires all returns prepared in electronic form but filed in paper form to be filed electronically, to the extent practicable, for taxable years beginning after 2001.

The provision requires the Secretary to promote electronic filing and to create an electronic commerce advisory group and to report annually to the Congress on electronic filing implementation issues. The Act also requires that the annual report discuss the effects on small businesses and the self-employed of electronically filing tax and information returns.

In addition, the Act states that the policy of Congress is that the IRS should cooperate with and encourage the private sector by encouraging competition to increase electronic filing of returns. The intent of the Congress with respect to this provision is for the IRS and Treasury to press for robust private sector competition. When disputes arise between the IRS and the private sector on the question of whether services offered by the IRS inhibit competition or are appropriate services not reasonably available to taxpayers or tax preparers, the Electronic Commerce Advisory Group shall recommend to the IRS Commissioner an appropriate course of action. Those recommendations shall also be made available to the Congress. Notwithstanding the previous sentence, the Congress also intends that the IRS should continue to offer and improve its Telefile program and make available a comparable program on the Internet.

### *Effective Date*

The provision is effective on the date of enactment (July 22, 1998).

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

## B. Due Date for Certain Information Returns (sec. 2002 of the Act)

### *Present and Prior Law*

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

### *Reasons for Change*

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

### *Explanation of Provision*

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

The Act also requires the Treasury to issue a study evaluating the merits and disadvantages, if any, of extending the deadline for providing taxpayers with copies of information returns (other than Forms W-2) from January 31 to February 15.

### *Effective Date*

The provision is effective for information returns required to be filed after December 31, 1999. The Treasury study is due by June 30, 1999.

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

## C. Paperless Electronic Filing (sec. 2003 of the Act and sec. 6061 of the Code)

### *Present and Prior Law*

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

A return generally is considered timely filed when it is received by the IRS on or before the due date of the return. If the requirements of Code section 7502 are met, timely mailing is treated as timely filing. If the return is mailed by registered mail, the dated registration statement is prima facie evidence of delivery.

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

### *Reasons for Change*

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

### *Explanation of Provision*

The Act requires the Secretary to develop procedures that would eliminate the need to file a paper form relating to signature information. The Secretary is permitted to waive the signature requirement, but only returns signed or subscribed under alternative methods prescribed by the Secretary (not including waiver) are entitled to be treated as though signed or subscribed.

The provision also authorizes the Secretary to provide rules for determining when electronic returns are deemed filed and requires the Secretary to provide rules to authorize return preparers to communicate with the IRS on matters included on electronically filed returns.

The provision requires the Secretary to establish procedures, to the extent practicable, to receive all forms electronically for taxable periods beginning after December 31, 1999.

The Secretary of the Treasury must establish procedures for all tax forms, instructions, and publications created in the most recent 5-year period to be made available electronically on the Internet in a searchable database at approximately the same time such records are available to the public in printed form. The Secretary of the Treasury must, to the extent practicable, establish procedures for other taxpayer guidance to be made available electronically on the Internet in a searchable database at approximately the same time such guidance is available to the public in printed form.

### *Effective Date*

The provision is generally effective on the date of enactment (July 22, 1998). The provision which relates to Internet access to IRS forms, instructions, publications, and guidance is effective for taxable periods beginning after December 31, 1998. The provision that requires the Secretary, to the extent practicable, to receive all forms electronically applies to taxable periods after December 31, 1999.

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

## D. Return-Free Tax System (sec. 2004 of the Act)

### *Present and Prior Law*

Taxpayers generally are required to calculate their own tax liabilities and submit returns showing their calculations. Under prior law, there was no statutory requirement that Treasury study the implementation of a return-free tax system.

### *Reasons for Change*

The Congress believed that it could benefit taxpayers to be relieved, to the extent feasible, from the burden of determining tax liability and filing returns. Accordingly, the Congress believed that further study of those issues would be valuable.

### *Explanation of Provision*

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

### *Effective Date*

The provision is effective on the date of enactment (July 22, 1998).

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

## E. Access to Account Information (sec. 2005 of the Act)

### *Prior Law*

Taxpayers who filed their returns electronically could not review their accounts electronically.

### *Reasons for Change*

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

### *Explanation of Provision*

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

### *Effective Date*

The provision is effective on the date of enactment (July 22, 1998).

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

## TITLE III. TAXPAYER PROTECTION AND RIGHTS

### A. Burden of Proof (sec. 3001 of the Act and new sec. 7491 of the Code)

#### *Present and Prior Law*

Under present law, a rebuttable presumption exists that the Commissioner's determination of tax liability is correct.[33] "This presumption in favor of the Commissioner is a procedural device that requires the plaintiff to go forward with prima facie evidence to support a finding contrary to the Commissioner's determination. Once this procedural burden is satisfied, the taxpayer must still carry the ultimate burden of proof or persuasion on the merits. Thus, the plaintiff not only has the burden of proof of establishing that the Commissioner's determination was incorrect, but also of establishing the merit of its claims by a preponderance of the evidence."[34]

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

Under prior law, there was no statutory provision that generally provided burden of proof rules.

#### *Reasons for Change*

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

The Congress believed that it is inappropriate for the IRS to rely solely on statistical information on unrelated taxpayers to reconstruct unreported income of an individual taxpayer. The Congress

[33] *Welch* v. *Helvering,* 290 U.S. 111, 115 (l933).
[34] *Danville Plywood Corp.* v. *U.S.,* U.S. Cl. Ct., 63 AFTR 2d 89–1036, 1043 (1989).

also believed that, in a court proceeding, the IRS should not be able to rest on its presumption of correctness if it does not provide any evidence whatsoever relating to penalties.

### *Explanation of Provision*

The Act provides that the Secretary has the burden of proof in any court proceeding with respect to a factual issue if the taxpayer introduces credible evidence with respect to the factual issue relevant to ascertaining the taxpayer's specified tax liability. The provision applies to income,[35] estate, gift, and generation-skipping transfer taxes. Four conditions apply. First, the taxpayer must comply with the requirements of the Internal Revenue Code and the regulations issued thereunder to substantiate any item (as under prior law). Second, the taxpayer must maintain records required by the Code and regulations (as under prior law). Third, the taxpayer must cooperate with reasonable requests by the Secretary for meetings, interviews, witnesses, information, and documents (including providing, within a reasonable period of time, access to and inspection of witnesses, information, and documents within the control of the taxpayer, as reasonably requested by the Secretary). Cooperation also includes providing reasonable assistance to the Secretary in obtaining access to and inspection of witnesses, information, or documents not within the control of the taxpayer (including any witnesses, information, or documents located in foreign countries[36]). A necessary element of cooperating with the Secretary is that the taxpayer must exhaust his or her administrative remedies (including any appeal rights provided by the IRS). The taxpayer is not required to agree to extend the statute of limitations to be considered to have cooperated with the Secretary. Cooperation also means that the taxpayer must establish the applicability of any asserted privilege. Fourth, taxpayers other than individuals or estates must meet the net worth limitations that apply for awarding attorney's fees (accordingly, no net worth limitation would be applicable to individuals). Corporations, trusts,[37] and partnerships whose net worth exceeds $7 million are not eligible for the benefits of the provision. The taxpayer has the burden of proving that it meets each of these conditions, because they are necessary prerequisites to establishing that the burden of proof is on the Secretary.

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

[35] For this purpose, self-employment taxes are treated as income taxes.

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

[37] An exception to this rule removes the net worth limitation from certain revocable trusts for the same period of time that the trust would have been treated as part of the estate had the trust made the election under section 645 to be treated as part of the estate. This reflects the technical correction enacted in section 4002(b) of the Tax and Trade Relief Extension Act of 1998, described in Part Three of this publication.

the taxpayer merely makes implausible factual assertions, frivolous claims, or tax protestor-type arguments. The introduction of evidence will not meet this standard if the court is not convinced that it is worthy of belief. If after evidence from both sides, the court believes that the evidence is equally balanced, the court shall find that the Secretary has not sustained his burden of proof.

Nothing in the provision shall be construed to override any requirement under the Code or regulations to substantiate any item. Accordingly, taxpayers must meet applicable substantiation requirements, whether generally imposed [38] or imposed with respect to specific items, such as charitable contributions [39] or meals, entertainment, travel, and certain other expenses.[40] Substantiation requirements include any requirement of the Code or regulations that the taxpayer establish an item to the satisfaction of the Secretary.[41] Taxpayers who fail to substantiate any item in accordance with the legal requirement of substantiation will not have satisfied the legal conditions that are prerequisite to claiming the item on the taxpayer's tax return and will accordingly be unable to avail themselves of this provision regarding the burden of proof. Thus, if a taxpayer required to substantiate an item fails to do so in the manner required (or destroys the substantiation), this burden of proof provision is inapplicable.[42]

In the case of an individual taxpayer, the Secretary has the burden of proof in any court proceeding with respect to any item of income which was reconstructed by the Secretary solely through the use of statistical information on unrelated taxpayers.

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

### *Effective Date*

The provision applies to court proceedings arising in connection with examinations commencing after the date of enactment (after July 22, 1998). In any case in which there is no examination, the

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

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

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

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

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

provision applies to court proceedings arising in connection with taxable periods or events beginning or occurring after the date of enactment. An audit is not the only event that would be considered an examination for purposes of this provision. For example, the matching of an information return against amounts reported on a tax return is intended to be an examination for purposes of this provision. Similarly, the review of a claim for refund prior to issuing that refund is also intended to be an examination for purposes of this provision.

### *Revenue Effect*

The provision is estimated to reduce Federal fiscal year budget receipts by less than $1 million in 1998, $231 million in 1999, $256 million in 2000, $269 million in 2001, $278 million in 2002, $297 million in 2003, $311 million in 2004, $327 million in 2005, $344 million in 2006, and $360 million in 2007.

## B. Proceedings by Taxpayers

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

### *Present and Prior Law*

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

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

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

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

### *Reasons for Change*

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

The Congress believed that the pro bono publicum representation of taxpayers should be encouraged and the value of the legal services rendered in these situations should be recognized. Where the IRS takes positions that are not substantially justified, it should not be relieved of its obligation to bear reasonable administrative and litigation costs because representation was provided the taxpayer on a pro bono basis.

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

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

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

### *Explanation of Provision*

The Act:

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

(2) Raises the hourly rate to $125 per hour, which parallels the rate utilized under the Equal Access to Justice Act (the statute that authorizes the awarding of attorney's fees in non-tax Federal cases). This new cap will continue to be indexed for inflation (as under prior law). Provides that the difficulty of the issues presented or the unavailability of local tax expertise can be used to justify an award of attorney's fees of more than the statutory limit of $125 per hour;

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

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

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

(6) Clarifies that the award of attorney's fees is permitted in actions for civil damages for unauthorized inspection or disclosure of taxpayer returns and return information. Fees are payable by the United States only when the United States is the defendant and the plaintiff is a prevailing party. Also, individual defendants (such as State employees or contractors) may be liable for attorneys' fees and costs in cases where the United States is not a party, whenever they are found to have made a wrongful disclosure.

### *Effective Date*

The provision is effective with respect to costs incurred and services performed more than 180 days after the date of enactment (after January 18, 1999).

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts in 1998, and to reduce Federal fiscal year budget receipts by $11 million in 1999, $12 million in 2000, $13 million in 2001, $14 million in 2002, $16 million in 2003, $18 million in 2004, $19 million in 2005, $20 million in 2006, and $22 million in 2007.

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

### *Prior Law*

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

### *Reasons for Change*

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

### *Explanation of Provision*

The Act permits recovery of up to $100,000 in civil damages caused by an officer or employee of the IRS who negligently disregards provisions of the Internal Revenue Code or Treasury regulations in connection with the collection of Federal tax with respect to the taxpayer. The provision also permits recovery of up to $1 million in civil damages caused by an officer or employee of the IRS who willfully violates provisions of the Bankruptcy Code relating to automatic stays or discharges. The provision also provides that persons other than the taxpayer may sue for civil damages for unauthorized collection actions.

### *Effective Date*

The provision is effective with respect to actions of officers or employees of the IRS occurring after the date of enactment (after July 22, 1998).

### *Revenue Effect*

The provision is estimated to reduce Federal fiscal year budget receipts by $2 million in 1998, $15 million in 1999, $25 million in 2000, $50 million in 2001, $30 million in 2002, and $25 million in each of the years 2003 through 2007.

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

### *Present and Prior Law*

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

### *Reasons for Change*

The Congress believed that use of the small case procedures should be expanded.

### *Explanation of Provision*

The Act increases the specified maximum for small case treatment from $10,000 to $50,000. An increase of this size may encompass a small number of cases of significant precedential value. Accordingly, it is anticipated that the Tax Court will carefully consider (1) IRS objections to small case treatment, such as objections based upon the potential precedential value of the case, as well as (2) the financial impact on the taxpayer, including additional legal fees and costs, of not utilizing small case treatment.

### *Effective Date*

The provision is effective with respect to proceedings commenced after the date of enactment (after July 22, 1998).

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

## 4. Actions for refund with respect to certain estates which have elected the installment method of payment (sec. 3104 of the Act and sec. 7422 of the Code)

### *Present and Prior Law*

In general, the U.S. Court of Federal Claims and the U.S. district courts have jurisdiction over suits for the refund of taxes, as long as full payment of the assessed tax liability has been made. Under Code section 6166, if certain conditions are met, the executor of a decedent's estate may elect to pay the estate tax attributable to certain closely-held businesses over a 14-year period. Under prior law, courts had held that U.S. district courts and the U.S. Court of Federal Claims do not have jurisdiction over claims for refunds by taxpayers deferring estate tax payments pursuant to section 6166 unless the entire estate tax liability has been paid. Under section 7479 of prior law, the U.S. Tax Court had limited authority to provide declaratory judgments regarding initial or continuing eligibility for deferral under section 6166.

### *Reasons for Change*

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

### *Explanation of Provision*

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

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

### *Effective Date*

The provision is effective for claims for refunds filed after the date of enactment (after July 22, 1998).

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

## 5. Administrative appeal of adverse IRS determination of a bond issue's tax-exempt status (sec. 3105 of the Act)

### *Present and Prior Law*

Interest on debt incurred by States or local governments generally is excluded from gross income if the proceeds of the borrowing are used to carry out governmental functions of those entities and the debt is repaid with governmental funds.

A State or local government that seeks to issue bonds, the interest on which is intended to be excludable from gross income, can request a ruling from the IRS regarding the eligibility of such bonds for tax-exemption. The prospective issuer can challenge the IRS's determination (or failure to make a timely determination) in a declaratory judgment proceeding in the Tax Court. Under prior law, there was no mechanism that explicitly allowed tax-exempt bond issuers examined by the IRS to appeal adverse examination determinations to the Appeals Division of the IRS as a matter of right.

### *Reasons for Change*

The Congress believed that issuers of governmental bonds, as parties with a strong incentive to ensure the continued tax-exemption of outstanding bonds, should have the opportunity to appeal

IRS revocations of the tax-exempt status of the bonds, in order better to protect the holders of those bonds and the market.

### *Explanation of Provision*

The Act directs the Internal Revenue Service to modify its administrative procedures to allow tax-exempt bond issuers examined by the IRS to appeal adverse examination determinations to the Appeals Division of the IRS as a matter of right. Because of the complexity of the issues involved, the IRS is directed to provide that these appeals will be heard by senior appeals officers having experience in resolving complex cases.

It is intended that Congress will evaluate judicial remedies in future legislation once the IRS's tax-exempt bond examination program has developed more fully and the Congress is better able to ensure that any such future measure protects all parties in interest to these determinations (i.e., issuers, bondholders, conduit borrowers, and the Federal Government).

### *Effective Date*

The direction to the IRS is effective on the date of enactment (July 22, 1998).

### *Revenue Effect*

The provision is estimated to reduce Federal fiscal year budget receipts by less than $1 million in 1998, and $5 million in 1999, and $2 million in each of the years 2000 through 2007.

## 6. Civil action for release of erroneous lien (sec. 3106 of the Act and sec. 6325 of the Code)

### *Prior Law*

Prior to 1995, the provisions governing jurisdiction over refund suits had generally been interpreted to apply only if an action was brought by the taxpayer against whom tax was assessed. Remedies for third parties from whom tax was collected (rather than assessed) were found in other provisions of the Internal Revenue Code. The Supreme Court has held [43] that a third party who paid another person's tax under protest to remove a lien on the third party's property could bring a refund suit, because she had no other adequate administrative or judicial remedy. In that case, the IRS had filed a nominee lien against property that was owned by the taxpayer's former spouse and that was under a contract for sale. In order to complete the sale, the former spouse paid the amount of the lien under protest, and then sued in district court to recover the amount paid. The Supreme Court held that parties who are forced to pay another's tax under duress could bring a refund suit, because no other judicial remedy was adequate.

[43] *Williams* v. *United States,* 514 U.S. 527 (1995).

### *Reasons for Change*

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

### *Explanation of Provision*

The Act creates an administrative procedure permitting a record owner of property against which a Federal tax lien has been filed to obtain a certificate of discharge of property from the lien as a matter of right. The third party is required to apply to the Secretary of the Treasury for such a certificate and either to deposit cash or to furnish a bond sufficient to protect the lien interest of the United States.

The Act also establishes a judicial cause of action for third parties challenging a lien. The period within which such an action must be commenced is 120 days after the date the certificate of discharge is issued to ensure an early resolution of the parties' interests.

### *Effective Date*

The provision is effective on the date of enactment (July 22, 1998).

### *Revenue Effect*

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

## C. Relief for Innocent Spouses and for Taxpayers Unable to Manage Their Financial Affairs Due to Disabilities

## 1. Relief for innocent spouses (sec. 3201 of the Act and new sec. 6015 of the Code)

### *Prior Law*

Under prior law, relief from liability for tax, interest and penalties was available for "innocent spouses" only in certain limited circumstances. To qualify for such relief, the innocent spouse was required to establish: (1) that a joint return was made; (2) that an understatement of tax, which exceeds the greater of $500 or a specified percentage[44] of the innocent spouse's adjusted gross income for the preadjustment (most recent) year, was attributable to a grossly erroneous item of the other spouse; (3) that in signing the return, the innocent spouse did not know, and had no reason to know, that there was an understatement of tax; and (4) that taking into account all the facts and circumstances, it was inequitable to hold the innocent spouse liable for the deficiency in tax.

The proper forum for contesting the Secretary's denial of innocent spouse relief under prior law was determined by whether an underpayment was asserted or the taxpayer was seeking a refund

[44] The specified percentage was 10 percent if adjusted gross income was $20,000 or less. Otherwise, the specified percentage was 25 percent.

of overpaid taxes. Accordingly, the Tax Court did not have jurisdiction to review all denials of innocent spouse relief.

### *Reasons for Change*

The Congress was concerned that the innocent spouse provisions of prior law were inadequate. The Congress believed it was inappropriate to limit innocent spouse relief only to the most egregious cases, those cases where the understatement was large and the tax position taken grossly erroneous. The Congress believed that partial innocent spouse relief should be considered in appropriate circumstances, and that all taxpayers should have access to the Tax Court in resolving disputes concerning their status as an innocent spouse.

The Congress believed that an elective system based on separate liabilities would provide more appropriate protection for taxpayers that are no longer married, are separated, or are living apart than does the current system. The Congress intended that this election only be available for tax deficiencies attributable to items of which the electing spouse had no knowledge. The Congress was concerned that taxpayers not be allowed to abuse these rules by knowingly signing false returns, or by transferring assets for the purpose of avoiding the payment of tax by the use of this election. The Congress believed that rules restricting the ability of taxpayers to limit their liability in such situations are appropriate.

The Congress believed that taxpayers need to be informed of their right to make this election and that the IRS is the best source of that information. The Congress believed that the failure of spouses to receive timely notice of their joint tax liabilities has contributed to the difficulties they face. Accordingly, the Congress believed that the IRS should take appropriate steps to insure that both spouses are made aware of their tax situation, and not rely on a single notice sent to a single address to inform both spouses.

### *Explanation of Provision* [45]

#### *In general*

The provision establishes three procedures for limiting the portion of a joint and several liability that is a spouse's (or former spouse's) responsibility. First, the provision establishes a separate liability election for a taxpayer who is no longer married to, is legally separated from, or has been living apart at all times for at least 12 months from the person with whom the taxpayer originally filed the joint return. Second, the provision expands the circumstances in which innocent spouse relief similar to that available under prior law is available. Third, the provision authorizes the Secretary to provide equitable relief in appropriate situations. The provision also establishes jurisdiction in the Tax Court over disputes arising in this area.

[45] This reflects the technical correction enacted in section 4002(c) of the Tax and Trade Relief Extension Act of 1998, described in Part Three of this publication.

***Deficiencies of taxpayers who are no longer married, are separated, or are living apart***

The provision establishes a separate liability election applicable to the deficiencies of a taxpayer who, at the time of election, is no longer married[46] to, is legally separated from, or has been living apart at all times for at least 12 months from the person with whom the taxpayer originally filed the joint return. Such taxpayers may elect to limit their liability for any deficiency to the portion of the deficiency that is attributable to items allocable to the taxpayer. Items are generally allocated between spouses in the same manner as they would have been allocated had the spouses filed separate returns. However, if any item of credit or deduction would be disallowed solely because a separate return is filed, the item of credit or deduction will be computed for this purpose without regard to such prohibition. The Secretary may prescribe other methods of allocation by regulation. The allocation of items is to be accomplished without regard to community property laws. An electing spouse has the burden of proof with respect to establishing the portion of any deficiency that is allocable to him or her under this provision.

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

If the deficiency relates entirely to an item attributable to one spouse, the other spouse is responsible for none of the deficiency if he or she elects limited liability under this provision. For example, a deficiency is assessed after IRS audit of a joint return. The deficiency relates to income earned by the husband that was not reported on the return. If the spouses who joined in the return are no longer married, are legally separated, or have lived apart for at least 12 months, either may elect limited liability under this provision. If the wife elects, she would owe none of the deficiency. The deficiency would be the sole responsibility of the husband whose income gave rise to the deficiency.

If the deficiency relates to the items of both spouses, the separate liability for the deficiency is allocated between the spouses in the same proportion as the net items taken into account in determining the deficiency. For example, a deficiency is assessed that is attributable to $70,000 of unreported income allocable to the husband and the disallowance of a $30,000 miscellaneous itemized deduction allocable to the wife. If the spouses who joined in the return are no longer married, are legally separated, or have lived apart for at

[46] For the purpose of this rule, a taxpayer is no longer married if he or she is widowed.

least 12 months, either may elect limited liability under this provision. If the husband and wife both elect, the husband's liability would be limited to 70 percent of the deficiency and the wife's liability limited to 30 percent. This would be the case even if a portion of the miscellaneous itemized deductions had been disallowed under section 67(a). Each spouse is required to make the election in order to limit his or her liability. If either spouse fails to elect, the non-electing spouse would be liable for the full amount of the deficiency, unless reduced by innocent spouse relief or pursuant to the grant of authority to the Secretary to provide equitable relief.

If the deficiency arises as a result of the denial of an item of deduction or credit, the amount of the deficiency attributable to the spouse to whom the item of deduction or credit is allocated is limited to the amount of income or tax allocated to such spouse that was offset by the deduction or credit. The remainder of the liability is allocated to the other spouse to reflect the fact that income or tax allocated to that spouse was originally offset by a portion of the disallowed deduction or credit.

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

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

Where a deficiency is attributable to the disallowance of a credit, or to any tax other than regular or alternative minimum income tax, the portion of the deficiency attributable to such credit or other tax is considered first. For example, on examination a deficiency of $10,000 ($2,800 of self-employment tax and $7,200 of income tax) is determined to be attributable to $20,000 of unreported self-employment income of the husband and a disallowed itemized deduction of $5,000 allocable to the wife. The $2,800 of deficient self-employment taxes is first allocated to the husband, and the remaining $7,200 of income tax deficiency is allocated 80 percent to the husband and 20 percent to the wife.

Special rules to prevent the inappropriate use of the election are included.

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

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

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

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

***Innocent spouse relief***

The provision also expands the circumstances under which innocent spouse relief is available. For example, a taxpayer may be ineligible to make the separate liability election for a deficiency because he or she is not widowed, divorced, legally separated, or living apart (for at least 12 months) from the person with whom the taxpayer originally filed the joint return. Such a taxpayer may apply for relief of any deficiency that is attributable to an erroneous item of the other spouse, provided he or she did not know and had no reason to know of the understatement of tax, and it would be inequitable to hold the taxpayer responsible for the deficiency. The requirements of prior law that the understatement of tax be substantial, and that the item or items to which the understatement is attributable be grossly erroneous, are repealed.

The innocent spouse election is required to be made no later than the date that is two years after the Secretary has begun collection actions with respect to the individual. Innocent spouse relief may be provided on an apportioned basis. A spouse may be relieved of liability for the portion of an understatement of tax even if the spouse knew or had reason to know of other understatements of tax on the same return.

***Equitable relief in other circumstances***

The provision authorizes the Secretary to provide equitable relief in appropriate situations to avoid the inequitable treatment of spouses in such situations. For example, the Congress intends that equitable relief be available to a spouse that did not know, and had no reason to know, that funds intended for the payment of tax were taken by the other spouse for such other spouse's benefit. The Secretary is also authorized to provide relief at his discretion in other situations.

***Jurisdiction of Tax Court***

The Act specifically provides that the Tax Court has jurisdiction to review any denial of innocent spouse relief. Except for termination and jeopardy assessments, the Secretary may not levy or proceed in court to collect any tax from a taxpayer claiming innocent spouse status with regard to such tax until the expiration of the 90-day period in which such taxpayer may petition the Tax Court or, if such a petition is filed in Tax Court, before the decision of the Tax Court has become final. The running of the statute of limitations is suspended in such situations with respect to the spouse claiming innocent spouse status.

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

***Separate notice requirement***

The Secretary is expected, wherever practicable, to send any notice relating to a joint return separately to each spouse.

### *Effective Date*

The separate liability election, expanded innocent spouse relief and authority to provide equitable relief all apply to liabilities for tax arising after the date of enactment (after July 22, 1998), as well as any liability for tax arising on or before the date of enactment that remains unpaid on the date of enactment. The applicable 2-year election periods do not expire before the date that is two years after the first collection activity taken by the IRS after the date of enactment. An individual may be eligible for relief under the provision without regard to whether such individual has previously been denied innocent spouse relief under prior law. The Secretary is required to develop a separate form for electing innocent spouse relief within 180 days after the date of enactment.

#### *Revenue Effect*

The provision is estimated to reduce Federal fiscal year budget receipts by $10 million in 1998, $131 million in 1999, $92 million in 2000, $74 million in 2001, $86 million in 2002, $121 million in 2003, $157 million in 2004, $204 million in 2005, $243 million in 2006, and $288 million in 2007.

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

#### *Present and Prior Law*

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

Under prior law, there was no explicit statutory rule providing for equitable tolling of the statute of limitations. The U.S. Supreme Court had held[47] that Congress did not intend the equitable tolling doctrine to apply to the statutory limitations of section 6511 on the filing of tax refund claims.

#### *Reasons for Change*

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

#### *Explanation of Provision*

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

#### *Effective Date*

The provision applies to periods of disability before, on, or after the date of enactment (July 22, 1998) but does not apply to any claim for refund or credit that (without regard to the provision) is barred by the operation of any law, including the statute of limitations, as of the date of enactment.

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[47] *U.S.* v. *Brockamp*, 519 U.S. 347 (1997).

### *Revenue Effect*

The provision is estimated to reduce Federal budget receipts by $10 million in 1998, $70 million in 1999, $35 million in 2000, $15 million in 2001, $16 million in 2002, $17 million in 2003, $18 million in 2004, $19 million in 2005, $20 million in 2006, and $21 million in 2007.

## D. Provisions Relating to Interest and Penalties

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

### *Present and Prior Law*

A taxpayer that underpays its taxes is required to pay interest on the underpayment at a rate equal to the Federal short term interest rate plus three percentage points.[48] A special "hot interest" rate equal to the Federal short term interest rate plus five percentage points applies in the case of certain large corporate underpayments.

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

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

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

### *Reasons for Change*

The Congress did not believe that the Federal Government should charge taxpayers a higher interest rate than the Federal Government pays to the extent interest is owed both by and to the Federal Government for the same period on equivalent amounts.

[48] This provision was modified with respect to non-corporate taxpayers (see sec. 3302 of the Act).

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

### *Explanation of Provision*

The provision[49] establishes a net interest rate of zero where interest is payable and allowable on equivalent amounts of overpayment and underpayment for a period of any tax that is imposed by the Internal Revenue Code. Each overpayment and underpayment is considered only once in determining whether equivalent amounts of overpayment and underpayment exist. The special rules that increase the interest rate paid on large corporate underpayments and decrease the interest rate received on corporate overpayments in excess of $10,000 do not prevent the application of the net zero rate. It is anticipated that the Secretary will take into account interest paid on previously determined deficiencies or refunds for the purpose of determining the rate of interest in periods for which this provision is effective without regard to whether the underpayments or overpayments are currently outstanding. It is also anticipated that where interest is both payable from and allowable to an individual taxpayer for the same period, the Secretary will take all reasonable efforts to offset the liabilities, rather than process them separately using the net interest rate of zero. Where interest is payable and allowable on an equivalent amount of underpayment and overpayment that is attributable to a taxpayer's interest in a pass-thru entity (e.g., a partnership), it is intended that the benefits of the provision apply.

The Congress expects the Secretary to implement the procedures necessary to allow for the automatic application of this provision when practicable. Until such procedures are implemented, the Congress expects that the Secretary will promptly and carefully consider any taxpayer's request to have interest charges recalculated in accordance with this provision.

### *Effective Date*

The provision affects the determination of interest for periods beginning after the date of enactment (after July 22, 1998). In addition, the provision applies to the determination of interest for periods beginning before the date of enactment if: (1) as of the date of enactment, a statute of limitations has not expired with respect to the underpayment or overpayment; (2) the taxpayer identifies the periods of underpayment and overpayment for which the zero rate applies; and (3) on or before December 31, 1999, the taxpayer asks the Secretary to apply the zero rate. A statute of limitations must not have expired as of the date of enactment with respect to both the underpayment and overpayment for the provision to apply.

[49] This reflects the technical correction enacted in section 4002(d) of the Tax and Trade Relief Extension Act of 1998, described in Part Three of this publication.

### *Revenue Effect*

The provision is estimated to reduce Federal fiscal year budget receipts by $26 million in 1998, $68 million in 1999, $58 million in 2000, $61 million in 2001, $56 million in 2002, $59 million in 2003, $62 million in 2004, $65 million in 2005, $68 million in 2006, and $72 million in 2007.

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

### *Present and Prior Law*

A taxpayer that underpays its taxes is required to pay interest on the underpayment at a rate equal to the Federal short-term interest rate ("AFR") plus three percentage points. A taxpayer that overpays its taxes receives interest on the overpayment at a rate equal to the Federal short-term interest rate ("AFR") plus two percentage points; under prior law, this rule applied to all taxpayers.

### *Reasons for Change*

The Congress believed that the interest differential for noncorporate taxpayers should be eliminated.

### *Explanation of Provision*

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

### *Effective Date*

The provision is effective for interest for the second and succeeding calendar quarters beginning after the date of enactment (after July 22, 1998).

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts in 1998, and to reduce such receipts by $36 million in 1999, $54 million in 2000, $56 million in 2001, $59 million in 2002, $62 million in 2003, $65 million in 2004, $69 million in 2005, $72 million in 2006, and $76 million in 2007.

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

### *Present and Prior Law*

Taxpayers who fail to pay their taxes are subject to a penalty of one-half percent per month on the unpaid amount, up to a maximum of 25 percent. If the liability is shown on the return, the penalty begins to accrue on the date prescribed for payment of the tax (with regard to extensions). If the liability should have been shown on the return but was not, the penalty generally begins to accrue after the date that is 21 days from the date of the IRS notice and demand for payment with respect to such liability. Under prior law, taxpayers who made installment payments pursuant to an agreement with the IRS could also be subject to the full amount of this penalty.

### *Reasons for Change*

The Congress believed it inappropriate to apply the full amount of the penalty for failure to pay taxes to taxpayers who are in fact paying their taxes through an installment agreement.

### *Explanation of Provision*

The Act provides that the rate of the penalty for failure to pay taxes is half the usual rate (0.25 percent instead of 0.5 percent) for any month in which an installment payment agreement with the IRS is in effect, provided that the individual filed the tax return in a timely manner (including extensions).

### *Effective Date*

The provision is effective for installment agreement payments made after December 31, 1999.

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts in 1998 and 1999, and to reduce such receipts by $108 million in 2000, $136 million in 2001, $143 million in 2002, $152 million in 2003, $159 million in 2004, $167 million in 2005, $175 million in 2006, and $185 million in 2007.

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

### *Present and Prior Law*

Deposits of payroll taxes are allocated to the earliest period for which such a deposit is due. If a taxpayer misses or makes an insufficient deposit, later deposits will first be applied to satisfy the shortfall for the earlier period, the remainder is then applied to satisfy the obligation for the current period. Cascading penalties may result as payments that would otherwise be sufficient to satisfy current liabilities are applied to satisfy earlier shortfalls. The Secretary may waive the failure to make deposit penalty for inadvertent failures by first-time depositors of employment taxes. Under prior law, there may have been impediments to the ability of taxpayers to designate the period to which each deposit is applied.

### *Reasons for Change*

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

### *Explanation of Provision*

The Act allows the taxpayer to designate the period to which each deposit is applied. The designation must be made during the 90 days immediately following the sending of the related IRS penalty notice. The provision also extends the authorization to waive the failure to deposit penalty to the first deposit a taxpayer is required to make after the taxpayer is required to change the frequency of the taxpayer's deposits. For deposits required to be made after December 31, 2001, any deposit is to be applied to the most recent period to which the deposit relates, unless the taxpayer explicitly designates otherwise.

### *Effective Date*

The provision is effective for deposits made more than 180 days after the date of enactment (after January 18, 1999).

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts in 1998, and to reduce such receipts by $47 million in 1999, $64 million in each of the years 2000 and 2001, $65 million in 2002, $66 million in each of the years 2003 and 2004, $67 million in 2005, and $68 million in each of the years 2006 and 2007.

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

### *Prior Law*

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

### *Reasons for Change*

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

### *Explanation of Provision*

The Act suspends the accrual of penalties and interest after 1 year if the IRS has not sent the taxpayer a notice specifically stating the taxpayer's liability and the basis for the liability within the specified period. With respect to taxable years beginning before January 1, 2004, the 1-year period is increased to 18 months. Interest and penalties resume 21 days after the IRS sends the required notice to the taxpayer. The provision is applied separately with respect to each item or adjustment. The provision does not apply where a taxpayer has self-assessed the tax. The suspension only applies to taxpayers who file a timely tax return. The Act applies only to individuals and does not apply to the failure to pay penalty, in the case of fraud, or with respect to criminal penalties.

For example, if the IRS sends a math error notice to a taxpayer 2 months after the return is filed and also sends a notice of deficiency related to a different item 2 years later, the provision applies to the item reflected on the second notice (notwithstanding that the first notice was sent within the applicable time period).

### *Effective Date*

The provision is effective for taxable years ending after the date of enactment (after July 22, 1998).

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts in 1998 and 1999, and to reduce such receipts by $146 million in 2000, $174 million in 2001, $196 million in 2002, $209 million in 2003, $248 million in 2004, $431 million in 2005, $435 million in 2006, and $439 million in 2007.

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

### *Prior Law*

Prior law did not require the IRS to show how penalties are computed on the notice of penalty. In some cases, penalties may have been imposed without supervisory approval.

### *Reasons for Change*

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

### *Explanation of Provision*

The Act requires that each notice imposing a penalty include the name of the penalty, the Code section imposing the penalty, and a computation of the penalty.

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

### *Effective Date*

The provision is effective for notices issued and penalties assessed after December 31, 2000.

### *Revenue Effect*

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

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

#### *Present and Prior Law*

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

#### *Reasons for Change*

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

#### *Explanation of Provision*

The Act permits in-person delivery, as an alternative to delivery by mail, of a preliminary notice that the IRS intends to assess a 100-percent penalty.

#### *Effective Date*

The provision is effective on the date of enactment (July 22, 1998).

#### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

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

#### *Present and Prior Law*

Taxpayers generally must pay interest on amounts due to the IRS. Under prior law, there was no explicit statutory requirement that every IRS notice sent to an individual taxpayer that includes an amount of interest required to be paid by the taxpayer also include a detailed computation of the interest charged and a citation to the Code section under which such interest is imposed.

#### *Reasons for Change*

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

### *Explanation of Provision*

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

### *Effective Date*

The provision is effective for notices issued after December 31, 2000.

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

## 9. Abatement of interest on underpayments by taxpayers in Presidentially declared disaster areas (sec. 3309 of the Act and sec. 6404 of the Code)

### *Present and Prior Law*

In the case of a Presidentially declared disaster, the Secretary of the Treasury has the authority to postpone some tax-related deadlines; however, under prior law, there was no general authority to abate interest.

Under a provision of the Taxpayer Relief Act of 1997, if the Secretary of the Treasury extends the filing date of an individual tax return for individuals living in an area that has been declared a disaster area by the President during 1997,[50] no interest is charged as a result of the failure of the individual taxpayer to file an individual tax return, or to pay the taxes shown on such return, during the extension.

### *Reasons for Change*

The Congress believed it appropriate to extend permanently this special 1997 rule.

### *Explanation of Provision*

The Act provides that taxpayers located in a Presidentially declared disaster area do not have to pay interest on taxes due for the length of any extension for filing their tax returns granted by the Secretary of the Treasury.

This provision is designated as emergency legislation under section 252(e) of the Balanced Budget and Emergency Deficit Control Act.

[50] This provision also applies to disasters declared in 1998. This reflects the technical correction enacted in section 4003(e) of the Tax and Trade Relief Extension Act of 1998, described in Part Three of this publication.

### *Effective Date*

The provision is effective for disasters declared after December 31, 1997, with respect to taxable years beginning after December 31, 1997.

### *Revenue Effect*

The provision is estimated to reduce Federal fiscal year budget receipts by $8 million in 1998 and by $25 million in each of the years 1999 through 2007.

## E. Protections for Taxpayers Subject to Audit or Collection Activities

### 1. Due process in IRS collection actions (sec. 3401 of the Act and new secs. 6320 and 6330 of the Code)

### *Present and Prior Law*

Levy is the IRS's administrative authority to seize a taxpayer's property to pay the taxpayer's tax liability. The IRS is entitled to seize a taxpayer's property by levy if the Federal tax lien has attached to such property. The Federal tax lien arises automatically where (1) a tax assessment has been made, (2) the taxpayer has been given notice of the assessment stating the amount and demanding payment, and (3) the taxpayer has failed to pay the amount assessed within 10 days after the notice and demand. A Notice of Lien must be filed in order to inform potential purchasers or creditors of the Federal government's priority interest in the taxpayer's property.

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

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

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

### *Reasons for Change*

The Congress believed that the IRS should afford taxpayers adequate notice of collection activity and a meaningful hearing before the IRS deprives them of their property. When collection of tax is in jeopardy, the Congress believed it appropriate to provide notice and a hearing promptly after the seizure of property. The Congress also believed that a dwelling that is the principal residence of the taxpayer, the taxpayer's spouse, or the taxpayer's minor children should only be seized for the payment of taxes as a last resort and only where judicial approval is obtained prior to seizure. The Congress believed that following procedures designed to afford taxpayers due process in collections would increase fairness to taxpayers.

### *Explanation of Provision*

#### *In general*

The provision establishes new due process procedures the IRS must follow whenever it seeks to levy against the property of a taxpayer in the collection of a Federal tax liability or a Notice of Lien is filed.

#### *Levies*

Before the IRS can seize a taxpayer's property, it is required to provide the taxpayer with a "Notice of Intent to Levy," formally stating its intention to collect a tax liability by levy against the taxpayer's property or rights to property. Subject to the exceptions noted below, no levy can occur within the 30-day period beginning with the mailing of the "Notice of Intent to Levy." During that 30-day period, the taxpayer may demand a hearing before an appeals officer who has had no prior involvement with the taxpayer's case, other than in connection with a hearing after the filing of a notice of tax lien. If a hearing is requested within the 30-day period, no levy can occur until a determination by the appeals officer is rendered. This procedure applies only with regard to the first levy with respect to the amount of the unpaid tax for a taxable period.

The Notice of Intent to Levy must be provided to the taxpayer either by personal delivery, by leaving it at the taxpayer's dwelling or usual place of business, or by sending the notice to the taxpayer's last known address by certified or registered mail. The due process notice must describe in simple and nontechnical terms (1) the amount of unpaid tax, (2) the taxpayer's right to request a hearing within the 30-day period, and (3) the proposed action by the Secretary and the rights of the person with respect to such action. Such notice must also include a brief statement that sets forth the provision of the Code applicable to the levy and sale of property, the procedures that will be used, the administrative appeals available to the taxpayer and the procedures relating to such appeals, the alternatives available to the taxpayer that could prevent levy, and the procedures for redemption of property and release of liens.

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

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

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

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

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

The taxpayer is allowed to raise any issue relevant to the proposed collection activity at the hearing. Issues eligible to be raised include (but are not limited to):

(1) appropriate spousal defenses under section 6015;

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

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

The validity of the tax liability can be challenged during the hearing only if the taxpayer did not actually receive the statutory notice of deficiency or has not otherwise had an opportunity to dispute the liability. Also, an issue may not be raised as part of a due process hearing if it was raised and considered at a prior due process or other judicial or administrative hearing and the person seeking to raise the issue meaningfully participated in that prior hearing.

Following the hearing, the appeals officer conducting the hearing is expected to issue his or her determination. The determination of the appeals officer is to address whether the proposed collection action balances the need for the efficient collection of taxes with the legitimate concern of the taxpayer that the collection action be no more intrusive than necessary. The Internal Revenue Office of Appeals retains jurisdiction with respect to the determination. It may, in its discretion, hold additional hearings at the request of the taxpayer to determine if collection actions undertaken by the Secretary are consistent with its determination or to consider whether a change in circumstances justifies a revision of the original determination.[51] Such additional hearings may be held by the appellate officer making the original determination or by another appellate officer.

If a delivery of a Notice of Intent to Levy is accomplished by sending the notice to the taxpayer's last known address by certified or registered mail and the return receipt is not returned, the Secretary may proceed to levy on the taxpayer's property or rights to property 30 days after the Notice of Intent to Levy was mailed. The Congress expects that the Secretary will provide a hearing equivalent to the pre-levy hearing if later requested by the taxpayer. The Secretary is not required to suspend the levy process pending the completion of a hearing that is not requested within 30 days of the mailing of the Notice. However, if the taxpayer demonstrates that it did not receive the required notice and requests a hearing after collection activity has begun, the Congress expects that the collec-

[51] A taxpayer must exhaust any other available administrative remedy before it requests that a change in circumstances be considered as the basis for a change in a determination.

tion process will be suspended and a hearing provided to the taxpayer.

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

***Notices of lien***

The IRS is required to issue a due process notice to a taxpayer whenever it files a Notice of Lien against the taxpayer's property or the taxpayer's rights to property. This due process notice must be provided not more than five (5) business days after the Notice of Lien is filed. The due process notice must be provided to the taxpayer either by personal delivery, by leaving it at the taxpayer's dwelling or usual place of business, or by sending the notice to the taxpayer's last known address by certified or registered mail. The due process notice must describe in simple and nontechnical terms (1) the amount of unpaid tax to which the Notice of Lien relates, (2) the taxpayer's right to a hearing, and (3) the administrative appeals available to the taxpayer with respect to such lien and the procedures related to appeals. This procedure applies only with regard to the first Notice of Lien with respect to the amount of the unpaid tax for the taxable period.[52]

At any time during the 30-day period that begins with the mailing or delivery of the due process notice that relates to the first Notice of Lien filed in connection with a particular tax liability, the taxpayer may demand a hearing before an appeals officer who has had no prior involvement with respect to the particular liability of the taxpayer.[53] In general, any issue relevant to the lien or to the appropriateness of any other proposed collection action against the taxpayer can be raised at this hearing. For example, the taxpayer can request section 6015 spousal relief, request the abatement of penalties or interest, make an offer-in-compromise, propose an installment agreement or suggest which assets should be used to satisfy the tax liability. However, the validity of the tax liability can be challenged only if the taxpayer did not actually receive the statutory notice of deficiency or has not otherwise had an opportunity to dispute the liability.

A taxpayer is entitled to only one hearing under this provision with respect to the taxable period to which the liability relates. The taxpayer must request the hearing within the 30-day period that begins with the delivery or mailing of the first due process notice. The receipt of subsequent due process notices related to the same liability for the same taxable period do not create a right to an additional hearing under this provision, unless all previous due process notices failed to properly inform the taxpayer of his right to a

[52] A technical correction may be necessary to accomplish this result.

[53] A taxpayer may waive the requirement that the hearing be held before an Appeals officer that had no prior involvement with respect to the particular liability.

hearing. In such cases, the Congress expects that the previous due process notices will be disregarded for this purpose, that the taxpayer will be properly informed of the right to a hearing under this provision in the next due process notice, and that any timely request for such a hearing will be respected.

### *Combined hearings*

The Congress anticipates that the IRS will combine Notice of Intent to Levy and Notice of Lien hearings whenever possible. If multiple hearings are held, it is expected that, to the extent practicable, the same appellate officer will hear the taxpayer with regard to both lien and levy issues. If the taxpayer requests a hearing following receipt of a Notice of Lien or Notice of Intent to Levy and, prior to the date of the hearing, receives the other notice, the scheduled hearing will serve for both purposes and the taxpayer is obligated to raise all relevant issues at such hearing. The Congress does not intend that a Notice of Lien hearing be delayed to allow a Notice of Intent to Levy to be issued.

### *Judicial review*

The Congress expects that the appeals officer will prepare a written determination addressing the issues presented by the taxpayer and considered at the due process hearing. The determination of the appeals officer may be appealed to Tax Court or, where appropriate, the Federal district court. Where the validity of the tax liability was properly at issue in the hearing, and where the determination with regard to the tax liability is a part of the appeal, no levy may take place during the pendency of the appeal. The amount of the tax liability will in such cases be reviewed by the appropriate court on a *de novo* basis. Where the validity of the tax liability is not properly part of the appeal, the taxpayer may challenge the determination of the appeals officer for abuse of discretion. In such cases, the appeals officer's determination as to the appropriateness of collection activity will be reviewed using an abuse of discretion standard of review. Levies will not be suspended during the appeal provided the Secretary shows good cause why the levy should be allowed to proceed.

No further hearings are provided under this provision as a matter of right. It is the responsibility of the taxpayer to raise all relevant issues at the time of the hearing. A taxpayer can apply for consideration of new information, make an offer-in-compromise, request an installment agreement, or raise other considerations at any time before, during, or after the hearing. Nothing in this provision is intended to limit any remedy that is otherwise available under present law.

### *Prior judicial approval required for seizures of principal residences*

No seizure of a dwelling that is the principal residence of the taxpayer or the taxpayer's spouse, former spouse, or minor child would be allowed without prior judicial approval. Notice of the judicial hearing must be provided to the taxpayer and family members residing in the property. At the judicial hearing, the Secretary would be required to demonstrate (1) that the requirements of any applicable law or administrative procedure relevant to the levy have been met, (2) that the liability is owed, and (3) that no reasonable alternative for the collection of the taxpayer's debt exists.

### *Effective Date*

The provision is effective for collection actions initiated more than 180 days after the date of enactment (after January 18, 1999).

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts in 1998, and to reduce such receipts by $11 million in 1999, $7 million in each of the years 2000 through 2004, and $8 million in each of the years 2005 through 2007.

## 2. Examination activities

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

### *Present and Prior Law*

A common law privilege of confidentiality exists for communications between an attorney and client with respect to the legal advice the attorney gives the client. Communications protected by the attorney-client privilege must be based on facts of which the attorney is informed by the taxpayer, for the purpose of securing the professional advice of the attorney. The privilege may not be claimed where the purpose of the communication is the commission of a crime or tort. The taxpayer must either be a client of the attorney or be seeking to become a client of the attorney.

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

The privilege of confidentiality also does not apply where the communication is made for further communication to third parties. For example, information that is communicated to an attorney for inclusion in a tax return is not privileged because it is communicated for the purpose of disclosure. The privilege of confidentiality does not apply where an attorney is acting in another capacity, or where an attorney who is licensed to practice another profession is performing such other profession.

The attorney-client privilege is considered waived if the communication is voluntarily disclosed to anyone other than the attorney, the client or the agents of the client or the attorney.

The attorney-client privilege in tax matters is limited to communications between taxpayers and attorneys. Under prior law, no equivalent privilege was provided for communications between taxpayers and other professionals authorized to practice before the Internal Revenue Service, such as accountants or enrolled agents.

### *Reasons for Change*

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

### *Explanation of Provision*

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

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

The privilege granted by the provision may only be asserted in noncriminal tax proceedings before the IRS and in any noncriminal tax proceeding in Federal court brought by or against the United States.

The privilege may not be asserted to prevent the disclosure of information to any regulatory body other than the IRS. The ability of any other regulatory body, including the Securities and Exchange Commission ("SEC"), to gain or compel information is unchanged by the provision. No privilege may be asserted under this provision by a taxpayer in dealings with such other regulatory bodies in an administrative or court proceeding. The privilege of confidentiality created by this provision does not apply to any written communication between a federally authorized tax practitioner and any director, shareholder, officer, employee, agent, or representative of a corporation in connection with the promotion of the direct or indirect participation of such corporation in any tax shelter (as defined in section 6662(d)(2)(C)(iii)). A tax shelter for this purpose is any partnership, entity, plan, or arrangement a significant purpose of which is the avoidance or evasion of income tax. Tax shelters for which no privilege of confidentiality will apply include, but are not limited to, those required to be registered as confidential corporate tax shelter arrangements under section 6111(d).

The privilege created by this provision may be waived in the same manner as the attorney-client privilege. For example, if a taxpayer or federally authorized tax practitioner discloses to a third party the substance of a communication protected by the privilege, the privilege for that communication and any related communications is considered to be waived to the same extent and in the same manner as the privilege would be waived if the disclosure related to an attorney-client communication.

This provision relates only to matters of privileged communications. No inference is intended as to whether aspects of Federal tax practice covered by the new privilege constitute the authorized or unauthorized practice of law under various State laws.

### *Effective Date*

The provision is effective with regard to communications made on or after the date of enactment (July 22, 1998).

### *Revenue Effect*

The provision is estimated to reduce Federal fiscal year budget receipts by less than $5 million in each of the years 1998 through 2007.

## b. Limitation on financial status audit techniques (sec. 3412 of the Act and sec. 7602 of the Code)

### *Present and Prior Law*

The Secretary is authorized and required to make the inquiries and determinations necessary to insure the assessment of Federal income taxes. For this purpose, any reasonable method may be used to determine the amount of Federal income tax owed. The courts have upheld the use of financial status and economic reality examination techniques to determine the existence of unreported income in appropriate circumstances. There were no restrictions under prior law on the use of these examination techniques.

### *Reasons for Change*

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

### *Explanation of Provision*

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

### *Effective Date*

The provision is effective on the date of enactment (July 22, 1998).

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

## c. Software trade secrets protection (sec. 3413 of the Act and new sec. 7612 of the Code)

### *Present and Prior Law*

The Secretary of the Treasury is authorized to examine any books, papers, records, or other data that may be relevant or material to an inquiry into the correctness of any Federal tax return. The Secretary may issue and serve summonses necessary to obtain such data, including summonses on certain third-party recordkeepers.

The Secretary is considered to have made a prima facie case for the enforcement of a summons if the so-called "Powell standards" are met.[54] The Powell standards require: (1) that the examination to which the summons relates is being conducted pursuant to a legitimate purpose; (2) that the summons seek information that may be relevant to such examination; (3) that the IRS not already be in possession of the information; and (4) that the administrative steps required by the Code have been followed. However, a summons will not be enforced if the burden it places on the summonsed party is out of proportion to the end sought.[55] Where the summons is issued against a third-party, particularly one that is a stranger to the taxpayer's affairs, the IRS has been required to show that the circumstances of the investigation indicate a realistic expectation, and not merely an idle hope, that something relevant to the investigation may be discovered in order to have the summons enforced.[56]

Under prior law, there were no specific statutory restrictions on the ability of the Secretary to demand the production of computer records, programs, source code or similar materials, whether held by the taxpayer or by a third-party.

### *Reasons for Change*

The Congress believed that the intellectual property rights of the developers and owners of computer programs should be respected. The Congress was concerned that the examination of computer pro-

[54] See *Powell* v. *U.S.,* 379 U.S. 48 (1964).
[55] *Harrington* v. *U.S.,* 388 F. 2d 520 (2nd Cir, 1968).
[56] *Harrington,* supra.

grams and source code by the IRS could lead to the diminution of those rights through the inadvertent disclosure of trade secrets. The Congress believed that special protection against such inadvertent disclosure should be established.

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

### *Explanation of Provision*

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

(1) Such software or source code may be examined only in connection with the examination of the taxpayer's return with regard to which it was received. This is intended to prevent the Secretary from using the software for the purpose of examining other, unrelated taxpayers. It is not intended to prevent the Secretary from using knowledge it obtains in the course of the examination, so long as such use does not result in the disclosure of tax return information (including the software or source code) or the violation of any statutory protection or judicial order.

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

(3) Such source code may not be removed from the owner's place of business without the owner's consent unless such removal is pursuant to a court order.

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

(5) Such software or source code may be copied only as necessary to perform the specific examination. The owner of the software must be informed of any copies that are made, such copies must be numbered, and at the conclusion of the examination and any related court proceedings, all such copies must be accounted for and returned to the owner, permanently deleted, or destroyed. The Secretary must provide the owner of such software or source code with the names of any individuals who will have access to such software or source code.

(6) If an individual who is not an officer or employee of the U.S. Government will examine the software or source code, such individual must enter into a written agreement with the Secretary that such individual will not disclose such software or source code to any person other than authorized employees or agents of the Secretary at any time, and that such individ-

ual will not participate in the development of software that is intended for a similar purpose as such software for a period of two years.

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

(8) Computer software or source code that is obtained by the IRS in the course of the examination of a taxpayer's return is considered to be return information for the purposes of section 6103.

***Summons of tax-related computer software source code***

No summons may be issued for tax-related computer software source code unless (1) the Secretary is unable otherwise to ascertain the correctness of any item on a return from the taxpayer's books and records or the computer software program and associated data, (2) the Secretary identifies with reasonable specificity the portion of the computer source code needed to verify the correctness of the item and (3) the Secretary determines that the need for the source code outweighs the risk of unauthorized disclosure of trade secrets. The Secretary is considered to have satisfied the first two of these requirements if the Secretary makes a formal request for such materials to both the taxpayer and the owner of the software that is not satisfied within 180 days.

This limitation on the summons of tax-related computer software source code does not apply if the summons is issued in connection with an inquiry into any offense connected with the administration or enforcement of the internal revenue laws. The limitation also does not apply to a summons of computer software source code that was acquired or developed by the taxpayer or a related person primarily for internal use by the taxpayer or such person rather than for commercial distribution. A finding that computer software source code was developed for internal use, and thus not eligible for the limitation in summons authority in this provision, is not intended to be dispositive of whether such software was intended for internal use for any other purpose of this title.

Communications between the owner of the tax-related computer software source code and the taxpayer are not protected from summons by this provision. Communications between the owner of the tax-related source code and persons not related to the taxpayer that are related to the functioning and operation of the software may be treated as a part of the computer software source code.

***Other issues***

The provision does not change or eliminate any other requirement of the Code. A summons for third-party tax-related computer source code that meets the standards established by the provision will not be enforced if it would not have been enforced under prior law. For example, if the Secretary's purpose in issuing the summons is shown to be improper, the summons would not be enforced, even if the Secretary otherwise met the standards for the summons of computer source code established by the provision. The limitations on the summons of tax-related computer software source code apply only with respect to computer software that is used for accounting, tax return preparation, tax compliance or tax planning purposes. No inference is intended with respect to computer software used for all other purposes. In such cases, prior law will continue to apply, subject to the protections against the disclosure and improper use of trade secrets and other confidential information added by this provision.

Software or source code that is required to be provided under prior law must be provided without regard to this provision. For example, computer software or source code that is required to be provided in connection with the registration of a confidential corporate tax shelter arrangement under section 6111 would continue to be required to be provided without regard to this provision. Thus, the registration requirement of section 6111 cannot be avoided where the tax benefits of the shelter are discernible only from the operation of a computer program.

### *Effective Date*

The provision is effective for summonses issued and software acquired after the date of enactment (after July 22, 1998). In addition, 90 days after the date of enactment, the protections against the disclosure and improper use of trade secrets and confidential information added by the provision (except for the requirement that the Secretary provide a written agreement from non-U.S. government officers and employees) apply to software and source code acquired on or before the date of enactment.

### *Revenue Effect*

The provision is estimated to have no revenue effect on Federal fiscal year budget receipts in 1998, and to reduce such receipts by $13 million in 1999, $16 million in 2000, $20 million in 2001, $22 million in 2002, $26 million in 2003, $30 million in 2004, $33 million in 2005, $36 million in 2006, and $37 million in 2007.

## d. Threat of audit prohibited to coerce tip reporting alternative commitment agreements (sec. 3414 of the Act)

### *Present and Prior Law*

Restaurants may enter into Tip Reporting Alternative Commitment ("TRAC") agreements. A restaurant entering into a TRAC agreement is obligated to educate its employees on their tip reporting obligations, to institute formal tip reporting procedures, to fulfill all filing and record keeping requirements, and to pay and deposit taxes. In return, the IRS agrees to base the restaurant's liability for employment taxes solely on reported tips and any unreported tips discovered during an IRS audit of an employee. Under prior law, there was no statutory prohibition on threatening to audit a taxpayer in an attempt to coerce the taxpayer to enter into a TRAC agreement.

### *Reasons for Change*

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

### *Explanation of Provision*

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

### *Effective Date*

The provision is effective on the date of enactment (July 22, 1998).

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal years budget receipts.

#### e. Taxpayers allowed motion to quash all third-party summonses (sec. 3415 of the Act and sec. 7609 of the Code)

### *Present and Prior Law*

When the IRS issues a summons to a "third-party recordkeeper" relating to the business transactions or affairs of a taxpayer, notice of the summons must be given to the taxpayer within three days by certified or registered mail. The taxpayer is thereafter given up to 23 days to begin a court proceeding to quash the summons. If the taxpayer does so, third-party recordkeepers are prohibited from complying with the summons until the court rules on the taxpayer's petition or motion to quash, but the statute of limitations for assessment and collection with respect to the taxpayer is stayed during the pendency of such a proceeding. Under prior law, third-party recordkeepers were generally persons who hold financial information about the taxpayer, such as banks, brokers, attorneys, and accountants; some third parties were not included.

### *Reasons for Change*

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

### *Explanation of Provision*

The Act generally expands the "third-party recordkeeper" procedures to apply to summonses issued to persons other than the taxpayer. Thus, the taxpayer whose liability is being investigated receives notice of the summons and is entitled to bring an action in the appropriate U.S. District Court to quash the summons. As under the prior-law third-party recordkeeper provision, the statute of limitations on assessment and collection is stayed during the litigation, and certain kinds of summonses specified under prior law are not subject to these requirements. Nothing in section 7609 of the Code (relating to special procedures for third-party summonses) shall be construed to limit the ability of the IRS to obtain information (other than by summons) through formal or informal procedures authorized by the Code.

### *Effective Date*

The provision is effective for summonses served after the date of enactment (after July 22, 1998).

### *Revenue Effect*

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

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

### *Present and Prior Law*

Under prior law, a summons was required to be served "by an attested copy delivered in hand to the person to whom it is directed or left at his last and usual place of abode." Under present and prior law, if a third-party recordkeeper summons is served, the IRS may give the taxpayer notice of the summons via certified or registered mail. The Federal Rules of Civil Procedure permit service of process by mail even in summons enforcement proceedings, under both present and prior law.

### *Reasons for Change*

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

### *Explanation of Provision*

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

### *Effective Date*

The provision is effective for summonses served after the date of enactment (after July 22, 1998).

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

### g. Notice of IRS contact of third parties (sec. 3417 of the Act and sec. 7602 of the Code)

#### *Present and Prior Law*

Third parties may be contacted by the IRS in connection with the examination of a taxpayer or the collection of the tax liability of the taxpayer. The IRS has the right to summon third-party recordkeepers. In general, the taxpayer must be notified of the service of summons on a third party within three days of the date of service. The IRS also has the right to seize property of the taxpayer that is held in the hands of third parties. Except in jeopardy situations, the Internal Revenue Manual provides that IRS will personally contact the taxpayer and inform the taxpayer that seizure of the asset is planned. Under prior law, there was no statutory requirement that IRS provide reasonable notice that the IRS may contact persons other than the taxpayer.

#### *Reasons for Change*

The Congress believed that further clarification of these provisions would benefit taxpayers.

#### *Explanation of Provision*

The Act provides that the IRS may not contact any person other than the taxpayer with respect to the determination or collection of the tax liability of the taxpayer without providing reasonable notice in advance to the taxpayer that the IRS may contact persons other than the taxpayer. It is intended that in general this notice will be provided as part of an existing IRS notice provided to taxpayers. The Act also requires the IRS to provide periodically to the taxpayer a record of persons previously contacted during that period by the IRS with respect to the determination or collection of that taxpayer's tax liability. This record shall also be provided upon request of the taxpayer. The provision does not apply to criminal tax matters, if the collection of the tax liability is in jeopardy, if the Secretary determines for good cause shown that disclosure may involve reprisal against any person, or if the taxpayer authorized the contact.

#### *Effective Date*

The provision is effective for contacts made after 180 days after the date of enactment (after January 18, 1999).

#### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts in 1998, and reduce such receipts by less than $5 million in each of the years 1999 through 2007.

### 3. Collection activities

#### a. Approval process for liens, levies, and seizures (sec. 3421 of the Act)

*Prior Law*

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

*Reasons for Change*

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

*Explanation of Provision*

The Act requires the IRS to implement an approval process under which any lien, levy or seizure would, where appropriate, be approved by a supervisor, who would review the taxpayer's information, verify that a balance is due, and affirm that a lien, levy or seizure is appropriate under the circumstances. Circumstances to be considered include the amount due and the value of the asset.

The Commissioner is to have discretion in promulgating the procedures required by this provision to determine the circumstances under which supervisory review of liens or levies issued by the automated collection system is or is not appropriate.

*Effective Date*

The provision is effective for collection actions commenced after date of enactment (after July 22, 1998), except in the case of any action under the automated collection system, the provision applies to actions initiated after December 31, 2000.

*Revenue Effect*

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

#### b. Modifications to certain levy exemption amounts (sec. 3431 of the Act and sec. 6334 of the Code)

*Present and Prior Law*

IRS may levy on all non-exempt property of the taxpayer. Under prior law, property exempt from levy included up to $2,500 in value of fuel, provisions, furniture, and personal effects in the taxpayer's household and up to $1,250 in value of books and tools necessary for the trade, business or profession of the taxpayer.

*Reasons for Change*

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

### *Explanation of Provision*

The Act increases the value of personal effects exempt from levy to $6,250 and the value of books and tools exempt from levy to $3,125. These amounts are indexed for inflation.

### *Effective Date*

The provision is effective for levies issued after the date of enactment (after July 22, 1998).

### *Revenue Effect*

The provision is estimated to reduce the Federal fiscal year budget receipts by less than $1 million in 1998, $1 million in each of the years 1999 through 2002 and $2 million in each of the years 2003 through 2007.

## c. Release of levy upon agreement that amount is uncollectible (sec. 3432 of the Act and sec. 6343 of the Code)

### *Prior Law*

Some taxpayers contended that the IRS did not release a wage levy immediately upon receipt of proof that the tax was not collectible. Instead, they claimed, the IRS levied on one period's wage payment before releasing the levy.

### *Reasons for Change*

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

### *Explanation of Provision*

The Act requires the IRS to release, as soon as practicable, a wage levy upon agreement with the taxpayer that the tax is not collectible. The IRS is not to intentionally delay until after one wage payment has been made and levied upon before releasing the levy.

### *Effective Date*

The provision is effective for levies imposed after December 31, 1999.

### *Revenue Effect*

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

### d. Levy prohibited during pendency of refund proceedings (sec. 3433 of the Act and sec. 6331 of the Code)

#### *Present and Prior Law*

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

Generally, full payment of the tax at issue is a prerequisite to a refund suit. However, if the tax is divisible (such as employment taxes or the trust fund penalty under Code section 6672), the taxpayer need only pay the tax for the applicable period before filing a refund claim.

#### *Reasons for Change*

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

#### *Explanation of Provision*

The Act requires the IRS to withhold collection of liabilities that are the subject of a refund suit during the pendency of the litigation. This will only apply when refund suits can be brought without the full payment of the tax, i.e., in the case of divisible taxes. Collection by levy must be withheld unless jeopardy exists or the taxpayer waives the suspension of collection in writing (because collection will stop the running of interest and penalties on the tax liability). The Secretary may not commence a civil action to collect a liability except in a proceeding related to the initial refund proceeding. The statute of limitations on collection is stayed for the period during which the IRS is prohibited from collecting by levy or otherwise.

Proceedings related to a proceeding [57] under this provision include, but are not limited to, civil actions or third-party complaints initiated by the United States or another person with respect to the same kinds of tax (or related taxes or penalties) for the same (or overlapping) tax periods. For example, if a taxpayer brings a suit for a refund of a portion of a penalty that the taxpayer has paid under section 6672, the United States could, consistent with this provision, counterclaim against the taxpayer for the balance of the penalty or initiate related claims against other persons assessed penalties under section 6672 for the same employment taxes.

#### *Effective Date*

The provision is effective with respect to unpaid tax attributable to taxable periods beginning after December 31, 1998.

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[57] For purposes of new section 6331(i)(4)(A)(ii) of the Code.

### *Revenue Effect*

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

### e. Approval required for jeopardy and termination assessments and jeopardy levies (sec. 3434 of the Act and sec. 7429 of the Code)

### *Present and Prior Law*

In general, a 30-day waiting period is imposed after assessment of all types of taxes. In certain circumstances, the waiting period puts the collection of taxes at risk. The Code provides special procedures that allow the IRS to make jeopardy assessments or termination assessments in certain extraordinary circumstances, such as if the taxpayer is leaving or removing property from the United States, or if assessment or collection would be jeopardized by delay. In jeopardy or termination situations, a levy may be made without the 30-days' notice of intent to levy that is ordinarily required. Under prior law, there was no statutory requirement of IRS Counsel review and approval.

### *Reasons for Change*

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

### *Explanation of Provision*

The Act requires IRS Counsel review and approval before the IRS can make a jeopardy assessment, a termination assessment, or a jeopardy levy. If Counsel's approval is not obtained, the taxpayer is entitled to obtain abatement of the assessment or release of the levy, and, if the IRS fails to offer such relief, to appeal first to IRS Appeals under the new due process procedure for IRS collections and then to court.

### *Effective Date*

The provision is effective with respect to taxes assessed and levies made after the date of enactment (after July 22, 1998).

### *Revenue Effect*

The provision is estimated to have a negligible revenue effect on Federal fiscal year budget receipts.

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

### *Present and Prior Law*

A Federal tax lien attaches to all property and rights in property of the taxpayer, if the taxpayer fails to pay the assessed tax liability after notice and demand. However, the Federal tax lien is not valid as to certain "superpriority" interests.

Two of these interests are limited by a specific dollar amount. Purchasers of personal property at a casual sale were protected, under prior law, against a Federal tax lien attached to such property to the extent the sale was for less than $250. In addition, prior law provided protection to mechanic's lienors with respect to the repairs or improvements made to owner-occupied personal residences, but only to the extent that the contract for repair or improvement was for not more than $1,000.

In addition, a superpriority was granted to banks and building and loan associations which make passbook loans to their customers, provided that those institutions retained the passbooks in their possession until the loan was completely paid off.

### *Reasons for Change*

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

### *Explanation of Provision*

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

### *Effective Date*

The provision is effective on the date of enactment (July 22, 1998).

### *Revenue Effect*

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

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

### *Present and Prior Law*

Under present law, a distribution from an employer-sponsored retirement plan or an individual retirement arrangement ("IRA") generally is includible in gross income in the year it is paid or distributed, except to the extent the amount distributed represents the employee's after-tax contributions or investment in the contract (i.e., basis).

Distributions from qualified plans and IRAs prior to age 59½ generally are subject to a 10-percent early withdrawal tax on the amount includible in income, unless an exception to the tax applies. Exceptions to the 10-percent early withdrawal tax applicable to both qualified plans and IRAs include distributions due to death or disability, distributions made in the form of certain periodic payments, and distributions used to pay medical expenses in excess of 7.5 percent of adjusted gross income ("AGI"). Also, in the case of distributions from IRAs, there are exceptions to the 10–percent early withdrawal tax for distributions for education expenses, for up to $10,000 of first-time homebuyer expenses, and for the purchase of health insurance by unemployed individuals. Furthermore, a distribution from a qualified plan made by an employee after separation from service after attainment of age 55 is not subject to the 10–percent early withdrawal tax.

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

Distributions from employer-sponsored retirement plans or IRAs made on account of an IRS levy are includible in the gross income of the individual, except to the extent the amount distributed represents after-tax contributions by the employee. Under prior law, the amount includible in income also was subject to the 10–percent early withdrawal tax, unless an exception described above applied.

### *Reasons for Change*

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

### *Explanation of Provision*

The Act provides an exception to the 10–percent early withdrawal tax for amounts withdrawn from an employer-sponsored retirement plan or an IRA as a result of a levy by the IRS on the plan or IRA. The exception applies only if the plan or IRA is levied; it does not apply, for example, if the taxpayer withdraws funds to pay taxes in the absence of a levy or if the taxpayer withdraws funds in order to release a levy on other interests.

### *Effective Date*

The provision is effective for distributions after December 31, 1999.

### *Revenue Effect*

The provision is estimated to reduce Federal fiscal year budget receipts by $1 million in 2000, $3 million in 2001, $4 million in 2002, $4 million in 2003, $5 million in 2004, $5 million in 2005, $5 million in 2006, and $5 million in 2007.

### h. Prohibition of sales of seized property at less than minimum bid (sec. 3441 of the Act and sec. 6335 of the Code)

#### *Present and Prior Law*

A minimum bid price must be established for seized property offered for sale. To conserve the taxpayer's equity, the minimum bid price should normally be computed at 80 percent or more of the forced sale value of the property less encumbrances having priority over the Federal tax lien. If the group manager concurs, the minimum sales price may be set at less than 80 percent. The taxpayer is to receive notice of the minimum bid price within 10 days of the sale. The taxpayer has the opportunity to challenge the minimum bid price, which cannot be more than the tax liability plus the expenses of sale. Prior law did not contemplate a sale of the seized property at less than the minimum bid price. Rather, if no person offered the minimum bid price, the IRS could have bought the property at the minimum bid price or the property could have been released to the owner.

#### *Reasons for Change*

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

#### *Explanation of Provision*

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

#### *Effective Date*

This provision is effective with respect to sales occurring after the date of enactment (after July 22, 1998).

#### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

### i. Accounting of sales of seized property (sec. 3442 of the Act and sec. 6340 of the Code)

#### *Present and Prior Law*

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

The IRS is required to keep records of all sales of real property. The records must set forth all proceeds and expenses of the sale.

The IRS is required to apply the proceeds first against the expenses of the sale, then against a specific tax liability on the seized property, if any, and finally against any unpaid tax liability of the taxpayer. Any surplus proceeds are credited to the taxpayer or persons legally entitled to the proceeds.

### *Reasons for Change*

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

### *Explanation of Provision*

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

### *Effective Date*

The provision is effective for seizures occurring after the date of enactment (after July 22, 1998).

### *Revenue Effect*

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

## j. Uniform asset disposal mechanism (sec. 3443 of the Act)

### *Present and Prior Law*

The IRS must sell property seized by levy either by public auction or by public sale under sealed bids. Under prior law, these were often conducted by the revenue officer charged with collecting the tax liability.

### *Reasons for Change*

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

### *Explanation of Provision*

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

### *Effective Date*

The Act requires the uniform asset disposal system to be implemented within two years from the date of enactment (by July 22, 2000).

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

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

### *Present and Prior Law*

The Internal Revenue Manual ("IRM") provides general guidelines for seizure actions.

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

### *Reasons for Change*

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

### *Explanation of Provision*

The Act codifies the IRS administrative procedures which require the IRS to investigate the status of property to be sold pursuant to section 6335 prior to levy.

### *Effective Date*

The provision is effective on the date of enactment (July 22, 1998).

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

## l. Procedures for seizure of residences and businesses (sec. 3445 of the Act and sec. 6334 of the Code)

### *Present and Prior Law*

Subject to certain procedural rules and limitations, the Secretary may seize the property of the taxpayer who neglects or refuses to pay any tax within 10 days after notice and demand. The IRS may not levy on the personal residence of the taxpayer unless the District Director (or the assistant District Director) personally approves in writing or in cases of jeopardy. Under prior law, there were no special rules for property that was used as a residence by parties other than the taxpayer. IRS Policy Statement P–5–34 states that the facts of a case and alternative collection methods must be thoroughly considered before deciding to seize the assets of a going business.

### *Reasons for Change*

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

### *Explanation of Provision*

The Act generally prohibits the IRS from seizing real property that is used as a residence to satisfy an unpaid liability of $5,000 or less, including penalties and interest. This prohibition applies to any real property used as a residence by the taxpayer or any nonrental real property of the taxpayer used by any other individual as a residence.

The Act requires the IRS to exhaust all other payment options before seizing the taxpayer's business assets or principal residence. The definition of business assets applies to tangible personal property or real property used in the trade or business of an individual taxpayer (other than real property that is rented). Future income that may be derived by a taxpayer from the commercial sale of fish or wildlife under a specified State permit must be considered in evaluating other payment options before seizing the taxpayer's business assets. The provision does not apply in cases of jeopardy.

A levy is permitted on a principal residence only if a judge or magistrate of a United States district court approves (in writing) of the levy.

### *Effective Date*

The provision is effective on the date of enactment (July 22, 1998).

### *Revenue Effect*

The provision is estimated to reduce the Federal fiscal year budget receipts by less than $1 million in 1998 and by $3 million in each of the years 1999 through 2007.

## 4. Provisions relating to examination and collection activities

### a. Procedures relating to extensions of statute of limitations by agreement (sec. 3461 of the Act and secs. 6501 and 6502 of the Code)

### *Present and Prior Law*

The statute of limitations within which the IRS may assess additional taxes is generally three years from the date a return is filed.

Prior to the expiration of the statute of limitations, both the taxpayer and the IRS may agree in writing to extend the statute. An extension may be for either a specified period or an indefinite period. The statute of limitations within which a tax may be collected after assessment is 10 years after assessment. Under prior law, prior to the expiration of the statute of limitations on collection, both the taxpayer and the IRS could agree in writing to extend the statute.

### *Reasons for Change*

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

Moreover, the Congress believed that the IRS should collect all taxes within 10 years, and that such statute of limitations should not generally be extended.

### *Explanation of Provision*

The Act eliminates the provision of prior law that allows the statute of limitations on collections to be extended by agreement between the taxpayer and the IRS, except that extensions of the statute of limitations on collection may be made in connection with an installment agreement; the extension is only for the period for which the waiver of the statute of limitations entered in connection with the original written terms of the installment agreement extends beyond the end of the otherwise applicable 10-year period, plus 90 days.

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

### *Effective Date*

The provision applies to requests to extend the statute of limitations made after December 31, 1999. If, in any request to extend the period of limitations made on or before December 31, 1999, a taxpayer agreed to extend that period beyond the 10-year statute of limitations on collection, that extension shall expire on the latest of: the last day of such 10-year period, December 31, 2002, or, in the case of an extension in connection with an installment agreement, the 90th day after the end of the period of such extension.

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts in 1998 and 1999, and reduce such receipts by $9 million in 2000, $13 million in 2001, $16 million in 2002, $18 million in 2003, $19 million in each of the years 2004 and 2005, $21 million in 2006, and $24 million in 2007.

### b. Offers-in-compromise (sec. 3462 of the Act and secs. 6331 and 7122 of the Code)

#### *Present and Prior Law*

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

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

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

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

#### *Reasons for Change*

The Congress believed that the ability to compromise tax liability and to make payments of tax liability by installment enhances taxpayer compliance. In addition, the Congress believed that the IRS should be flexible in finding ways to work with taxpayers who are sincerely trying to meet their obligations and remain in the tax system. Accordingly, the Congress believed that the IRS should make it easier for taxpayers to enter into offer-in-compromise agreements, and should do more to educate the taxpaying public about the availability of such agreements.

#### *Explanation of Provision*

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

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

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

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

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

*Guidelines to determine whether an offer-in-compromise should be accepted.*—The Act authorizes the Secretary to prescribe guidelines for the IRS to determine whether an offer-in-compromise is adequate and should be accepted to resolve a dispute. Accordingly, it is expected that the present regulations will be expanded so as to permit the IRS, in certain circumstances, to consider additional factors (i.e., factors other than doubt as to liability or collectibility) in determining whether to compromise the income tax liabilities of individual taxpayers. For example, it is anticipated that the IRS will take into account factors such as equity, hardship, and public policy where a compromise of an individual taxpayer's income tax liability would promote effective tax administration. It is anticipated that, among other situations, the IRS may utilize this new authority to resolve longstanding cases by forgoing penalties and interest which have accumulated as a result of delay in determining the taxpayer's liability.

### *Effective Date*

The provision is generally effective for offers-in-compromise and installment agreements submitted after the date of enactment (after July 22, 1998). The provision suspending levy is effective with respect to offers-in-compromise pending on or made after December 31, 1999.

### *Revenue Effect*

The provision is estimated to reduce the Federal fiscal year budget receipts by $1 million in 1998, have no revenue effect in 1999, and to increase such receipts by $9 million in 2000 and by $4 million in each of the years 2001 through 2007.

## c. Notice of deficiency to specify deadlines for filing Tax Court petition (sec. 3463 of the Act and sec. 6213 of the Code)

### *Prior Law*

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

### *Reasons for Change*

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

### *Explanation of Provision*

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

### *Effective Date*

The provision is effective with respect to notices mailed after December 31, 1998.

### *Revenue Effect*

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

### d. Refund or credit of overpayments before final determination (sec. 3464 of the Act and sec. 6213 of the Code)

#### *Present and Prior Law*

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

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

#### *Reasons for Change*

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

#### *Explanation of Provision*

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

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

#### *Effective Date*

The provision is effective on the date of enactment (July 22, 1998).

#### *Revenue Effect*

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

### e. IRS procedures relating to appeal of examinations and collections (sec. 3465 of the Act and new sec. 7123 of the Code)

#### *Present and Prior Law*

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

In certain cases under Coordinated Examination Program procedures, the taxpayer has an opportunity to seek early Appeals jurisdiction over some issues while an examination is still pending on other issues. The early referral procedures also apply to employment tax issues on a limited basis.

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

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

### *Reasons for Change*

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

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

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

### *Explanation of Provision*

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

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

The Act requires the IRS to make Appeals officers available on a regular basis in each State, and consider videoconferencing of Appeals conferences for taxpayers seeking appeals in rural or remote areas.

### *Effective Date*

The provision is effective on the date of enactment (July 22, 1998).

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

## f. Application of certain fair debt collection practices (sec. 3466 of the Act and new sec. 6304 of the Code)

### *Present and Prior Law*

The Fair Debt Collection Practices Act provides a number of rules relating to debt collection practices. Among these are restrictions on communication with the consumer, such as a general prohibition on telephone calls outside the hours of 8:00 a.m. to 9:00 p.m. local time, and prohibitions on harassing or abusing the consumer. Under prior law, these provisions generally did not apply to the Federal Government.[58]

### *Reasons for Change*

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

### *Explanation of Provision*

The Act applies the restrictions relating to communication with the taxpayer/debtor and the prohibitions on harassing or abusing the debtor to the IRS. The restrictions relating to communication with the taxpayer/debtor are not intended to hinder the ability of the IRS to respond to taxpayer inquiries (such as answering telephone calls from taxpayers).

### *Effective Date*

The provision is effective on the date of enactment (July 22, 1998).

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

[58] Several of these provisions were applied to the IRS through the annual appropriations process.

### g. Guaranteed availability of installment agreements (sec. 3467 of the Act and sec. 6159 of the Code)

#### *Present and Prior 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. An installment agreement does not reduce the amount of taxes, interest, or penalties owed, but does provide for a longer period during which payments may be made during which other IRS enforcement actions (such as levies or seizures) are held in abeyance. The IRS in most instances readily approves these requests if the amounts involved are not large (in general, below $10,000) and if the taxpayer has filed tax returns on time in the past. Some taxpayers are required to submit background information to the IRS substantiating their application.

#### *Reasons for Change*

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

#### *Explanation of Provision*

In the case of individual income taxes, the provision requires the Secretary to enter an installment agreement, at the taxpayer's option, if: (1) the liability is $10,000, or less (excluding penalties and interest); (2) within the previous 5 years, the taxpayer has not failed to file or to pay, nor entered an installment agreement under this provision; (3) if requested by the Secretary, the taxpayer submits financial statements, and the Secretary determines that the taxpayer is unable to pay the tax due in full; (4) the installment agreement provides for full payment of the liability within 3 years; and (5) the taxpayer agrees to continue to comply with the tax laws and the terms of the agreement for the period (up to 3 years) that the agreement is in place.

#### *Effective Date*

The provision is effective on the date of enactment (July 22, 1998).

#### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

### h. Prohibition on requests to taxpayers to waive rights to bring actions (sec. 3468 of the Act)

*Prior Law*

There was no restriction on the circumstances under which the Government could request a taxpayer to waive the taxpayer's right to sue the United States or one of its employees for any action taken in connection with the tax laws.

*Reasons for Change*

The Congress believed it would be beneficial to taxpayers to circumscribe these requests.

*Explanation of Provision*

The Act provides that the Government may not request a taxpayer to waive the taxpayer's right to sue the United States or one of its employees for any action taken in connection with the tax laws, unless (1) the taxpayer knowingly and voluntarily waives that right, or (2) the request is made to the taxpayer's attorney or other representative. This provision is not intended to apply to the waiver of claims for attorneys' fees or costs or to the waiver of one or more claims brought in the same administrative or judicial proceeding with other claims that are being settled.

*Effective Date*

The provision is effective on the date of enactment.

*Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

## F. Disclosures to Taxpayers

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

*Present and Prior Law*

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

*Reasons for Change*

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

### *Explanation of Provision*

The Act requires that the IRS establish procedures clearly to alert married taxpayers of their joint and several liability on all appropriate tax publications and instructions. Notification must also be given of an individual's right to relief under new section 6015 of the Code in Publication Number 1 and in any collection-related notices.

### *Effective Date*

The provision requires that the procedures be established as soon as practicable, but no later than 180 days after the date of enactment (by January 18, 1999).

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

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

### *Present and Prior Law*

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

### *Reasons for Change*

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

### *Explanation of Provision*

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

### *Effective Date*

The addition to Publication 1 must be made not later than 180 days after the date of enactment (by January 18, 1999).

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts in 1998, and to reduce such receipts by $13 million in 1999 and by less than $1 million in each of the years 2000 through 2007.

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

#### *Present and Prior Law*

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

#### *Reasons for Change*

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

#### *Explanation of Provision*

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

#### *Effective Date*

The addition to Publication 1 must be made not later than 180 days after the date of enactment (by January 18, 1999).

#### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

### 4. Explanation of the appeals and collection process (sec. 3504 of the Act)

#### *Prior Law*

There was no statutory requirement that a description of the entire process from examination through collections be given to taxpayers with the first letter of proposed deficiency that allows the taxpayer an opportunity for administrative review in the IRS Office of Appeals.

#### *Reasons for Change*

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

#### *Explanation of Provision*

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

### *Effective Date*

The provision requires that the explanation be included as soon as practicable, but no later than 180 days after the date of enactment (by January 18, 1999).

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

## 5. Explanation of reason for refund disallowance (sec. 3505 of the Act and 6402 of the Code)

### *Present and Prior Law*

The Examination Division of the IRS examines claims for refund submitted by taxpayers. The Internal Revenue Manual requires examination or other audit action on refund claims within 30 days after receipt of the claims. The refund claim is preliminarily examined to determine if it should be disallowed because it (1) was untimely filed, (2) was based solely on alleged unconstitutionality of the Revenue Acts, (3) was already waived by the taxpayer as consideration for a settlement, (4) covers a taxable year and issues which were the subject of a final closing agreement or an offer in compromise, or (5) relates to a return closed on the basis of a final order of the Tax Court. In those cases, the taxpayer will receive a form from the IRS stating that the claim for refund cannot be considered. Under prior law, there was no statutory requirement that this form include the reason for the disallowance (or partial disallowance) of the claim. Other cases are examined as quickly as possible and the disposition of the case, including the reasons for the disallowance or partial disallowance of the refund claim, must be stated in the portion of the revenue agent's report that is sent to the taxpayer.

### *Reasons for Change*

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

### *Explanation of Provision*

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

### *Effective Date*

The provision is effective 180 days after the date of enactment (January 18, 1999).

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

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

### *Present and Prior Law*

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

### *Reasons for Change*

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

### *Explanation of Provision*

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

### *Effective Date*

The provision is effective beginning on July 1, 2000.

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

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

### *Present and Prior Law*

In general, the tax treatment of items of partnership income, loss, deductions and credits are determined at the partnership level in a unified partnership proceeding rather than in separate proceedings with each partner. In providing notice to taxpayers with respect to partnership proceedings, the IRS relies on information furnished by a party designated as the tax matters partner ("TMP") of the partnership. The TMP is required to keep each partner informed of all administrative and judicial proceedings with respect to the partnership. Under certain circumstances, the IRS may require the resignation of the incumbent TMP and designate another partner as the TMP of a partnership. Under prior law, there was no requirement that the IRS notify all partners of any resignation of the TMP that is required by the IRS, and notify the partners of any successor TMP.

### *Reasons for Change*

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

### *Explanation of Provision*

The Act requires the IRS to notify all partners of any resignation of the TMP that is required by the IRS, and to notify the partners of any successor TMP.

### *Effective Date*

The provision is effective with respect to selections of TMPs made by the Secretary after the date of enactment (after July 22, 1998).

### *Revenue Effect*

The provision is estimated to reduce the Federal fiscal year budget receipts by less than $500,000 in each of the years 1998 through 2007.

## 8. Conditions under which taxpayers' returns may be disclosed (sec. 3508 of the Act)

### *Prior Law*

There was no statutory requirement that the general tax forms instruction booklets include a description of conditions under which tax return information may be disclosed outside the IRS (including to States).

### *Reasons for Change*

The Congress believed it would be valuable to require statutorily that this description be provided to taxpayers.

### *Explanation of Provision*

The Act requires that general tax forms instruction booklets include a description of conditions under which tax return information may be disclosed outside the IRS (including to States). The statement currently contained in the general tax forms instruction booklets was considered to be sufficient to fulfill the requirements of this provision.

### *Effective Date*

The provision is effective on the date of enactment (July 22, 1998).

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

### 9. Disclosure of Chief Counsel advice (sec. 3509 of the Act and sec. 6110 of the Code)

#### *Present and Prior Law*

Section 6110 of the Code provides for the public inspection of written determinations, i.e., rulings, determination letters, and technical advice memoranda. The IRS issues annual revenue procedures setting forth the procedures for requests for these various forms of written determinations and participation in the formulation of such determinations.[59] Under section 6110 and the regulations promulgated thereunder, the taxpayer who is the subject of a written determination can participate in the redaction of the documents to ensure that the taxpayer's privacy is protected and that sensitive private information is removed before the determination is publicly disclosed. In the event there is disagreement as to the information to be deleted, the section provides for litigation in the courts to resolve such disagreements.

One of the Office of Chief Counsel's major roles is to advise IRS personnel on legal matters at all stages of case development. The Office of Chief Counsel thus issues various forms of written legal advice to field agents of the IRS and to its own field attorneys that do not fall within the current definition of "written determination" under section 6110. Traditionally, field Counsel offices provided most of the assistance to the IRS, usually at IRS field offices, but since 1988, the National Office of Chief Counsel has been rendering more assistance to field Counsel and IRS offices. National Office of Chief Counsel assistance in taxpayer-specific cases is generally called "field service advice." The taxpayers who are the subject of field service advice generally do not participate in the process, leading some tax commentators to express concern that the field service advice process was displacing the technical advice process.

There had been controversy under prior law as to whether the Office of Chief Counsel must release forms of advice other than written determinations pursuant to the Freedom of Information Act ("FOIA"). In *Tax Analysts* v. *IRS,*[60] the D.C. Circuit held that the legal analysis portions of field service advice created in the context of specific taxpayers' cases are not "return information," as defined by section 6103(b)(2), and must be released under FOIA. The court also found that portions of field service advice issued in docketed cases may be withheld as privileged attorney work product. However, under prior law, some issues remained outstanding. Although the extent to which such materials must be released was still in dispute, it was clear that they were not expressly covered by section 6110. As a consequence, there existed no mechanism by which taxpayers could participate in the administrative process of redacting their private information from such documents or to resolve disagreements in court.

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[59] See, e.g., Rev. Procs. 98–1 and 98–2.
[60] 117 F.3d 607 (D.C. Cir. 1997).

## *Explanation of Provision*

### *In general*

The Congress believed that written documents issued by the National Office of Chief Counsel to its field components and field agents of the IRS should be subject to public release in a manner similar to technical advice memoranda or other written determinations. In this way, all taxpayers can be assured of access to the "considered view of the Chief Counsel's national office on significant tax issues."[61] Creating a structured mechanism by which these types of legal memoranda are open to public inspection will increase the public's confidence that the tax system operates fairly and in an even-handed manner with respect to all taxpayers.

As part of making these documents public, however, the privacy of the taxpayer who is the subject of the advice must be protected. Any procedure for making such advice public must therefore include adequate safeguards for taxpayers whose privacy interests are implicated. There should be a mechanism for taxpayer participation in the deletion of any private information. There should also be a process whereby appropriate governmental privileges may be asserted by the IRS and contested by the public or the taxpayer.

The provision amends section 6110 of the Code, establishing a structured process by which the IRS will make certain work products, designated as "Chief Counsel Advice," open to public inspection on an ongoing basis. It is designed to protect taxpayer privacy while allowing the public inspection of these documents in a manner generally consistent with the mechanism of section 6110 for the public inspection of written determinations. In general, the provision operates by establishing that Chief Counsel Advice are written determinations subject to the public inspection provisions of section 6110.

### *Definition of Chief Counsel Advice*

For purposes of this provision, Chief Counsel Advice is written advice or instruction prepared and issued by any national office component of the Office of Chief Counsel to field employees of the Service or the Office of Chief Counsel that convey certain legal interpretations or positions of the IRS or the Office of Chief Counsel concerning existing or former revenue provisions. For these purposes, the term "revenue provisions" includes, without limitation: the Internal Revenue Code itself; regulations, revenue rulings, revenue procedures, or other administrative interpretations or guidance, whether published or unpublished (including, for example, other Chief Counsel Advice); tax treaties; and court decisions and opinions. Chief Counsel Advice also includes legal interpretations of State law, foreign law, or other federal law relating to the assessment or collection of liabilities under revenue provisions.

Chief Counsel Advice may interpret or set forth policies concerning the internal revenue laws either in general or as applied to specific taxpayers or groups of specific taxpayers. The definition is not, however, meant to include advice written with respect to nontax

[61] 117 F.3d at 617.

matters, including but not limited to employment law, conflicts of interest, or procurement matters.

The new statutory category of written determination encompasses certain existing categories of advisory memoranda or instructions written by the National Office of Chief Counsel to field personnel of either the IRS or the Office of Chief Counsel. Specifically, Chief Counsel Advice includes field service advice, technical assistance to the field, service center advice, litigation guideline memoranda, tax litigation bulletins, general litigation bulletins, and criminal tax bulletins. The definition applies not only to the case-specific field service advice issued from the offices of the Associate Chief Counsel (International), Associate Chief Counsel (Employee Benefits and Exempt Organizations), and the Assistant Chief Counsel (Field Service), which were at issue in the *Tax Analysts* decision, but any case-specific or noncase-specific written advice or instructions issued by the National Office of Chief Counsel to field personnel of either the IRS or the Office of Chief Counsel.

Moreover, Chief Counsel Advice includes any documents created subsequent to the enactment of this provision that satisfy the general statutory definition, regardless of their name or designation. Chief Counsel Advice also includes any such advice or instruction even if the organizations currently issuing them are reorganized or reconstituted as part of any IRS restructuring.

The new subsection covers written advice "issued" to field personnel of either the IRS or the Office of Chief Counsel in its final form. With respect to Chief Counsel Advice, issuance occurs when the Chief Counsel Advice has been approved within the national office component of the office of Chief Counsel in which the Chief Counsel Advice was proposed, signed by the person authorized to do so (usually the Assistant Chief Counsel or a Branch Chief), and sent to the field. Chief Counsel Advice does not include written recordations of informal telephonic advice by the National Office of Chief Counsel to field personnel of either the IRS or the Office of Chief Counsel. Drafts of Chief Counsel Advice sent to the field for review, criticism, or comment prior to approval within the National Office also need not be made public. However, Chief Counsel Advice may be treated as issued even if supplemental advice is contemplated. The Secretary is expected to issue regulations to clarify the distinction between issuance as it applies to Chief Counsel Advice and as it applies to other documents disclosed under section 6110.

The provision also allows the Secretary to promulgate regulations providing that additional types of advice or instruction issued by the Office of Chief Counsel (or components of the Office of Chief Counsel, such as regional or local Counsel offices) will be treated as Chief Counsel Advice and subject to public inspection pursuant to this provision. No inference is to be drawn from the failure of the Secretary to treat additional types of advice or instruction as Chief Counsel Advice in determining whether such advice or instruction is to be disclosed under FOIA.

As with other written determinations, Chief Counsel Advice may not be used or cited as precedent, except as the Secretary otherwise establishes by regulation.

### *Redaction process*

Under this provision, Chief Counsel Advice will be redacted prior to their public release in a manner similar to that provided for private letter rulings, technical advice memoranda, and determination letters. Specific taxpayers or groups of specific taxpayers who are the subject of Chief Counsel Advice will be afforded the opportunity to participate in the process of redacting the Chief Counsel Advice prior to their public release.

In addition, the new provision affords additional protection for certain governmental interests implicated by Chief Counsel Advice. Information may be redacted from Chief Counsel Advice under subsections (b) and (c) of the FOIA, 5 U.S.C. sec. 552 (except, with respect to 5 U.S.C. sec. 552(b)(3), only material required to be withheld under a Federal statute, other than title 26, may be redacted), as those provisions have been, or shall be, interpreted by the courts of the United States. For those deletions that are discretionary, such as those under FOIA section 552(b)(5), it is expected that the Office of Chief Counsel and the IRS will apply any discretionary standards applicable to federal agencies in general or the Chief Counsel or the IRS in particular.[62]

Under new section 6110(i), as with prior and present section 6110(c)(1), identifying details consisting of names, addresses, and any other information that the Secretary determines could identify any person, including the taxpayer's representative, will be redacted, after the participation of the taxpayer in the redaction process. In some situations, information included in a Chief Counsel Advice (other than a name or address) may not identify a person as of the time the advice is made open to public inspection, but that information, together with information that is expected to be disclosed by another source at a later date, will serve to identify a person. Consequently, in deciding whether a Chief Counsel Advice contains identifying information, the Secretary is to take into account information that is available to the public at the time that the advice is made open to public inspection as well as information that is expected to be publicly available from other sources within a reasonable time after the Chief Counsel Advice is made open to public inspection. Generally, it is intended that the standard the IRS is to use in determining whether information will identify a person is a standard of a reasonable person generally knowledgeable with respect to the appropriate community. The standard is not, however, to be one of a person with inside knowledge of the particular taxpayer.

As under prior section 6110, taxpayers who are the subject of Chief Counsel Advice, as well as members of the public, will be afforded the opportunity to challenge judicially the redaction determinations by the Secretary.

### *Relation to prior law*

The public inspection of Chief Counsel Advice is to be accomplished only pursuant to the rules and procedures set forth in sec-

[62] The current standards for the exercise of such discretion are set forth in the Internal Revenue Manual (part 1230, section 293(2)) and the Attorney General's October 4, 1993, Memorandum for Heads of Departments and Agencies.

tion 6110, as amended, and not under those of any other provision of law, such as FOIA. This provision is not intended to affect the disclosure under FOIA, or under any other provision of law, of any documents not included within the definition of Chief Counsel Advice in new sections 6110(i)(1) and (i)(2). The only FOIA exemption affected by this provision is 5 U.S.C. section 552(b)(3), to the extent that it incorporates section 6103 of the Code. The timetable and the manner in which existing Chief Counsel Advice may ultimately be open to public inspection shall be governed by this provision, except that the provision is inapplicable to Chief Counsel Advice that any federal district court has, prior to the date of enactment, ordered be disclosed. Disclosure of any documents that are subject to such a court order is to proceed pursuant to the order rather than this provision. Finally, no inference is intended with respect to the disclosure, under FOIA or any other provision of law, of any other documents produced by the Office of Chief Counsel that are not included in the definition of Chief Counsel Advice.

### *Effective Date*

The provision applies to Chief Counsel Advice issued more than 90 days after enactment (after October 20, 1998). In addition, the provision contains certain rules governing disclosure of any document fitting the definition of Chief Counsel Advice issued after 1985 and before 90 days after the date of enactment by the offices of the Associate Chief Counsel for domestic, employee benefits and exempt organizations, and international. It sets forth a schedule for the IRS to release such Chief Counsel Advice over a six year period after the date of enactment. Finally, additional advice or instruction that the Secretary determines by regulations to treat as Chief Counsel Advice shall be made public pursuant to this provision in accordance with the effective dates set forth in such regulations.

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

## G. Low-Income Taxpayer Clinics (sec. 3601 of the Act and new sec. 7526 of the Code)

### *Prior Law*

There were no provisions in prior law providing for grants from the Treasury Department to clinics that assist low-income taxpayers.

### *Reasons for Change*

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

### *Explanation of Provision*

The Act provides that the Secretary is authorized to provide up to $6,000,000 per year in matching grants to certain low-income taxpayer clinics. No clinic can receive more than $100,000 per year. 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.

A "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 exempt from tax under Code section 501(c) which either represents low-income taxpayers or provides referral to qualified representatives.

### *Effective Date*

The provision is effective on the date of enactment (July 22, 1998).

### *Revenue Effect*

The provision is estimated to have no effect on Federal year budget receipts.

## H. Other Provisions

### 1. Cataloging complaints (sec. 3701 of the Act)

### *Present and Prior Law*

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

### *Reasons for Change*

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

### *Explanation of Provision*

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

### *Effective Date*

The provision is effective beginning on January 1, 2000.

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

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

### *Present and Prior Law*

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

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

### *Reasons for Change*

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

### *Explanation of Provision*

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

### *Effective Date*

The provision is effective for requests made by the Archivist after the date of enactment (after July 22, 1998).

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

### 3. Payment of taxes (sec. 3703 of the Act)

#### *Present and Prior Law*

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

#### *Reasons for Change*

The Congress believed it more appropriate that checks be made payable to the United States Treasury.

#### *Explanation of Provision*

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

#### *Effective Date*

The provision is effective on the date of enactment (July 22, 1998).

#### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

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

#### *Prior Law*

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

#### *Reasons for Change*

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

#### *Explanation of Provision*

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

#### *Effective Date*

The provision is effective on the date of enactment (July 22, 1998).

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

## 5. IRS employee contacts (sec. 3705 of the Act)

### *Present and Prior Law*

The IRS sends many different notices to taxpayers. Under prior law, some (but not all) of these notices contained a name and telephone number of an IRS employee whom the taxpayer may call if the taxpayer has any questions.

### *Reasons for Change*

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

### *Explanation of Provision*

The Act requires that any manually generated correspondence received by a taxpayer from the IRS must include in a prominent manner the name, telephone number, and unique identifying number of an IRS employee the taxpayer may contact with respect to the correspondence. Any other correspondence or notice received by a taxpayer from the IRS must include in a prominent manner a telephone number that the taxpayer may contact. An IRS employee must give a taxpayer during a telephone or personal contact the employee's name and unique identifying number. In addition, to the extent practicable and advantageous to the taxpayer, the IRS should assign one employee to handle a matter with respect to a taxpayer until that matter is resolved.

The Act also requires that, in appropriate circumstances, IRS telephone helplines provide that taxpayer questions on those IRS telephone helplines are answered in Spanish.

Further, the Act requires that IRS telephone helplines provide, in appropriate circumstances, an option for any taxpayer to talk to an IRS employee during normal business hours. That person can then direct the taxpayer to other IRS personnel who can provide assistance to the taxpayer.

### *Effective Date*

The notice provisions are effective 60 days after the date of enactment (after September 20, 1998).

The requirements pertaining to a unique identifying number are effective six months after the date of enactment (after January 18, 1998). The telephone helpline provisions are effective on January 1, 2000.

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

### 6. Use of pseudonyms by IRS employees (sec. 3706 of the Senate amendment)

#### *Prior Law*

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

#### *Reasons for Change*

The Congress was concerned that IRS employees may use pseudonyms in inappropriate circumstances.

#### *Explanation of Provision*

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

#### *Effective Date*

The provision is effective with respect to requests made after the date of enactment (July 22, 1998).

#### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

### 7. Illegal tax protester designations (sec. 3707 of the Act)

#### *Prior Law*

The IRS designated individuals who met certain criteria as "illegal tax protesters" in the IRS master file.

#### *Reasons for Change*

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

#### *Explanation of Provision*

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

While this provision prohibits the use by the IRS of the "illegal tax protester" designation, it does allow the IRS to continue its current practice of tracking "potentially dangerous taxpayers." The Congress recognized the potential hazards connected with the assessment and collection of taxes, and this provision is not intended to jeopardize the safety of IRS employees. Accordingly, if the IRS needs to implement additional procedures, such as the maintenance of appropriate records, in connection with this provision so as to ensure IRS employees' safety, it has the authority to do so.

### *Effective Date*

The provision is effective on the date of enactment (July 22, 1998), except that the removal of any designation from the master file is not required to begin before January 1, 1999.

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

## 8. Provision of confidential information to Congress by whistleblowers (sec. 3708 of the Act and sec. 6103(f) of the Code)

### *Present and Prior Law*

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

### *Reasons for Change*

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

### *Explanation of Provision*

The Act provides that any person (i.e., a whistleblower) who otherwise has or had access to any return or return information under section 6103 may disclose such return or return information to the House Ways and Means Committee, the Senate Finance Committee, or the Joint Committee on Taxation or to any individual authorized by one of those committees to receive or inspect any return or return information if such person (the whistleblower) believes such return or return information may relate to evidence of possible misconduct, maladministration, or taxpayer abuse. Disclosure to one of these committees could be made either to the Chairman or to the full committee (sitting in closed executive session), but would not be permitted to be made to an individual Member of Congress (unless explicitly authorized as an agent). No inference is intended that such whistleblower disclosures were not permitted under prior law.

### *Effective Date*

The provision is effective on the date of enactment (July 22, 1998).

### *Revenue Effect*

The provision is estimated to have no revenue effect on Federal fiscal year budget receipts.

## 9. Listing of local IRS telephone numbers and addresses (sec. 3709 of the Act)

### *Prior Law*

The IRS was not statutorily required to publish the local telephone number or address of its local offices.

### *Reasons for Change*

The Congress believed it could be helpful to taxpayers if the addresses and local phone numbers of local IRS offices were published in local telephone directories.

### *Explanation of Provision*

The Act requires the IRS, as soon as is practicable, to publish addresses and local telephone numbers of local IRS offices in a local telephone directory for that area. It is intended that (1) the IRS not be required to publish in more than one directory in any local area and (2) publication in alternate language directories is permissible.

### *Effective Date*

The provision is effective on the date of enactment (July 22, 1998).

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

## 10. Identification of return preparers (sec. 3710 of the Act and sec. 6109 of the Code)

### *Prior Law*

Any return or claim for refund prepared by an income tax return preparer was required to bear the social security number of the return preparer, if such preparer is an individual.

### *Reasons for Change*

The Congress was concerned that inappropriate use might be made of a return preparer's social security number.

### *Explanation of Provision*

The Act authorizes the IRS to approve alternatives to social security numbers to identify tax return preparers.

### *Effective Date*

The provision is effective on the date of enactment (July 22, 1998).

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

## 11. Offset of past-due, legally enforceable State income tax obligations against overpayments (sec. 3711 of the Act and sec. 6402 of the Code)

### *Present and Prior 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. Prior law did not permit the offset of past-due, legally enforceable State income tax obligations against overpayments.

### *Reasons for Change*

The Congress believed it is appropriate to expand the offset program to encompass past-due, legally enforceable State income tax obligations.

### *Explanation of Provision*

The Act permits States to participate in the IRS refund offset program for specified past-due, legally enforceable State income tax debts, providing the person making the Federal tax overpayment has shown on the Federal return for the taxable year of the overpayment an address that is within the State seeking the tax offset. The offset applies after the offsets provided in present and prior law for internal revenue tax liabilities, past-due support, and past-due, legally enforceable obligations owed a Federal agency. The offset occurs before the designation of any refund toward future Federal tax liability. The provision permits the Secretary to prescribe additional conditions (pursuant to new section 6402(e)(4)(D)) to ensure that the determination is valid that the State or local income tax liability is past-due and legally enforceable. This is intended to include consideration of questions that may arise as a result of the taxpayer being a Native American.

### *Effective Date*

The provision is effective with respect to Federal income tax refunds payable after December 31, 1999.

### *Revenue Effect*

The provision is estimated to have no revenue effect on Federal fiscal year budget receipts in 1998 and 1999, and to increase such receipts by $2 million in 2000, $3 million in each of the years 2001 through 2004, and $4 million in each of the years 2005 through 2007.

## 12. Reporting requirements relating to education tax credits (sec. 3712 of the Act and sec. 6050S of the Code)

### *Present and Prior Law*

Individual taxpayers are allowed to claim a nonrefundable HOPE credit against Federal income taxes up to $1,500 per eligible student per year of qualified tuition and related expenses for the first two years of the student's post-secondary education in a degree program. A nonrefundable Lifetime Learning credit against Federal income taxes equal to 20 percent of qualified expenses (up to a maximum credit of $1,000 per taxpayer return for 1998 through 2002 and $2,000 per taxpayer return after 2002) also is available with respect to students for whom a Hope credit is not claimed. Qualified tuition and related expenses do not include expenses covered by educational assistance that is not required to be included in the gross income of either the student or the taxpayer claiming the credit (e.g., scholarship or fellowship grants).

Under present and prior law, Code section 6050S requires information reporting by eligible educational institutions which receive payments for qualified tuition and related expenses, and certain other persons who make reimbursement or refunds of qualified tuition and related expenses, in order to assist students, their parents, and the IRS in calculating the amount of the HOPE and Lifetime Learning credits potentially available. Under prior law, section 6050S(b) provided that the annual information report to the Secretary must be in the form prescribed by the Secretary and must contain the following: (1) the name, address, and taxpayer identification number ("TIN") of the individual with respect to whom the qualified tuition and related expenses were received or the reimbursement or refund was paid; (2) the name, address, and TIN of any individual certified by the student as the taxpayer who will claim that student as a dependent for purposes of the deduction under section 151 for any taxable years ending with or within the year for which the information return is filed; (3) the aggregate amount of payments of qualified tuition and related expenses received by the eligible educational institution and the aggregate amount of reimbursements or refunds (or similar amounts) paid during the calendar year with respect to the student; and (4) such other information as the Secretary may prescribe. Under section 6050S(d), an eligible educational institution also must provide to each person identified on the information return submitted to the Secretary (e.g., the student and his or her parent(s)) a written statement showing the name, address, and phone number of the reporting person's information contact, and the amounts set forth in (3) above.

On December 22, 1997, the Department of Treasury issued Notice 97–73 setting forth the information reporting requirements under section 6050S for 1998. Notice 97–73 describes who must report information and the nature of the information that must be reported for 1998. In general, the required reporting under Notice 97–73 is more limited than that which ultimately will be required under section 6050S upon the issuance of final regulations. Accordingly, for 1998, educational institutions must report the following information: (1) the name, address, and TIN of the educational institution; (2) the name, address, and TIN of the student with respect to whom payments of qualified tuition and related expenses were received during 1998; (3) an indication as to whether the student was enrolled for at least half the full-time academic workload during any academic period commencing in 1998; and (4) an indication as to whether the student was enrolled exclusively in a program or programs leading to a graduate-level degree, graduate-level certificate, or other recognized graduate-level educational credential. Educational institutions must provide the information listed above to students, as well as the phone number of the information contact at the school. Information returns must be provided to students by February 1, 1999 and filed with the IRS by March 1, 1999. Notice 97–73 states that until final regulations are adopted, no penalties will be imposed under sections 6721 and 6722 for failure to file correct information returns or to furnish correct statements to the individuals with respect to whom information reporting is required under section 6050S. In addition, Notice 97–73 states that, even after final regulations are adopted, no penalties will be imposed under sections 6721 and 6722 for 1998 if the institution made a good faith effort to file information returns and furnish statements in accordance with Notice 97–73. On August 20, 1998, the Department of Treasury issued Notice 98–46 (I.R.B. 98–36, Sept. 8, 1998), which extended the application of Notice 97–73 to information reporting required under section 6050S for 1999.

### *Explanation of Provision*

The Act modifies the information reporting requirements under section 6050S. In addition to reporting the aggregate amount of payments for qualified tuition and related expenses received by the educational institution with respect to a student, the institution must report any grant amount received by the student and processed through the institution during the applicable calendar year. The institution is not required to report on grant aid that is paid directly to the student and is not processed through the institution. Furthermore, an educational institution is required to report only the aggregate amount of reimbursements or refunds paid to a student by the institution (and not by any other party). The Act also clarifies that the definition of "qualified tuition and related expenses" shall be as set forth in section 25A, determined without regard to section 25A(g)(2) (which requires adjustments for certain scholarships).

Under the Act, eligible educational institutions that receive payments of qualified tuition and related expenses (or reimburse or refund such payments) are required separately to report the following items with respect to each student under section 6050S(b)(2)(C): (1)

the aggregate amount of qualified tuition and related expenses (not including certain expenses relating to sports, games, or hobbies, or nonacademic fees); (2) any grant amount (whether or not excludable from income) received by such individual for payment of costs of attendance and processed through the institution during the applicable calendar year; and (3) the aggregate amount of reimbursements or refunds (or similar amounts) paid to such individual during the calendar year by the institution.

The Congress understood that the Department of Treasury is in the process of issuing regulatory guidance with respect to the education credit reporting requirements. In developing such guidance, the Congress urged Treasury to minimize the reporting burdens imposed on educational institutions in connection with the HOPE Scholarship and Lifetime Learning credits. For example, section 472(1) of the Higher Education Act contains a definition of tuition and fees that is used in calculating a student's total "cost of attendance." The Congress urged Treasury to conform the definition of "qualified tuition and related expenses" for purposes of the HOPE Scholarship and Lifetime Learning credits to the definition set forth in section 472(1) to the extent possible, so as to minimize the additional reporting burden on educational institutions.

In general, the Congress expressed its expectation that the regulatory guidance regarding the education credit reporting requirements will have an effective date that will provide educational institutions with sufficient time, after any notice and comment period, to implement additional required reporting. In addition, although the provision generally applies to taxable years beginning after December 31, 1998, the Congress intended that no reporting beyond the reporting currently required in Notice 97–73 would be required of educational institutions until such final regulatory guidance is available.

In furtherance of the objective of minimizing the reporting burden on educational institutions, the Congress noted that, pursuant to the regulatory authority granted in section 25A(i), Treasury may exempt educational institutions from the reporting requirements with respect to certain categories of students, such as non-degree students enrolled in a course for which academic credit is not granted by the institution, provided that such exemptions do not undermine the overall compliance objectives of the provision. The Congress further expressed its expectation that Treasury will provide clarification regarding the reasonable cause exception contained in section 6724(a) as it may apply to the education information reporting requirements. Finally, the Congress urged that any update and modernization of IRS computer systems incorporate the capacity to match a dependent's TIN with the return filed by the person claiming the individual as a dependent.

### *Effective Date*

The provision applies to returns required to be filed with respect to taxable years beginning after December 31, 1998.

### *Revenue Effect*

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

## I. Studies

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

### *Prior Law*

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

### *Reasons for Change*

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

### *Explanation of Provision*

The Act requires the Joint Committee on Taxation and the Treasury to each conduct a separate study reviewing the interest and penalty provisions of the Code, and making any legislative and administrative recommendations they deem appropriate to simplify penalty administration and reduce taxpayer burden. It is expected that the Joint Committee on Taxation and the Treasury Department studies will examine whether the current penalty and interest provisions encourage voluntary compliance. The studies should also consider whether the provisions operate fairly, whether they are effective deterrents to undesired behavior, and whether they are designed in a manner that promotes efficient and effective administration of the provisions by the IRS. It is expected that the Joint Committee on Taxation and the Treasury Department will consider comments from taxpayers and practitioners on issues relevant to the studies.

### *Effective Date*

The reports must be provided not later than one year after the date of enactment (by July 22, 1999).

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

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

### *Present and Prior Law*

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

### *Reasons for Change*

The Congress believed that a study of the confidentiality provisions would be useful in assisting the Congress in determining whether improvements can be made to these provisions.

### *Explanation of Provision*

The Act requires the Joint Committee on Taxation and Treasury to each conduct a separate study on provisions regarding taxpayer confidentiality. The studies are to examine:

(1) present-law protections of taxpayer privacy;

(2) the need, if any, for third parties to use tax return information;

(3) whether greater levels of voluntary compliance can be achieved by allowing the public to know who is legally required to file tax returns but does not do so;

(4) the interrelationship of the taxpayer confidentiality provisions in the Internal Revenue Code with those elsewhere in the United States Code (such as the Freedom of Information Act);

(5) the impact on taxpayer privacy of sharing tax information for the purposes of enforcing State and local tax laws (other than income tax laws); and

(6) an examination of whether the public interest would be served by greater disclosure of information relating to tax-exempt organizations (described in section 501 of the Code).

### *Effective Date*

The findings of the studies, along with any recommendations, are required to be reported to the Congress no later than 18 months after the date of enactment (by January 22, 2000).

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

## 3. Noncompliance with revenue laws by taxpayers (sec. 3803 of the Act)

### *Prior Law*

No provision of prior law required that a study of noncompliance with the internal revenue laws be conducted.

### *Reasons for Change*

The Congress believed it would be valuable to receive a study of noncompliance with the internal revenue laws.

### *Explanation of Provision*

The Act provides that the Secretary of the Treasury and the Commissioner of the Internal Revenue Service, in consultation with the Joint Committee on Taxation, must jointly conduct a study of noncompliance with the internal revenue laws by taxpayers (including willful noncompliance and noncompliance due to tax law complexity or other factors).

### *Effective Date*

The study must be reported to the Congress within one year of the date of enactment (by July 22, 1999).

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

## 4. Payments for detection of underpayments and fraud (sec. 3804 of the Act)

### *Present and Prior Law*

Rewards may be paid for information relating to civil violations, as well as criminal violations. The rewards are paid out of the proceeds of amounts (other than interest) collected by reason of the information provided. An annual report on the rewards program is required.

### *Reasons for Change*

The Congress believed that it would be valuable to receive a study of this provision.

### *Explanation of Provision*

The Act requires that a study and report be completed by the Treasury and submitted to the Congress (within one year of the date of enactment) of the reward program (including results) and any legislative or administrative recommendations regarding the program and its application.

### *Effective Date*

The study must be reported to the Congress within one year of the date of enactment (by July 22, 1999).

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

# TITLE IV. CONGRESSIONAL ACCOUNTABILITY FOR THE IRS

## A. Review of Requests for GAO Investigations of the IRS (sec. 4001 of the Act and sec. 8021(e) of the Code)

### *Present and Prior Law*

Under prior law, there was no specific statutory requirement that requests for investigations by the General Accounting Office ("GAO") relating to the IRS be reviewed by the Joint Committee on Taxation (the "Joint Committee"). However, some of the studies that GAO conducts relating to taxation and oversight of the IRS require access under section 6103 of the Code to confidential tax returns and return information. Under section 6103, the GAO may inform the Joint Committee of its initiation of an audit of the IRS and obtain access to confidential taxpayer information unless, within 30 days, 3/5ths of the Members of the Joint Committee disapprove of the audit. This provision has not been utilized; the GAO generally seeks advance access to confidential taxpayer return information from the Joint Committee.

### *Reasons for Change*

The Restructuring Commission recommended changes to the approval process for GAO reports based on its findings that the GAO conducts myriad audits of the IRS, many of which relate to lesser matters and which are not integrated into a constructive, focused package. The Congress believed that GAO audits and reports can be helpful as an oversight tool, but that they should be coordinated so as to ensure appropriate allocation of resources, both of the IRS and the GAO.

### *Explanation of Provision*

Under the provision, the Joint Committee on Taxation reviews all requests (other than requests by the chair or ranking member of a Committee or Subcommittee of the Congress) for investigations of the IRS by the GAO and approves such requests when appropriate. In reviewing such requests, the Joint Committee is to eliminate overlapping investigations, ensure that the GAO has the capacity to handle the investigation, and ensure that investigations focus on areas of primary importance to tax administration. The Congress intends that the provision exclude requests made by the chairman or ranking member of a committee or subcommittee, investigations required by statute, and work initiated by GAO under its basic statutory authorities.

The provision does not change the rules under section 6103.

### *Effective Date*

The provision is effective with respect to requests for GAO investigations made after the date of enactment (after July 22, 1998).

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

## B. Joint Congressional Reviews and Coordinated Oversight Reports (secs. 4001 and 4002 of the Act and secs. 8021(f) and 8022 of the Code)

### *Present and Prior Law*

Under the Congressional committee structure, a number of committees have jurisdiction with respect to IRS oversight. The committees most responsible for IRS oversight are the House Committees on Ways and Means, Appropriations, Government Reform and Oversight, the corresponding Senate Committees on Finance, Appropriations, and Government Affairs, and the Joint Committee on Taxation. While these Committees have a shared interest in IRS matters, they typically act independently, and have separate hearings and make separate investigations into IRS matters. Each committee also has jurisdiction over certain issues. For example, the House Ways and Means Committee and the Senate Finance Committee have exclusive jurisdiction over changes to the tax laws. Similarly, the House and Senate Appropriations Committees have exclusive jurisdiction over IRS annual appropriations. The Joint Committee on Taxation does not have legislative jurisdiction, but has significant responsibilities with respect to tax matters and IRS oversight.

### *Reasons for Change*

The Restructuring Commission found that the Congressional committees responsible for IRS oversight "focus on different issues that change from year to year. While these issues are important, there is a lack of coordinated focus on high level and strategic matters. Because the IRS tries to satisfy requests from Congress, this nonintegrated approach to oversight further blurs the ability to set strategic direction and focus on priorities."

The Congress believed that Congressional oversight of the IRS should be more coordinated, and should include long-term objectives.

### *Explanation of Provision*

Under the provision, there will be one annual joint review of: (1) the progress of the IRS in meeting its objectives under the strategic and business plans; (2) the progress of the IRS in improving taxpayer service and compliance; (3) the progress of the IRS on technology modernization; and (4) the annual filing season. The review is conducted by two majority and one minority members of each of the Senate Committees on Finance, Appropriations, and Government Affairs and the House Committees on Ways and Means, Appropriations, and Government Reform and Oversight. The joint review will be held at the call of the Chairman of the Joint Committee on Taxation, and is to take place before June 1 of each calendar year. The provision does not modify the existing jurisdiction of the Committees involved in the joint review.

The provision provides that the Joint Committee on Taxation is to make a report once in each Congress to the Committee on Finance and the Committee on Ways and Means on the overall state of the Federal tax system, together with recommendations with respect to possible simplification proposals and other matters relating to the administration of the Federal tax system as it may deem advisable. This report shall be prepared only if amounts necessary to carry out this requirement are specifically appropriated to the Joint Committee on Taxation. The Joint Committee on Taxation also is to report annually to the Senate Committees on Finance, Appropriations, and Government Affairs and the House Committees on Ways and Means, Appropriations, and Government Reform and Oversight with respect to the matters that are the subject of the joint reviews by members of such Committees.

#### *Effective Date*

The provision generally is effective on the date of enactment (July 22, 1998), except that the requirement for an annual joint review, and report by the Joint Committee on Taxation, applies only for calendar years 1999–2003.

#### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

### C. Funding for Century Date Change (sec. 4011 of the Act)

#### *Present Law*

No specific provision.

#### *Reasons for Change*

Operations of the IRS computer systems are critical to the viability of the Federal tax system. The Congress believed that adequate funding of efforts to resolve this problem is essential.

#### *Explanation of Provision*

The provision provides that it is the sense of the Congress that the IRS should place resolving the century date change computing problems as a high priority, and that the IRS efforts to resolve the century date change computing problems should be fully funded to provide for certain resolution of such problems.

#### *Effective Date*

The provision is effective on the date of enactment (July 22, 1998).

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

## D. Tax Law Complexity Analysis (secs. 4021–4022 of the Act)

### *Present Law*

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

### *Reasons for Change*

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

The Congress was aware that it may not be possible or desirable to eliminate all complexity in the tax system. There are many objectives of a tax system and particular tax provisions, and simplicity is only one. In some cases other policies, such as fairness, may outweigh concerns about complexity. Nevertheless, the Congress believed complexity of the tax system should be reduced whenever possible. Accordingly, the Congress believed it appropriate to introduce new procedural rules that will focus attention on complexity.

The Congress also believed that the tax-writing committees should receive periodic input from the IRS regarding areas of the law that cause problems for taxpayers. This input will be valuable in developing future legislation.

### *Explanation of Provision*

#### *Role of the IRS*

The provision provides that it is the sense of the Congress that the IRS should provide the Congress with an independent view of tax administration and that the tax-writing committees should hear from front-line technical experts at the IRS during the legislative process with respect to the administrability of pending amendments to the Internal Revenue Code.

The IRS Commissioner is to report to the House Ways and Means Committee and the Senate Finance Committee annually not later than March 1 of each year, regarding sources of complexity in the administration of the Federal tax laws. Factors the IRS may take into account include: (1) frequently asked questions by taxpayers; (2) common errors made by taxpayers in filling out returns; (3) areas of the law that frequently result in disagreements between taxpayers and the IRS; (4) major areas in which there is no or incomplete published guidance or in which the law is uncertain; (5) areas in which revenue agents make frequent errors in interpreting or applying the law; (6) impact of recent legislation on complexity; (7) information regarding forms, including a listing of IRS forms, the time it takes for taxpayers to complete and review forms, the number of taxpayers who use each form, and how the time required changed as a result of recently enacted legislation; and (8) recommendations for reducing complexity in the administration of the Federal tax system.

***Complexity analysis with respect to current legislation***

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

The provision provides that a point of order arises in the House of Representatives with respect to the floor consideration of a bill or conference report if the required complexity analysis has not been completed. The point of order may be waived by a majority vote. The point of order is subject to the Constitutional right of each House of the Congress to establish its own rules and procedures; thus, such point of order may be changed at any time pursuant to the procedures of the House of Representatives. The Congress intended that the complexity analysis be prepared by the staff of the Joint Committee on Taxation, and that it shall, to the extent feasible, be included in committee or conference committee reports.

### ***Effective Date***

The provisions are effective for calendar years after 1998.

### ***Revenue Effect***

The provisions are estimated to have no effect on Federal fiscal year budget receipts.

# TITLE V. ADDITIONAL PROVISIONS

## A. Elimination of 18-Month Holding Period for Capital Gains (sec. 5001 of the Act and sec. 1(h) of the Code)

### *Prior Law*

The Taxpayer Relief Act of 1997 Act ("the 1997 Act") provided lower capital gains rates for individuals. Generally, the 1997 Act reduced the maximum rate on the adjusted net capital gain of an individual from 28 percent to 20 percent and provided a 10-percent rate for the adjusted net capital gain otherwise taxed at a 15-percent rate. The "adjusted net capital gain" is the net capital gain determined without regard to certain gain for which the 1997 Act provided a higher maximum rate of tax. The 1997 Act retained the prior-law 28-percent maximum rate for net long-term capital gain attributable to the sale or exchange of collectibles, certain small business stock to the extent the gain is included in income, and property held more than one year but not more than 18 months. In addition, the 1997 Act provided a maximum rate of 25 percent for the long-term capital gain attributable to depreciation from real estate held more than 18 months. Beginning in 2001, lower rates of 8 and 18 percent will apply to the gain from certain property held more than five years.

### *Explanation of Provision*

Under the Act, capital gain from the sale of property held more than one year (rather than more than 18 months) will be eligible for the 10-, 20-, and 25-percent capital gain rates provided by the 1997 Act.

### *Effective Date*

The provision applies to capital gains from the sale of property held more than one year which are properly taken into account on or after January 1, 1998. This generally has the effect of applying the lower capital gain rates to property sold or exchanged (or installment payments received) after 1997.

Generally, in the case of a pass-thru entity, such as a partnership or S corporation, capital gains properly taken into account by the entity on or after January 1, 1998, will qualify for the lower capital gain rates. In the case of a RIC or REIT, capital gain dividends made on or after January 1, 1998, will qualify for the lower capital gain rates, except for capital gains properly taken into account by the RIC or REIT before January 1, 1998, by reason of holding an interest in certain other pass-thru entities.[63] The lower capital gain rates will apply to capital gain distributions made by charitable remainder trusts on or after January 1, 1998.[64]

### *Revenue Effect*

The provision is estimated to increase Federal fiscal year budget receipts by $35 million in 1998 and $611 million in 1999 and to reduce Federal fiscal year budget receipts by $312 million in 2000, $335 million in 2001, $335 million in 2002, $337 million in 2003, $341 million in 2004, $347 million in 2005, $354 million in 2006 and $362 million in 2007.

## B. Deductibility of Meals Provided for the Convenience of the Employer (sec. 5002 of the Act and sec. 119 of the Code)

### *Present and Prior Law*

In general, subject to several exceptions, only 50 percent of business meals and entertainment expenses are allowed as a deduction (sec. 274(n)). Under one exception, meals that are excludable from employees' incomes as a de minimis fringe benefit (sec. 132) are fully deductible by the employer.

In addition, under prior law, the courts that considered the issue held that if substantially all of the meals are provided for the convenience of the employer pursuant to section 119, the cost of such meals is fully deductible because the employer is treated as operating a de minimis eating facility within the meaning of section 132(e)(2) (*Boyd Gaming Corp.* v. *Commissioner*[65] and *Gold Coast Hotel & Casino* v. *I.R.S.*[66]).

### *Reasons for Change*

The Congress believed it was appropriate to modify the applicability of these rules.

### *Explanation of Provision*

The Act provides that all meals furnished to employees at a place of business for the convenience of the employer are treated as provided for the convenience of the employer under section 119 if more than one-half of employees to whom such meals are furnished on the premises are furnished such meals for the convenience of the employer under section 119. If these conditions are satisfied, the value of all such meals is excludable from the employee's income and fully deductible to the employer. No inference is intended as to whether such meals are fully deductible under prior law.

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[63] The application of this provision to shareholders of RICs and REITs reflects the technical correction enacted by section 4002(i)(2) of the Tax and Trade Relief Extension Act of 1998, which is described in Part Three of this publication.

[64] The application of this provision to beneficiaries of charitable remainder trusts reflects the technical correction enacted by section 4002(i)(3) of the Tax and Trade Relief Extension Act of 1998, which is described in Part Three of this publication.

[65] 106 T.C. No. 19 (May 23, 1996).

[66] U.S. D. C. Nev. CV–5–94–1146–HDM(LRL) (September 26, 1996).

### *Effective Date*

The provision is effective for taxable years beginning before, on, or after the date of enactment (July 22, 1998).

### *Revenue Effect*

The provision is estimated to reduce Federal fiscal year budget receipts by $20 million in 1999, $33 million in 2000, $34 million in 2001, $35 million in 2002, $36 million in 2003, $38 million in 2004, $39 million in 2005, $40 million in 2006, and $41 million in 2007.

# TITLE VI. TAX TECHNICAL CORRECTIONS

## *TECHNICAL CORRECTIONS TO THE TAXPAYER RELIEF ACT OF 1997*

### A. Amendments to Title I of the 1997 Act Relating to the Child Credit

#### 1. Stacking rules for the child credit under the limitations based on tax liability (sec. 6003(a) of the 1998 IRS Restructuring Act, sec. 101(a) of the 1997 Act, and sec. 24 of the Code)

##### *Present and Prior Law*

Present law provides a $500 ($400 for taxable year 1998) tax credit for each qualifying child under the age of 17. A qualifying child is defined as an individual for whom the taxpayer can claim a dependency exemption and who is a son or daughter of the taxpayer (or a descendent of either), a stepson or stepdaughter of the taxpayer or an eligible foster child of the taxpayer. For taxpayers with modified adjusted gross income in excess of certain thresholds, the allowable child credit is phased out. The length of the phaseout range is affected by the number of the taxpayer's qualifying children.

Generally, the maximum amount of a taxpayer's child credit for each taxable year is limited to the excess of the taxpayer's regular tax liability over the taxpayer's tentative minimum tax liability (determined without regard to the alternative minimum foreign tax credit). In the case of a taxpayer with three or more qualifying children, the maximum amount of the taxpayer's child credit for each taxable year is limited to the greater of: (1) the amount computed under the rule described above, or (2) an amount equal to the excess of the sum of the taxpayer's regular income tax liability and the employee share of FICA taxes (and one-half of the taxpayer's SECA tax liability, if applicable) reduced by the earned income credit. In the case of a taxpayer with three or more qualifying children, the excess of the amount allowed in (2) over the amount computed in (1) is a refundable credit.

Nonrefundable credits may not be used to reduce tax liability below a taxpayer's tentative minimum tax. Certain credits not used as result of this rule may be carried over to other taxable years, while others may not. Special stacking rules apply in determining which nonrefundable credits are used in the current year. Generally, the stacking rules require that nonrefundable personal credits be considered first,[67] followed by other credits, business credits, and the investment tax credit. Under prior law, refundable credits, which are not limited by the minimum tax, were not stacked until after the nonrefundable credits.

### *Explanation of Provision*

The provision clarifies the application of the income tax liability limitation to the refundable portion of the child credit by treating the refundable portion of the child credit in the same way as the other refundable credits. Specifically, after all the other credits are applied according to the stacking rules of the income tax limitation then the refundable credits are applied first to reduce the taxpayer's tax liability for the year and then to provide a credit in excess of income tax liability for the year.

### *Effective Date*

The provision is effective for taxable years beginning after December 31, 1997.

## 2. Treatment of a portion of the child credit as a supplemental child credit (sec. 6003(b) of the 1998 IRS Restructuring Act, sec. 101(b) of the 1997 Act, and sec. 32(n) of the Code)

### *Present and Prior Law*

A portion of the child credit may be treated as a supplemental child credit. The supplemental child credit is treated as provided under the earned income credit and the child credit amount is reduced by the amount of the supplemental child credit.

### *Explanation of Provision*

The provision clarifies that the treatment of a portion of the child credit as a supplemental child credit under the earned income credit (sec. 32) and the offsetting reduction of the child credit (sec. 24) does not affect the total tax credits allowed to the taxpayer or any other tax credit available to the taxpayer. Rather, it simply reduces the otherwise allowable nonrefundable child credit dollar-for-dollar by the amount treated as a supplemental child credit. The provision also clarifies that the amount of the supplemental child credit under section 32(n) is the lesser of (1) the amount by which the taxpayer's total nonrefundable personal credits (as limited by the tax liability limitation of section 26(a)) are increased by reason of the child credit, or (2) the "negative" tax liability of the taxpayer,

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[67] It is understood that there is also a stacking rule under which the income tax liability limitation applies between the nonrefundable personal credits, including the nonrefundable portion of the child credit. Generally, the nonrefundable portion of the child credit and the other nonrefundable personal credits which do not provide a carryforward are grouped together and stacked first followed by the nonrefundable personal credits which provide a carryforward for purposes of applying the income tax liability limitation. Therefore, if the sum of the taxpayer's nonrefundable credits exceeds the difference between the taxpayer's regular income tax liability and the taxpayer's tentative minimum tax (determined without regard to the alternative minimum foreign tax credit) then the nonrefundable personal credits which do not provide a carryforward would be applied to reduce the income tax liability for that year first and any excess credits which allow a carryforward would be available to reduce the taxpayer's income tax liability in future years.

defined as the excess of taxpayer's total tax credits, including the earned income credit over the sum of the taxpayer's regular income taxes and social security taxes. For purposes of this calculation, subsection 32(n) is not taken into account. The provision also clarifies that the earned income credit rules (e.g., the phaseout of the earned income credit) generally do not apply to the supplemental child credit.

### *Effective Date*

The provision is effective for taxable years beginning after December 31, 1997.

## B. Amendments to Title II of the 1997 Act Relating to Education Incentives

### 1. Clarifications to HOPE and Lifetime Learning tax credits (sec. 6004(a) of the 1998 IRS Restructuring Act, sec. 201 of the 1997 Act, and secs. 25A and 6050S of the Code)

### *Present and Prior Law*

Individual taxpayers are allowed to claim a nonrefundable HOPE credit against Federal income taxes up to $1,500 per student for qualified tuition and fees paid during the year on behalf of a student (i.e., the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer) who is enrolled in a post-secondary degree or certificate program at an eligible post-secondary institution on at least a half-time basis. The HOPE credit is available only for the first two years of a student's post-secondary education. The credit rate is 100 percent of the first $1,000 of qualified tuition and fees and 50 percent on the next $1,000 of qualified tuition and fees. The HOPE credit amount that a taxpayer may otherwise claim is phased out for taxpayers with modified adjusted gross income (AGI) between $40,000 and $50,000 ($80,000 and $100,000 for joint returns). For taxable years beginning after 2001, the $1,500 maximum HOPE credit amount and the AGI phase-out range will be indexed for inflation. The HOPE credit is available for expenses paid after December 31, 1997, for education furnished in academic periods beginning after such date.

If a student is not eligible for the HOPE credit (or in lieu of claiming a HOPE credit with respect to a student), individual taxpayers are allowed to claim a nonrefundable Lifetime Learning credit against Federal income taxes equal to 20 percent of qualified tuition and fees paid during the taxable year on behalf of the taxpayer, the taxpayer's spouse, or a dependent. In contrast to the HOPE credit, the student need not be enrolled on at least a half-time basis in order to be eligible for the Lifetime Learning credit, which is available for an unlimited number of years of post-secondary training. For expenses paid before January 1, 2003, up to $5,000 of qualified tuition and fees per taxpayer return will be eligible for the Lifetime Learning credit (i.e., the maximum credit per taxpayer return will be $1,000). For expenses paid after December 31, 2002, up to $10,000 of qualified tuition and fees per taxpayer return will be eligible for the Lifetime Learning credit (i.e., the maximum credit per taxpayer return will be $2,000). The Lifetime

Learning credit amount that a taxpayer may otherwise claim is phased out over the same modified AGI phase-out range as applies for purposes of the HOPE credit. The Lifetime Learning credit is available for expenses paid after June 30, 1998, for education furnished in academic periods beginning after such date.

Under prior law, Section 6050S provided that certain educational institutions and other taxpayers engaged in a trade or business must file information returns with the IRS and certain individual taxpayers, as required by regulations prescribed by the Secretary of the Treasury, containing information on individuals who made payments for qualified tuition and related expenses or to whom reimbursements or refunds were made of such expenses.

### *Explanation of Provision*

The provision clarifies that, under section 6050S, information returns containing information with respect to qualified tuition and fees must be filed by a person that is not an eligible educational institution only if such person is engaged in a trade or business of making payments to any individual under an insurance arrangement as reimbursements or refunds (or similar payments) of qualified tuition and related expenses. As under prior law, section 6050S continues to require the filing of information returns by persons engaged in a trade or business if, in the course of such trade or business, the person receives from any individual interest aggregating $600 or more for any calendar year on one or more qualified education loans.

### *Effective Date*

The provision is effective as if included in the 1997 Act, i.e., for expenses paid after December 31, 1997, for education furnished in academic periods beginning after such date.

## 2. Deduction for student loan interest (sec. 6004(b) of the 1998 IRS Restructuring Act, sec. 202 of the 1997 Act, and sec. 221 of the Code)

### *Present and Prior Law*

Certain individuals who have paid interest on qualified education loans may claim an above-the-line deduction for such interest expenses, up to a maximum deduction of $2,500 per year. The deduction is allowed only with respect to interest paid on a qualified education loan during the first 60 months in which interest payments are required. In this regard, required payments of interest do not include nonmandatory payments, such as interest payments made during a period of loan forbearance. Months during which the qualified education loan is in deferral or forbearance do not count against the 60-month period. No deduction is allowed to an individual if that individual is claimed as a dependent on another taxpayer's return for the taxable year.

A qualified education loan generally is defined as any indebtedness incurred to pay for the qualified higher education expenses of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred in attending (1) post-secondary educational institutions and certain vocational schools defined by reference to section 481 of the Higher Education Act of 1965, or (2) institutions conducting internship or residency programs leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training.

### *Explanation of Provision*

The provision clarifies that the student loan interest deduction may be claimed only by a taxpayer who is legally obligated to make the interest payments pursuant to the terms of the loan.

The provision clarifies that a "qualified education loan" means any indebtedness incurred solely to pay qualified higher education expenses. Thus, revolving lines of credit generally do not constitute qualified education loans unless the borrower agreed to use the line of credit to pay only qualifying education expenses. The provision further provides Treasury with authority to issue regulations regarding the calculation of the 60-month period in the case of consolidated loans, collapsed loans, and loans made before the date of enactment of the Taxpayer Relief Act of 1997 (August 5, 1997) for purposes of determining the deductibility of interest paid on such loans. In this regard, it is expected that such regulations will mirror the guidance contained in Notice 98–7 issued regarding the establishment of the 60-month period with respect to such loans for reporting purposes.

### *Effective Date*

The provision is effective for interest payments due and paid after December 31, 1997, on any qualified education loan.

## 3. Qualified State tuition programs (sec. 6004(c) of the 1998 IRS Restructuring Act, sec. 211 of the 1997 Act, and sec. 529 of the Code)

### *Present and Prior Law*

Section 529 provides tax-exempt status to "qualified State tuition programs," meaning certain programs established and maintained by a State (or agency or instrumentality thereof) under which persons may (1) purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of qualified higher education expenses of the beneficiary, or (2) make contributions to an account that is established for the purpose of meeting qualified higher education expenses of the designated beneficiary of the account. The term "qualified higher education expenses" means expenses for tuition, fees, books, supplies, and equipment required for the enrollment or attendance at an eligible post-secondary educational institution, as well as room and board expenses (meaning the minimum room and board allowance applicable to the student as determined by the institution in calculating costs of attendance for Federal financial aid programs under sec. 472 of the Higher Education Act of 1965) for any period during which the student is at least a half-time student.

Section 529 also provides that no amount shall be included in the gross income of a contributor to, or beneficiary of, a qualified State tuition program with respect to any distribution from, or earnings under, such program, except that (1) amounts distributed or educational benefits provided to a beneficiary (e.g., when the beneficiary attends college) will be included in the beneficiary's gross income (unless excludable under another Code section) to the extent such amounts or the value of the educational benefits exceed contributions made on behalf of the beneficiary, and (2) amounts distributed to a contributor or another distributee (e.g., when a parent receives a refund) will be included in the contributor's/distributee's gross income to the extent such amounts exceed contributions made on behalf of the beneficiary. Earnings on an account may be refunded to a contributor or beneficiary, but the State or instrumentality must impose a more than de minimis monetary penalty unless the refund is (1) used for qualified higher education expenses of the beneficiary, (2) made on account of the death or disability of the beneficiary, or (3) made on account of a scholarship received by the designated beneficiary to the extent the amount refunded does not exceed the amount of the scholarship used for higher education expenses.

A transfer of credits (or other amounts) from one account benefiting one designated beneficiary to another account benefiting a different beneficiary will be considered a distribution (as will a change in the designated beneficiary of an interest in a qualified State tuition program), unless the beneficiaries are members of the same family. For this purpose, the term "member of the family" means persons described in paragraphs (1) through (8) of section 152(a)—e.g., sons, daughters, brothers, sisters, nephews and nieces, certain in-laws, etc—and any spouse of such persons.

### *Explanation of Provision*

The provision clarifies that, under rules contained in section 72, distributions from qualified State tuition programs are treated as representing a pro-rata share of the principal (i.e., contributions) and accumulated earnings in the account.

In addition, the provision modifies section 529(e)(2) to clarify that—for purposes of tax-free rollovers and changes of designated beneficiaries—a "member of the family" includes the spouse of the original beneficiary.

### *Effective Date*

The provisions are effective for distributions made after December 31, 1997.

## 4. Education IRAs (sec. 6004(d) of the 1998 IRS Restructuring Act, sec. 213 of the 1997 Act, and sec. 530 of the Code)

### *Present and Prior Law*

Section 530 provides that taxpayers may establish "education IRAs," meaning certain trusts or custodial accounts created exclusively for the purpose of paying qualified higher education expenses of a named beneficiary. Annual contributions to education IRAs may not exceed $500 per designated beneficiary, and may not be made after the designated beneficiary reaches age 18. Contributions to an education IRA may not be made by certain high-income taxpayers—i.e., the contribution limit is phased out for taxpayers with modified adjusted gross income between $95,000 and $110,000 ($150,000 and $160,000 for taxpayers filing joint returns). No contribution may be made to an education IRA during any year in which any contributions are made by anyone to a qualified State tuition program on behalf of the same beneficiary.

Until a distribution is made from an education IRA, earnings on contributions to the account generally are not subject to tax.[68] In addition, distributions from an education IRA are excludable from gross income to the extent that the distribution does not exceed qualified higher education expenses incurred by the beneficiary during the year the distribution is made (provided that a HOPE credit or Lifetime Learning credit is not claimed with respect to the beneficiary for the same taxable year). The earnings portion of an education IRA distribution not used to pay qualified higher education expenses is includible in the gross income of the distributee and generally is subject to an additional 10-percent tax.[69] However, the additional 10-percent tax does not apply if a distribution is made of excess contributions above the $500 limit (and any earnings attributable to such excess contributions) if the distribution is made on or before the date that a return is required to be filed (including extensions of time) by the contributor for the year in which the excess contribution was made. In addition, section 530 allows tax-free rollovers of account balances from an education IRA benefiting one family member to an education IRA benefiting another family member. Section 530 is effective for taxable years beginning after December 31, 1997.

### *Explanation of Provision*

Consistent with the legislative history to the 1997 Act, the provision provides that any balance remaining in an education IRA is deemed to be distributed within 30 days after the date that the designated beneficiary reaches age 30 (or, if earlier, within 30 days of the date that the beneficiary dies). The provision further clarifies that, in the event of the death of the designated beneficiary, the balance remaining in an education IRA may be distributed (without imposition of the additional 10-percent tax) to any other (i.e., contingent) beneficiary or to the estate of the deceased designated beneficiary. If any member of the family of the deceased beneficiary becomes the new designated beneficiary of an education IRA, then no tax is imposed on such redesignation and the account will continue to be treated as an education IRA.

The provision clarifies that for purposes of the special rules regarding tax-free rollovers and changes of designated beneficiaries, the new beneficiary must be under the age of 30.

[68] However, education IRAs are subject to the unrelated business income tax ("UBIT") imposed by section 511.

[69] This 10-percent additional tax does not apply if a distribution from an education IRA is made on account of the death, disability, or scholarship received by the designated beneficiary.

Under the provision, the additional 10-percent tax provided for by section 530(d)(4) does not apply to a distribution from an education IRA, which (although used to pay for qualified higher education expenses) is includible in the beneficiary's gross income solely because the taxpayer elects to claim a HOPE or Lifetime Learning credit with respect to the beneficiary. The provision further provides that the additional 10-percent tax does not apply to the distribution of any contribution to an education IRA made during a taxable year if such distribution is made on or before the date that a return is required to be filed (including extensions of time) by the *beneficiary* for the taxable year during which the contribution was made (or, if the beneficiary is not required to file such a return, April 15th of the year following the taxable year during which the contribution was made). In addition, the provision amends section 4973(e) to provide that the excise tax penalty applies under that section for each year that an excess contribution remains in an education IRA (and not merely the year that the excess contribution is made).

The provision clarifies that, in order for taxpayers to establish an education IRA, the designated beneficiary must be a life-in-being. The provision also clarifies that, under rules contained in present-law section 72, distributions from education IRAs are treated as representing a pro-rata share of the principal (i.e., contributions) and accumulated earnings in the account.[70]

The provision also provides that, if any qualified higher education expenses are taken into account in determining the amount of the exclusion under section 530 for a distribution from an education IRA, then no deduction (under section 162 or any other section), or exclusion (under section 135) or credit is allowed under the Internal Revenue Code with respect to such qualified higher education expenses.

In addition, because the 1997 Act allows taxpayers to redeem U.S. Savings Bonds and be eligible for the exclusion under present-law section 135 (as if the proceeds were used to pay qualified higher education expenses) provided the proceeds from the redemption are contributed to an education IRA (or to a qualified State tuition program defined under section 529) on behalf of the taxpayer, the taxpayer's spouse, or a dependent, the provision conforms the definition of "eligible educational institution" under section 135 to the broader definition of that term under present-law section 530 (and

[70] For example, if an education IRA has a total balance of $10,000, of which $4,000 represents principal (i.e., contributions) and $6,000 represents earnings, and if a distribution of $2,000 is made from such an account, then $800 of that distribution will be treated as a return of principal (which under no event is includible in the gross income of the distributee) and $1,200 of the distribution will be treated as accumulated earnings. In such a case, if qualified higher education expenses of the beneficiary during the year of the distribution are at least equal to the $2,000 total amount of the distribution (i.e., principal plus earnings), then the entire earnings portion of the distribution will be excludible under section 530, provided that a Hope credit or Lifetime Learning credit is not claimed for that same taxable year on behalf of the beneficiary. If, however, the qualified higher education expenses of the beneficiary for the taxable year are less than the total amount of the distribution, then only a portion of the earnings will be excludable from gross income under section 530. Thus, in the example discussed above, if the beneficiary incurs only $1,500 of qualified higher education expenses in the year that a $2,000 distribution is made, then only $900 of the earnings will be excludable from gross income under section 530 (i.e., an exclusion will be provided for the pro-rata portion of the earnings, based on the ratio that the $1,500 of qualified higher education expenses bears to the $2,000 distribution) and the remaining $300 of the earnings portion of the distribution will be includible in the distributee's gross income.

section 529). Thus, for purposes of section 135, as under present-law sections 529 and 530, the term "eligible educational institution" is defined as an institution which (1) is described in section 481 of the Higher Education Act of 1965 (20 U.S.C. 1088) and (2) is eligible to participate in Department of Education student aid programs.

### *Effective Date*

The provisions are effective as if included in the 1997 Act, i.e., for taxable years beginning after December 31, 1997.

## 5. Enhanced deduction for corporate contributions of computer technology and equipment (sec. 6004(e) of the 1998 IRS Restructuring Act, sec. 224 of the 1997 Act, and sec. 170(e)(6) of the Code)

### *Present and Prior Law*

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the fair market value of property contributed to a charitable organization. However, in the case of a charitable contribution of inventory or other ordinary-income property, short-term capital gain property, or certain gifts to private foundations, the amount of the deduction is limited to the taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, a taxpayer's deduction is limited to the adjusted basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose.

The Taxpayer Relief Act of 1997 provided that certain contributions of computer and other equipment to eligible donees to be used for the benefit of elementary and secondary school children qualify for an augmented deduction. Under this special rule, the amount of the augmented deduction available to a corporation making a qualified contribution generally is equal to its basis in the donated property plus one-half of the amount of ordinary income that would have been realized if the property had been sold. However, the augmented deduction cannot exceed twice the basis of the donated property. To qualify for the augmented deduction, the contribution must satisfy various requirements.

The legislative history of the provision states that the special tax treatment for contributions of computer and other equipment was to be effective for contributions made during a three-year period in taxable years beginning after December 31, 1997, and before January 1, 2001.[71] However, as a result of a drafting error, the statutory provision did not apply to contributions made during taxable years beginning after December 31, 1999.

### *Explanation of Provision*

The provision corrects the termination date of the provision to provide that the special rule applies to contributions made during

[71] H. Rept. 105–220, p. 374.

taxable years beginning after December 31, 1997, and before December 31, 2000.

In addition, the provision clarifies that the requirements set forth in section 170(e)(6)(B)(ii)-(vii) apply regardless of whether the donee is an educational organization or a tax-exempt charitable entity. Similarly, the rule in section 170(e)(6)(C)(ii)(I) regarding subsequent contributions by private foundations is clarified to permit contributions to either educational organizations or tax-exempt charitable entities described in section 170(e)(6)(B)(i).

### *Effective Date*

The provision is effective as of August 5, 1997, the date of enactment of the 1997 Act.

## 6. Treatment of cancellation of certain student loans (6004(f) of the 1998 IRS Restructuring Act, sec. 225 of the 1997 Act, and sec. 108(f) of the Code)

### *Present and Prior Law*

An individual's gross income does not include forgiveness of loans made by tax-exempt educational organizations if the proceeds of such loans are used to pay costs of attendance at an educational institution or to refinance outstanding student loans and the student is not employed by the lender organization. The exclusion applies only if the forgiveness is contingent on the student's working for a certain period of time in certain professions for any of a broad class of employers. In addition, the student's work must fulfill a public service requirement.

### *Explanation of Provision*

The provision clarifies that gross income does not include amounts from the forgiveness of loans made by educational organizations and certain tax-exempt organizations to refinance *any* existing student loan (and not just loans made by educational organizations). In addition, the provision clarifies that refinancing loans made by educational organizations and certain tax-exempt organizations must be made pursuant to a program of the refinancing organization (e.g., school or private foundation) that requires the student to fulfill a public service work requirement.

### *Effective Date*

The provision is effective as of August 5, 1997, the date of enactment of the 1997 Act.

## 7. Qualified zone academy bonds (sec. 6004(g) of the 1998 IRS Restructuring Act, sec. 226 of the 1997 Act, and sec. 1397E of the Code)

### *Present and Prior Law*

Certain financial institutions (i.e., banks, insurance companies, and corporations actively engaged in the business of lending money) that hold "qualified zone academy bonds" are entitled to a nonrefundable tax credit in an amount equal to a credit rate (set monthly by the Treasury Department[72]) multiplied by the face amount of the bond (sec. 1397E). The credit rate applies to all such bonds issued in each month. A taxpayer holding a qualified zone academy bond on the credit allowance date (i.e., each one-year anniversary of the issuance of the bond) is entitled to a credit. The credit is includible in gross income (as if it were an interest payment on the bond), and may be claimed against regular income tax and AMT liability.

"Qualified zone academy bonds" are defined as any bond issued by a State or local government, provided that (1) at least 95 percent of the proceeds are used for the purpose of renovating, providing equipment to, developing course materials for use at, or training teachers and other school personnel in a "qualified zone academy"—meaning certain public schools located in empowerment zones or enterprise communities or with a certain percentage of students from low-income families—and (2) private entities have promised to make contributions to the qualified zone academy with a value equal to at least 10 percent of the bond proceeds.

A total of $400 million of "qualified zone academy bonds" may be issued in each of 1998 and 1999. The $400 million aggregate bond cap will be allocated each year to the States according to their respective populations of individuals below the poverty line.[73] Each State, in turn, will allocate the credit to qualified zone academies within such State. A State may carry over any unused allocation into subsequent years.

### *Explanation of Provision*

The provision clarifies that, for purposes of section 6655(g)(1)(B), the credit for certain holders of qualified zone academy bonds may be claimed for estimated tax purposes. Similarly, the provision clarifies for purposes of section 6401(b)(1) the manner in which the credit is taken into account when determining whether a taxpayer has made an overpayment of tax.

### *Effective Date*

The provisions are effective for obligations issued after December 31, 1997.

## C. Amendments to Title III of the 1997 Act Relating to Savings Incentives

### 1. Conversions of IRAs into Roth IRAs (sec. 6005(b) of the 1998 IRS Restructuring Act, sec. 302 of the 1997 Act, and secs. 408A and 72(t) of the Code)

### *Present and Prior Law*

A taxpayer with adjusted gross income of $100,000 or less may convert a deductible or nondeductible IRA into a Roth IRA at any

[72] The Treasury Department will set the credit rate each month at a rate estimated to allow issuance of qualified zone academy bonds without discount and without interest cost to the issuer.

[73] See Rev. Proc. 98–57, which sets forth the maximum face amount of qualified zone academy bonds that may be issued for each State during 1999; IRS Proposed Rules (REG–119449–97), which provides guidance to holders and issuers of qualified zone academy bonds.

time. The amount converted is includible in income in the year of the conversion, except that, if the conversion occurs in 1998, the amount converted is includible in income ratably over the 4-year period beginning with the year in which the conversion occurs.[74] Under prior law, the application of the 4-year spread was automatic. Under present and prior law, amounts includible in income as a result of the conversion are not taken into account in determining whether the $100,000 threshold is exceeded. The 10-percent tax on early withdrawals does not apply to conversions of IRAs into Roth IRAs.

In general, distributions of earnings from a Roth IRA are excludable from income if the individual has had a Roth IRA for at least 5 years and certain other requirements are satisfied. (Distributions that are excludable from income are referred to as qualified distributions.) Under prior law, the 5-year holding period with respect to conversion Roth IRAs began with the year of the conversion.

Prior law did not contain a specific rule addressing what happens if an individual dies during the 4-year spread period for 1998 conversions.

### *Explanation of Provision*

#### *Distributions of converted amounts*

*Distributions before the end of the 4-year spread*

The provision modifies the rules relating to conversions of IRAs into Roth IRAs in order to prevent taxpayers from receiving premature distributions from a Roth conversion IRA while retaining the benefits of 4-year income averaging. In the case of conversions to which the 4-year income inclusion rule applies, income inclusion is accelerated with respect to any amounts withdrawn before the final year of inclusion. Under this rule, a taxpayer that withdraws converted amounts prior to the last year of the 4-year spread is required to include in income the amount otherwise includible under the 4-year rule, plus the lesser of (1) the taxable amount of the withdrawal, or (2) the remaining taxable amount of the conversion (i.e., the taxable amount of the conversion not included in income under the 4-year rule in the current or a prior taxable year). In subsequent years (assuming no such further withdrawals), the amount includible in income under the 4-year will be the lesser of (1) the amount otherwise required under the 4-year rule (determined without regard to the withdrawal) or (2) the remaining taxable amount of the conversion.

Under the provision, application of the 4-year spread is elective. The election is made in the time and manner prescribed by the Secretary. If no election is made, the 4-year rule will be deemed to be elected. An election, or deemed election, with respect to the 4-year spread cannot be changed after the due date for the return for the first year of the income inclusion (including extensions).

The following example illustrates the application of these rules.

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[74] If the conversion is accomplished by means of a withdrawal and a rollover into a Roth IRA, the 4-year rule applies if the withdrawal is made during 1998 and the rollover occurs within 60 days of the withdrawal. In such a case, the 4-year period begins with the year in which the withdrawal was made. For purposes of this discussion, such conversions are treated as occurring in 1998.

*Example:* Taxpayer A has a nondeductible IRA with a value of $100 (and no other IRAs). The $100 consists of $75 of contributions and $25 of earnings. A converts the IRA into a Roth IRA in 1998 and elects the 4-year spread. As a result of the conversion, $25 is includible in income ratably over 4 years ($6.25 per year). The 10-percent early withdrawal tax does not apply to the conversion. At the beginning of 1999, the value of the account is $110, and A makes a withdrawal of $10. Under the provision, the withdrawal is treated as attributable entirely to amounts that were includible in income due to the conversion. In the year of withdrawal, $16.25 is includible in income (the $6.25 includible in the year of withdrawal under the 4-year rule, plus $10 ($10 is less than the remaining taxable amount of $12.50 ($25-$12.50)). In the next year, $2.50 is includible in income under the 4-year rule. No amount is includible in income in year 4 due to the conversion.

*Application of early withdrawal tax to converted amounts*

The provision modifies the rules relating to conversions to prevent taxpayers from receiving premature distributions (i.e., within 5 years) while retaining the benefit of the nonpayment of the early withdrawal tax. Under the provision, if converted amounts are withdrawn within the 5-year period beginning with the year of the conversion, then, to the extent attributable to amounts that were includible in income due to the conversion, the amount withdrawn is subject to the 10-percent early withdrawal tax.[75]

Applying this rule to the example above, the $10 withdrawal is subject to the 10-percent early withdrawal tax (unless as exception applies).

*Application of 5-year holding period*

The provision also eliminates the special rule under which a separate 5-year holding period begins for purposes of determining whether a distribution of amounts attributable to a conversion is a qualified distribution; thus, the 5-year holding rule for Roth IRAs begins with the year for which a contribution is first made to a Roth IRA. A subsequent conversion does not start the running of a new 5-year period.

*Ordering rules*

Ordering rules apply to determine what amounts are withdrawn in the event a Roth IRA contains both conversion amounts (possibly from different years) and other contributions. Under these rules, regular Roth IRA contributions are deemed to be withdrawn first, then converted amounts (starting with the amounts first converted). Withdrawals of converted amounts are treated as coming first from converted amounts that were includible in income. As under prior law, earnings are treated as withdrawn after contributions. For purposes of these rules, all Roth IRAs, whether or not maintained in separate accounts, will be considered a single Roth IRA.

[75] The otherwise available exceptions to the early withdrawal tax, e.g., for distributions after age 59½, apply.

*Corrections*

In order to assist individuals who erroneously convert IRAs into Roth IRAs or otherwise wish to change the nature of an IRA contribution, contributions to an IRA (and earnings thereon) may be transferred in a trustee-to-trustee transfer from any IRA to another IRA by the due date for the taxpayer's return for the year of the contribution (including extensions). Any such transferred contributions are treated as if contributed to the transferee IRA (and not to the transferor IRA). Trustee-to-trustee transfers include transfers between IRA trustees as well as IRA custodians, apply to transfers from and to IRA accounts and annuities, and apply to transfers between IRA accounts and annuities with the same trustee or custodian.

***Effect of death on 4-year spread***

Under the provision, in general, any amounts remaining to be included in income as a result of a 1998 conversion are includible in income on the final return of the taxpayer. If the surviving spouse is the sole beneficiary of the Roth IRA, the spouse may continue the deferral by including the remaining amounts in his or her income over the remainder of the 4-year period.

***Calculation of AGI limit for conversions***

The provision clarifies that for purposes of determining the $100,000 adjusted gross income ("AGI") limit on IRA conversions to Roth IRAs, the conversion amount is not taken into account. Thus, for this purpose, AGI (and all AGI-based phaseouts) are to be determined without taking into account the conversion amount. For purposes of computing taxable income, the conversion amount (to the extent otherwise includible in AGI) is to be taken into account in computing the AGI-based phaseout amounts.

### *Effective Date*

The provision is effective as if included in the 1997 Act, i.e., for taxable years beginning after December 31, 1997.

## 2. Penalty-free distributions for education expenses and purchase of first homes (sec. 6005(c) of the 1998 IRS Restructuring Act, secs. 203 and 303 of the 1997 Act, and sec. 402 of the Code)

### *Present and Prior Law*

The 10-percent early withdrawal tax does not apply to distributions from an IRA if the distribution is for first-time homebuyer expenses, subject to a $10,000 life-time cap, or for higher education expenses. These exceptions do not apply to distributions from employer-sponsored retirement plans. A distribution from an employer-sponsored retirement plan that is an "eligible rollover distribution" may be rolled over to an IRA. The term "eligible rollover distribution" means any distribution to an employee of all or a portion or the balance to the credit of the employee in a qualified trust, except the term does not include certain periodic distributions, distributions based on life or joint life expectancies and distributions required under the minimum distribution rules. Generally, distributions from cash or deferred arrangements made on account of hardship are eligible rollover distributions. An eligible rollover distribution which is not transferred directly to another retirement plan or an IRA is subject to 20-percent withholding on the distribution. Under prior law, participants in employer-sponsored retirement plans could avoid the early withdrawal tax applicable to such plans by rolling over hardship distributions to an IRA and withdrawing the funds from the IRA.

### *Explanation of Provision*

The provision modifies the rules relating to the ability to roll over hardship distributions from employer-sponsored retirement plans (including section 403(b) plans) in order to prevent avoidance of the 10-percent early withdrawal tax. The provision provides that distributions from cash or deferred arrangements and similar arrangements made on account of hardship of the employee are not eligible rollover distributions. Such distributions are not subject to the 20-percent withholding applicable to eligible rollover distributions.

### *Effective Date*

The provision is effective for distributions after December 31, 1998.

## 3. Limits based on modified adjusted gross income (sec. 6005(b) of the 1998 IRS Restructuring Act, sec. 302(a) of the 1997 Act, and sec. 72(t) of the Code)

### *Present and Prior Law*

The $2,000 Roth IRA maximum contribution limit is phased out for individual taxpayers with adjusted gross income ("AGI") between $95,000 and $110,000 and for married taxpayers filing a joint return with AGI between $150,000 and $160,000. The maximum deductible IRA contribution is phased out between $0 and $10,000 of AGI in the case of married couples filing a separate return.

### *Explanation of Provision*

The provision clarifies the phase-out range for the Roth IRA maximum contribution limit for a married individual filing a separate return and conforms it to the range for deductible IRA contributions. Under the provision, the phase-out range for married individuals filing a separate return will be $0 to $10,000 of AGI.

### *Effective Date*

The provision is effective as if included in the 1997 Act, i.e., for taxable years beginning after December 31, 1997.

### 4. Contribution limit to Roth IRAs (sec. 6005(b) of the 1998 IRS Restructuring Act, sec. 302 of the 1997 Act, and sec. 408A(c) of the Code)

#### *Present and Prior Law*

An individual who is an active participant in an employer-sponsored plan may deduct annual IRA contributions up to the lesser of $2,000 or 100 percent of compensation if the individual's adjusted gross income ("AGI") does not exceed certain limits. For 1998, the limit is phased-out over the following ranges of AGI: $30,000 to $40,000 in the case of a single taxpayer and $50,000 to $60,000 in the case of married taxpayers. An individual who is not an active participant in an employer-sponsored retirement plan (and whose spouse is not an active participant) may deduct IRA contributions up to the limits described above without limitation based on income. An individual who is not an active participant in an employer-sponsored retirement plan (and whose spouse is such an active participant) may deduct IRA contributions up to the limits described above if the AGI of the such individuals filing a joint return does not exceed certain limits. The limit is phased for out for such individuals with AGI between $150,000 and $160,000.

An individual may make nondeductible contributions up to the lesser of $2,000 or 100 percent of compensation to a Roth IRA if the individual's AGI does not exceed certain limits. An individual may make nondeductible contributions to an IRA to the extent the individual does not or cannot make deductible contributions to an IRA or contributions to a Roth IRA. Contributions to all an individual's IRAs for a taxable year may not exceed $2,000.

#### *Explanation of Provision*

The provision clarifies the intent of the 1997 Act that an individual may contribute up to $2,000 a year to all the individual's IRAs. Thus, for example, suppose an individual is not eligible to make deductible IRA contributions because of the phase-out limits, and is eligible to make a $1,000 Roth IRA contribution. The individual could contribute $1,000 to the Roth IRA and $1,000 to a nondeductible IRA.

#### *Effective Date*

The provision is effective as if included in the 1997 Act, i.e., for taxable years beginning after December 31, 1997.

### 5. Contribution limitations for active participants in an IRA (sec. 6005(a) of the 1998 IRS Restructuring Act, sec. 301(b) of the 1997 Act, and sec. 219(g) of the Code)

#### *Present and Prior Law*

If a married individual (filing a joint return) is an active participant in an employer-sponsored retirement plan, the $2,000 IRA deduction limit is phased out over the following levels of adjusted gross income ("AGI"):

| *Taxable years beginning in—* | *Phase-out range* |
| --- | --- |
| 1997 | $40,000 to $50,000 |
| 1998 | $50,000 to $60,000 |
| 1999 | $51,000 to $61,000 |
| 2000 | $52,000 to $62,000 |
| 2001 | $53,000 to $63,000 |
| 2002 | $54,000 to $64,000 |
| 2003 | $60,000 to $70,000 |
| 2004 | $65,000 to $75,000 |
| 2005 | $70,000 to $80,000 |
| 2006 | $75,000 to $85,000 |
| 2007 | $80,000 to $100,000 |

An individual is not considered an active participant in an employer-sponsored retirement plan merely because the individual's spouse is an active participant. The $2,000 maximum deductible IRA contribution for an individual who is not an active participant, but whose spouse is, is phased out for taxpayers with AGI between $150,000 and $160,000.

### *Explanation of Provision*

The provision clarifies the intent of the 1997 Act relating to the AGI phase-out ranges for married individuals who are active participants in employer-sponsored plans and the AGI phase-out range for spouses of such active participants as described above.

### *Effective Date*

The provision is effective as if included in the 1997 Act, i.e., for taxable years beginning after December 31, 1997.

## D. Amendments to Title III of the 1997 Act Relating to Capital Gains

### 1. Individual capital gains rate reductions (sec. 6005(d) of the 1998 IRS Restructuring Act, sec. 311 of the 1997 Act, and sec. 1(h) of the Code)

### *Present and Prior Law*

The 1997 Act provided lower capital gains rates for individuals. Generally, the 1997 Act reduced the maximum rate on the adjusted net capital gain of an individual from 28 percent to 20 percent and provided a 10-percent rate for the adjusted net capital gain otherwise taxed at a 15-percent rate. The "adjusted net capital gain" means the net capital gain determined without regard to certain gain for which the 1997 Act provided a higher maximum rate of tax. The 1997 Act generally retained a 28-percent maximum rate for the long-term capital gain from collectibles, certain long-term capital gain included in income from the sale of small business stock, and the net capital gain determined by including all capital gains and losses properly taken into account after July 28, 1997, from property held more than one year but not more than 18 months and all capital gains and losses properly taken into account for the portion of the taxable year before May 7, 1997. In addition, the 1997 Act provided a maximum rate of 25 percent for the long-term capital gain attributable to real estate depreciation ("unrecaptured section 1250 gain"). Beginning in 2001 and 2006, lower rates of 8 and 18 percent will apply to certain property held more than five years.

The amounts taxed at the 28- and 25-percent rates may not exceed the individual's net capital gain and also are reduced by amounts otherwise taxed at a 15-percent rate.

Under the provisions of the 1997 Act, net short-term capital losses and long-term capital loss carryovers reduce the amount of adjusted net capital gain before reducing amounts taxed at the maximum 25- and 28-percent rates.

The 1997 Act failed to coordinate the new multiple holding periods with certain provisions of the Code.

### *Explanation of Provision*

Under the provision, the "adjusted net capital gain" of an individual is the net capital gain reduced (but not below zero) by the sum of the 28-percent rate gain and the unrecaptured section 1250 gain.

"28-percent rate gain" means the amount of net gain attributable to collectibles gains and losses, an amount of gain equal to the gain excluded from gross income on the sale of certain small business stock under section 1202,[76] long-term capital gains and losses properly taken into account after July 28, 1997, from property held more than one year but not more than 18 months[77], the net short-term capital loss for the taxable year and the long-term capital loss carryover to the taxable year. Long-term capital gains and losses properly taken into account before May 7, 1997, also are included in computing 28-percent rate gain.[78]

"Unrecaptured section 1250 gain" means the amount of long-term capital gain (not otherwise treated as ordinary income) which would be treated as ordinary income if section 1250 recapture applied to all depreciation (rather than only to depreciation in excess of straight-line depreciation) from property held more than 18 months (one year for amounts properly taken into account after May 6, 1997, and before July 29, 1997).[79] The unrecaptured section 1250 depreciation is reduced (but not below zero) by the excess (if any) of amount of losses taken into account in computing 28-percent gain over the amount of gains taken into account in computing 28-percent rate gain.

The provision contains several conforming amendments to coordinate the multiple holding periods with other provisions of the Code. Inherited property (sec. 1223 (11) and (12)) and certain patents

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[76] For example, assume an individual has $300,000 gain from the sale of qualified stock in a small business corporation and assume that section 1202(b) limits the gain that may be taken into account under section 1202(a) to $240,000. $120,000 of the gain (50 percent of $240,000) is excluded from gross income under section 1202(a). The $180,000 of gain that is included in gross income is included in the computation of net capital gain, and $120,000 of that gain is taken into account under section 1(h)(5) in computing 28-percent rate gain. The maximum effective regular tax rate on the $240,000 of gain to which the 50-percent section 1202 exclusion applies is 14 percent and the maximum rate on the remaining $60,000 of gain is 20 percent.

[77] Section 5001 of the 1998 IRS Restructuring Act eliminated the 18-month holding period, effective January 1, 1998. This description does not include the changes made by that provision.

[78] The application of this provision to the beneficiaries of charitable remainder trusts was modified by section 4003(b) of the Tax and Trade Relief Act of 1998, described in part Three of this publication.

[79] In the case of a disposition of a partnership interest held more than 18 months, the amount of the individual's long-term capital gain which would be treated as ordinary income under section 751(a) if section 1250 applied to all depreciation, will be taken into account in computing unrecaptured section 1250 gain.

(sec. 1235) are deemed to have a holding period of more than 18 months, allowing the 10- and 20-percent rates to apply. Amounts treated as ordinary income by reason of section 1231(c) will be allocated among categories of net section 1231 gain in accordance with IRS forms or regulations. The provision clarifies that the amount treated as long-term capital gain or loss on a section 1256 contract is treated as attributable to property held for more than 18 months.

Under the provision, in applying section 1233(b) where the substantially identical property has been held more than one year but not more than 18 months, any gain on the closing of the short sale will be considered gain from property held not more than 18 months, and the substantially identical property will have be treated as held for one year on the day before the earlier of the date of the closing of the short sale or the date the property is disposed of. In applying section 1233(d) where, on the date of the short sale, the substantially identical property has been held more than 18 months, any loss on the closing of the short sale will be treated as a loss from the sale or exchange of a capital asset held more than 18 months. Finally, in applying section 1092(f), any loss with respect to the option shall be treated as a loss from the sale or exchange of a capital asset held more than 18 months, if at the time the loss is realized, gain on the sale or exchange of the stock would be treated as gain from the sale or exchange of a capital asset held more than 18 months. [80]

The provision reorders the rate structure under sections 1(h)(1) and 55(b)(3) without any substantive change.

The provision makes minor technical changes, including a provision to reduce the minimum tax preference on certain small business stock to 28 percent, beginning in 2006. [81]

### *Effective Date*

The provision applies to taxable years ending after May 6, 1997.

## 2. Exclusion of gain on the sale of a principal residence owned and used less than two years (sec. 6005(e)(1) and (2) of the 1998 IRS Restructuring Act, sec. 312(a) of the 1997 Act, and sec. 121 of the Code)

### *Present and Prior Law*

A taxpayer generally is able to exclude up to $250,000 ($500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. To be eligible for the exclusion, the taxpayer must have owned the residence and used it as a principal residence for at least two of the five years prior to the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or unforeseen circumstances is able to exclude a fraction of the taxpayer's realized

[80] Any loss treated as a long-term capital loss by reason of section 1233(d) or 1092(f) will be taken into account in computing 28-percent rate gain where the property causing such loss to be treated as a long-term capital loss was held not more than 18 months on the applicable date.

[81] Thus, the maximum rate under the minimum tax will be 17.92 percent (.64 times 28 percent).

gain equal to the fraction of the two years that the requirements are met.

### *Explanation of Provision*

The provision clarifies that an otherwise qualifying taxpayer who fails to satisfy the two-year ownership and use requirements is able to exclude an amount equal to the fraction of the $250,000 ($500,000 if married filing a joint return), not the fraction of the realized gain which is equal to the fraction of the two years that the ownership and use requirements are met. For example, an unmarried taxpayer who owns and uses a principal residence for one year then sells at realized gain of $500,000 may exclude $125,000 of gain (one-half of $250,000) not $250,000 of gain (one-half of the realized gain). Similarly, an unmarried taxpayer who owns and uses a principal residence for one year then sells at a realized gain of $50,000 may exclude the entire $50,000 of gain since it is less than one half of $250,000. The exclusion is not limited to $25,000 (one-half of the $50,000 realized gain).

In addition, the provision provides that if a married couple filing a joint return does not qualify for the $500,000 maximum exclusion, the amount of the maximum exclusion that may be claimed by the couple is the sum of each spouse's maximum exclusion determined on a separate basis.

### *Effective Date*

The provision is effective as if included in section 312 of the 1997 Act.

**3. Effective date of the exclusion of gain on the sale of a principal residence (sec. 6005(e)(3) of the 1998 IRS Restructuring Act, sec. 312(d)(2) of the 1997 Act, and sec. 121 of the Code)**

### *Present and Prior Law*

The exclusion for gain on sale of a principal residence as added by the 1997 Act generally applies to sales or exchanges occurring after May 6, 1997. A taxpayer may elect, however, to apply the law in effect prior to the 1997 Act to a sale or exchange (1) made before the date of enactment of the Act, (2) made after the date of enactment pursuant to a binding contract in effect on such date, or (3) where a replacement residence was acquired on or before the date of enactment (or pursuant to a binding contract in effect on the date of enactment) and the prior-law rollover provision would apply.

### *Explanation of Provision*

The provision clarifies that a taxpayer may elect to apply the law in effect prior to the 1997 Act with respect to a sale or exchange on the date of enactment of section 312 of the 1997 Act.

### *Effective Date*

The provision is effective as if included in section 312 of the 1997 Act.

## 4. Rollover of gain from sale of qualified stock (sec. 6005(f) of the 1998 IRS Restructuring Act, sec. 313 of the 1997 Act, and sec. 1045 of the Code)

### *Present and Prior Law*

The 1997 Act provided that gain from the sale of qualified small business stock held by an individual for more than six months can be "rolled over" tax-free to other qualified small business stock.

### *Explanation of Provision*

The provision provides that rules similar to the rules contained in subsections (f) through (k) of section 1202 will apply for purposes of the rollover provision (sec. 1045). Under these rules, for example, the benefit of a tax-free rollover with respect to the sale of small business stock by a partnership will flow through to a partner who is not a corporation if the partner held its partnership interest at all times the partnership held the small business stock. A similar rule applies to S corporations.

### *Effective Date*

The provision applies to sales on or after August 5, 1997, the date of enactment of the 1997 Act.

# E. Amendments to Title IV of the 1997 Act Relating to Alternative Minimum Tax

## 1. Clarification of the small business exemption (sec. 6006(a) of the 1998 IRS Restructuring Act, sec. 401 of the 1997 Act, and sec. 55 of the Code)

### *Present and Prior Law*

The corporate alternative minimum tax is repealed for small corporations for taxable years beginning after December 31, 1997. A small corporation is one that had average gross receipts of $5 million or less for a prior three-year period. A corporation that meets the $5 million gross receipts test will continue to be treated as a small corporation exempt from the alternative minimum tax so long as its average gross receipts do not exceed $7.5 million.

### *Explanation of Provision*

The provision clarifies the application of the $5 million and $7.5 million average annual gross receipts tests that a corporation must meet to be a small corporation exempt from the AMT. Under the provision, in order for a corporation to qualify as a small corporation exempt from the AMT for a taxable year, the corporation's average annual gross receipts for all 3-taxable-year periods beginning after December 31, 1993 and ending before such taxable year must be $7.5 million or less. The $7.5 million amount is reduced to $5 million for the corporation's first 3-taxable-year period (or portion thereof) beginning after December 31, 1993, and ending before the taxable year for which the exemption is claimed.

If a corporation's first taxable year beginning after December 31, 1997 (the first year the exemption is available) is its first taxable year (and the corporation does not lose its status as a small corporation because it is aggregated with one or more corporations under section 448(c)(2) or treated as having a predecessor corporation under section 448(c)(3)(D)), the corporation will be treated as an exempt small corporation for such year regardless of its gross receipts for such year.

The operation of the gross receipts tests for the small corporation AMT exemption is demonstrated by the following examples.

*Example 1:* Assume a calendar-year corporation was in existence on January 1, 1994. In order to qualify as a small corporation for 1998 (the first year the exemption is available), (1) the corporation's average annual gross receipts for the 3-taxable-year period 1994 through 1996 must be $5 million or less and (2) the corporation's average annual gross receipts for the 1995 through 1997 period must be $7.5 million or less. If the corporation qualifies for 1998, the corporation will qualify for 1999 if its average annual gross receipts for the 3-taxable-year period 1996 through 1998 also is $7.5 million or less. If the corporation does not qualify for 1998, the corporation cannot qualify for 1999 or any subsequent year.

*Example 2:* Assume a calendar-year corporation is first incorporated in 1999 and is neither aggregated with a related, existing corporation under section 448(c)(2) nor treated as having a predecessor corporation under section 448(c)(3)(D). The corporation will qualify as a small corporation for 1999 regardless of its gross receipts for such year. In order to qualify as a small corporation for 2000, the corporation's gross receipts for 1999 must be $5 million or less.[82] If the corporation qualifies for 2000, the corporation also will qualify for 2001 if its average annual gross receipts for the 2-taxable-year period 1999 through 2000 is $7.5 million or less. If the corporation does not qualify for 2000, the corporation cannot qualify for 2001 or any subsequent year. If the corporation qualifies for 2001, the corporation will qualify for 2002 if its average annual gross receipts for the 3-taxable-year period 1999 through 2001 is $7.5 million or less.

### *Effective Date*

The provision is effective for taxable years beginning after December 31, 1997.

## 2. Election to use AMT depreciation for regular tax purposes (sec. 6006(b) of the 1998 IRS Restructuring Act, sec. 402 of the 1997 Act, and sec. 168 of the Code)

### *Present and Prior Law*

For regular tax purposes, depreciation deductions for certain shorter-lived tangible property may be determined using the 200-

[82] The gross receipts for 1999 must be annualized under section 448(c)(3)(B) if the 1999 taxable year is less than 12 months.

percent declining balance method over 3-, 5-, 7-, or 10-year recovery periods (depending on the type of property). For alternative minimum tax ("AMT") purposes, depreciation on such property placed in service after 1986 and before 1999 is computed by using the 150-percent declining balance method over the longer class lives prescribed by the alternative depreciation system of section 168(g). A taxpayer may elect to use the methods and lives applicable to AMT depreciation for regular tax purposes.

The 1997 Act conformed the recovery periods (but not the methods) used for purposes of the AMT depreciation to the recovery periods used for purposes of the regular tax, for property placed in service after 1998. The 1997 Act did not make a conforming change to the election to use the pre-1998 AMT recovery methods and recovery periods for regular tax purposes.

### *Explanation of Provision*

For property placed in service after 1998, a taxpayer is allowed to elect, for regular tax purposes, to compute depreciation on tangible personal property otherwise qualified for the 200-percent declining balance method by using the 150-percent declining balance method over the recovery periods applicable to the regular tax (rather than the longer class lives of the alternative depreciation system of sec. 168(g)).

### *Effective Date*

The provision is effective for property placed in service after December 31, 1998.

## F. Amendments to Title V of the 1997 Act Relating to Estate and Gift Taxes

### 1. Clarification of effective date for indexing of generation-skipping exemption (sec. 6007(a) of the 1998 IRS Restructuring Act, secs. 501(d) and (f) of the 1997 Act, and sec. 2631(c) of the Code)

### *Present and Prior Law*

The 1997 Act provided for the indexation of the $1 million exemption from generation-skipping transfers effective for decedents dying after December 31, 1998.

### *Explanation of Provision*

The provision clarifies that the indexing of the exemption from generation-skipping transfers is effective with respect to all generation-skipping transfers (i.e., direct skips, taxable terminations, and taxable distributions) made after 1998.

With respect to existing trusts, transferors are permitted to make a late allocation of any additional GST exemption amount attributable to indexing adjustments in accordance with the present-law rules applicable to late allocations as set forth in sections 2632 and 2642, and the regulations promulgated thereunder. For example, assume an individual transferred $2 million to a trust in 1995, and allocated his entire $1 million GST exemption to the trust at that time (resulting in an inclusion ratio of .50). Assume further that in 2001, the GST exemption has increased to $1,100,000 as the result of indexing, and that the value of the trust assets is now $3 million. If the individual is still alive in 2001, he is permitted to make a late allocation of $100,000 of GST exemption to the trust, resulting in a new inclusion ratio of 1-(($1,500,000+100,000)/$3,000,000), or .467.

### *Effective Date*

The provision is effective for generation-skipping transfers (i.e., direct skips, taxable terminations, and taxable distributions) made after December 31, 1998.

## 2. Conversion of qualified family-owned business exclusion into a deduction (sec. 6007(b)(1)(A) of the 1998 IRS Restructuring Act, sec. 502 of the 1997 Act, and redesignated sec. 2057 of the Code)

### *Present and Prior Law*

The qualified family-owned business provision added by the 1997 Act provides an exclusion from estate taxes for certain qualified family-owned business interests. It is unclear whether the provision provided an exclusion of value or an exclusion of property from the estate, and thus it is unclear how the new provision interacts with other provisions in the Internal Revenue Code (e.g., secs. 1014, 2032A, 2056, 2612, and 6166).

### *Explanation of Provision*

The provision converts the qualified family-owned business exclusion into a deduction, and redesignates section 2033A as section 2057. Except as provided below, the requirements of the qualified family-owned business provision otherwise remain unchanged. The qualified family-owned business deduction is not available for generation-skipping transfer tax purposes.

### *Effective Date*

The provision is effective with respect to estates of decedents dying after December 31, 1997.

## 3. Coordination between unified credit and family-owned business provision (secs. 6007(b)(1)(B) and 6007(b)(4) of the 1998 IRS Restructuring Act, sec. 502 of the 1997 Act, and redesignated sec. 2057(a) of the Code)

### *Present and Prior Law*

The 1997 Act effectively increased the amount of lifetime gifts and transfers at death that are exempt from unified estate and gift tax from $600,000 to $1,000,000 over the period 1997 to 2006, through increases in an individual's unified credit. In addition, the 1997 Act provided a limited exclusion for certain family-owned business interests. The exclusion for family-owned business interests may be taken only to the extent that the exclusion for family-owned business interests, plus the amount effectively exempted by the unified credit, does not exceed $1.3 million. As a result, for years after 1998, the maximum amount of exclusion for family-owned business interests is reduced by increases in the dollar amount of transfers effectively exempted through the unified credit.

Because the structure of the 1997 Act increases the unified credit over time (until 2006) while decreasing over the same period the benefit of the closely-held business exclusion, the estate tax on estates with family-owned businesses increases over time until 2006. This increase in estate tax results from the fact that increases in the unified credit provide a benefit at the decedent's lowest estate tax brackets, while the exclusion for family-owned businesses provides a benefit at the decedent's highest estate tax brackets.

### *Explanation of Provision*

Under the provision, if an executor elects to utilize the qualified family-owned business deduction, the estate tax liability is calculated as if the estate were allowed a maximum qualified family-owned business deduction of $675,000 and an applicable exclusion amount under section 2010 (i.e., the amount exempted by the unified credit) of $625,000, regardless of the year in which the decedent dies. If the estate includes less than $675,000 of qualified family-owned business interests, the applicable exclusion amount is increased on a dollar-for-dollar basis, but only up to the applicable exclusion amount generally available for the year of death.

For example, assume the decedent dies in 2005, when the applicable exclusion amount under section 2010 is $800,000. If the estate includes qualified family-owned business interests valued at $675,000 or more, the estate tax liability is calculated as if the estate were allowed a qualified family-owned business deduction of $675,000, and the applicable exclusion amount under section 2010 is limited to $625,000. If the estate includes qualified family-owned business interests of $500,000 or less, all of the qualified family-owned business interests could be deducted from the estate, and the applicable exclusion amount under section 2010 is $800,000. If the estate includes qualified family-owned business interests valued between $500,000 and $675,000, all of the qualified family-owned business interests could be deducted from the estate, and the applicable exclusion amount under section 2010 is calculated as the excess of $1.3 million over the amount of qualified family-owned business interests. (For example, if the qualified family-owned business interests were valued at $600,000, the applicable exclusion amount under section 2010 is $700,000.)

If a recapture event occurs with respect to any qualified family-owned business interest, the total amount of estate taxes potentially subject to recapture is calculated as the difference between the actual amount of estate tax liability for the estate, and the amount of estate taxes that would have been owed had the qualified family-owned business election not been made.

### *Effective Date*

The provision is effective for decedents dying after December 31, 1997.

**4. Clarification of businesses eligible for family-owned business provision (sec. 6007(b)(2) of the 1998 IRS Restructuring Act, sec. 502 of the 1997 Act, and redesignated sec. 2057(b)(3) of the Code)**

***Present and Prior Law***

In order to be eligible to exclude from the gross estate a portion of the value of a family-owned business, the sum of (1) the adjusted value of family-owned business interests includible in the decedent's estate, and (2) the amount of gifts of family-owned business interests to family members of the decedent that are not included in the decedent's gross estate, must exceed 50 percent of the decedent's adjusted gross estate.

***Explanation of Provision***

The provision clarifies the formula for determining the amount of gifts of family-owned business interests made to members of the decedent's family that are not otherwise includible in the decedent's gross estate.

***Effective Date***

The provision is effective with respect to decedents dying after December 31, 1997.

**5. Clarification of "trade or business" requirement for family-owned business provision (sec. 6007(b)(5) of the 1998 IRS Restructuring Act, sec. 502 of the Act, and redesignated secs. 2057(e)(1) and 2057(f) of the Code)**

***Present and Prior Law***

A qualified family-owned business interest is defined as any interest in a trade or business that meets certain requirements—e.g., the decedent and members of his family must own certain percentages of the trade or business, the decedent or members of his family must have materially participated in the trade or business for five of the eight years preceding the decedent's death, and the qualified heir or members of his family must materially participate in the trade or business for at least five years of any eight-year period within 10 years following the decedent's death.

***Explanation of Provision***

The provision clarifies that an individual's interest in property used in a trade or business may qualify for the qualified family-owned business provision as long as such property is used in a trade or business by the individual or a member of the individual's family. Thus, for example, if a brother and sister inherit farmland upon their father's death, and the sister cash-leases her portion to her brother, who is engaged in the trade or business of farming, the "trade or business" requirement is satisfied with respect to both the brother and the sister. Similarly, if a father cash-leases farmland to his son, and the son materially participates in the trade or business of farming the land for at least five of the eight years preceding his father's death, the pre-death material participation and "trade or business" requirements are satisfied with respect to the father's interest in the farm.

### *Effective Date*

The provision is effective with respect to estates of decedents dying after December 31, 1997.

## 6. Clarification that interests eligible for family-owned business provision must be passed to a qualified heir (secs. 6007(b)(1)(B) of the 1998 IRS Restructuring Act, sec. 502 of the Act, and redesignated sec. 2057(a)(1) of the Code)

### *Present and Prior Law*

The 1997 Act provided a new exclusion for qualified family-owned business interests. One of the requirements for the exclusion is that such interests must pass to a "qualified heir," which includes members of the decedent's family and any individual who has been actively employed by the trade or business for at least 10 years prior to the date of the decedent's death.

### *Explanation of Provision*

The provision clarifies that qualified family-owned business interests must pass to a qualified heir in order to qualify for the deduction. For this purpose, if all beneficiaries of a trust are qualified heirs (and in such other circumstances as the Secretary of the Treasury may provide), property passing to the trust may be treated as having passed to a qualified heir.

### *Effective Date*

The provision is effective with respect to estates of decedents dying after December 31, 1997.

## 7. Other modifications to the qualified family-owned business provision (secs. 6007(b)(3), 6007(b)(6), and 6007(b)(7) of the 1998 IRS Restructuring Act, sec. 502 of the 1997 Act, and redesignated sec. 2057 of the Code)

### *Present and Prior Law*

The qualified family-owned business provision incorporates by cross-reference several other provisions of the Code, including a number of provisions in section 2032A and the personal holding company rules of section 543(a).

### *Explanation of Provision*

The provision modifies section 2033A(g) (relating to the security requirements for noncitizen qualified heirs) by deleting the cross-reference to section 2033A(i)(3)(M), which does not appear to be appropriate. The provision also makes rules similar to those set forth in section 2032A (h) and (i) (relating to conversions and exchanges of property under sections 1031 and 1033) applicable for purposes of section 2033A. The provision clarifies that, in identifying assets that produce (or are held for the production of) income of a type described in section 543(a), section 543(a) is applied without regard to section 543(a)(2)(B) (the dividend requirement for corporate entities).

The provision clarifies that an interest in property will not be disqualified, in whole or in part, as an interest in a family-owned business where the decedent leases that interest on a net cash basis to a member of the decedent's family who uses the leased property in an active business. The rental income derived by the decedent from the net cash lease in those circumstances is not treated as personal holding company income for purposes of Code section 2057.

### *Effective Date*

The provision is effective with respect to estates of decedents dying after December 31, 1997.

## 8. Clarification of interest on installment payment of estate tax on holding companies (sec. 6007(c) of the 1998 IRS Restructuring Act, sec. 503 of the 1997 Act, and secs. 6166(b)(7)(A) and 6166(b)(8)(A) of the Code)

### *Present and Prior Law*

If certain conditions are met, a decedent's estate may elect to pay the estate tax attributable to certain closely-held businesses over a 14-year period. The 1997 Act provided for a 2-percent interest rate on the estate tax on first $1 million in value of interests in qualified closely-held businesses, and a rate equal to 45 percent of the regular deficiency rate on the amount in excess of the portion eligible for the 2-percent rate, but also provided that none of interest on the deferred payment of estate taxes is deductible for income or estate tax purposes. Interests in holding companies and non-readily-tradeable business interests are not eligible for the 2-percent rate.

### *Explanation of Provision*

The provision clarifies that deferred payments of estate tax on holding companies and non-readily-tradable business interests do not qualify for the 2-percent interest rate, but instead are subject to a rate of 45 percent of the regular deficiency rate. Such interest payments are not deductible for income or estate tax purposes.

### *Effective Date*

The provision generally is effective for decedents dying after December 31, 1997.

### 9. Clarification on declaratory judgment jurisdiction of U.S. Tax Court regarding installment payment of estate tax (sec. 6007(d) of the 1998 IRS Restructuring Act, sec. 505 of the 1997 Act, and sec. 7479(a) of the Code)

#### *Present and Prior Law*

If certain conditions are met, a decedent's estate may elect to pay estate tax attributable to certain closely-held business over a 14-year period. The 1997 Act provided that the U.S. Tax Court would have jurisdiction to determine whether the estate of a decedent qualifies for the 14-year installment payment of estate tax.

#### *Explanation of Provision*

The provision clarifies that the jurisdiction of the U.S. Tax Court to determine whether an estate qualifies for installment payment of estate tax on closely-held businesses extends to determining which businesses in an estate are eligible for the deferral.

#### *Effective Date*

The provision is effective for decedents dying after the date of enactment of the 1997 Act.

### 10. Clarification of rules governing revaluation of gifts (sec. 6007(e) of the 1998 IRS Restructuring Act, sec. 506 of the 1997 Act, and sec. 2504(c) of the Code)

#### *Present and Prior Law*

The valuation of a gift becomes final for gift tax purposes after the statute of limitations on any gift tax assessed or paid has expired. The 1997 Act extended that rule to apply for estate tax purposes, provided for a lengthened statute of limitations for gift tax purposes if certain information is not disclosed with the gift tax return, and provided jurisdiction to the U.S. Tax Court to determine the value of any gift.

#### *Explanation of Provision*

The provision clarifies that in determining the amount of taxable gifts made in preceding calendar periods, the value of prior gifts is the value of such gifts as finally determined, even if no gift tax was assessed or paid on that gift. For this purpose, final determinations include, e.g., the value reported on the gift tax return (if not challenged by the IRS prior to the expiration of the statute of limitations), the value determined by the IRS (if not challenged in court by the taxpayer), the value determined by the courts, or the value agreed to by the IRS and the taxpayer in a settlement agreement.

#### *Effective Date*

The provision is effective with respect to gifts made after the date of enactment of the 1997 Act.

### 11. Clarification with respect to post-mortem conservation easements (sec. 6007(g) of the 1998 IRS Restructuring Act, sec. 508 of the 1997 Act, and sec. 2031(c) of the Code)

#### *Present and Prior Law*

A deduction is allowed for estate tax purposes for a contribution of a qualified real property interest to a charity (or other qualified organization) exclusively for conservation purposes (sec. 2055(f)). The 1997 Act also provided an election to exclude from the taxable estate 40 percent of the value of any land subject to a qualified conservation easement that meets certain requirements. The 1997 Act provided that the executor of the decedent's estate, or the trustee of a trust holding the land, could grant a qualifying easement after the decedent's death, as long as the easement is granted prior to the date of the election (generally, within nine months after the date of the decedent's death).

#### *Explanation of Provision*

The provision clarifies that, in the case of a qualified conservation contribution made after the date of the decedent's death, an estate tax deduction is allowed under section 2055(f). However, no income tax deduction is allowed to the estate or the qualified heirs with respect to such post-mortem conservation easements.

#### *Effective Date*

The provision is effective with respect to estates of decedents dying after December 31, 1997.

### G. Amendments to Title VII of the 1997 Act Relating to Incentives for the District of Columbia (sec. 6008 of the 1998 IRS Restructuring Act, sec. 701 of the 1997 Act, and secs. 1400, 1400B and 1400C of the Code)

#### *Present and Prior Law*

***Designation of D.C. Enterprise Zone***

Certain economically depressed census tracts within the District of Columbia are designated as the "D.C. Enterprise Zone," within which businesses and individual residents are eligible for special tax incentives. The census tracts that compose the D.C. Enterprise Zone for purposes of the wage credit, expensing, and tax-exempt financing incentives include all census tracts that presently are part of the D.C. enterprise community and census tracts within the District of Columbia where the poverty rate is not less than 20 percent. The D.C. Enterprise Zone designation generally will remain in effect for five years for the period from January 1, 1998, through December 31, 2002.

***Empowerment zone wage credit, expensing, and tax-exempt financing***

The following tax incentives generally are available in the D.C. Enterprise Zone: (1) a 20-percent wage credit for the first $15,000 of wages paid to D.C. residents who work in the D.C. Enterprise Zone; (2) an additional $20,000 of expensing under Code section 179 for qualified zone property placed in service by a "qualified D.C. Zone business"; and (3) special tax-exempt financing for certain zone facilities.

***Qualified D.C. Zone business***

For purposes of the increased expensing under section 179, as well as for purposes of the zero percent capital gains rate (described below), a corporation or partnership is a qualified D.C. Zone business if: (1) the sole trade or business of the corporation or partnership is the active conduct of a "qualified business" (defined below) within the D.C. Zone; (2) at least 50 percent (80 percent for purposes of the zero percent capital gains rate) of the total gross income of such entity is derived from the active conduct of a qualified business within the D.C. Zone; (3) a substantial portion of the use of the entity's tangible property (whether owned or leased) is within the D.C. Zone; (4) a substantial portion of the entity's intangible property is used in the active conduct of such business; (5) a substantial portion of the services performed for such entity by its employees are performed within the D.C. Zone; and (6) less than 5 percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to (a) certain financial property, or (b) collectibles not held primarily for sale to customers in the ordinary course of an active trade or business. Similar rules apply to a qualified business carried on by an individual as a proprietorship.

In general, a "qualified business" means any trade or business. However, a "qualified business" does not include any trade or business that consists predominantly of the development or holding of intangibles for sale or license. In addition, a qualified business does not include any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, liquor store, or certain large farms (so-called "excluded businesses"). The rental of residential real estate is not a qualified business. The rental of commercial real estate is a qualified business only if at least 50 percent of the gross rental income from the real property is from qualified D.C. Zone businesses. The rental of tangible personal property to others also is not a qualified business unless at least 50 percent of the rental of such property is by qualified D.C. Zone businesses or by residents of the D.C. Zone.

For purposes of the tax-exempt financing provisions, the term "D.C. Zone business" generally is defined as for purposes of the increased expensing under section 179. However, a qualified D.C. Zone business for purposes of the tax-exempt financing provisions includes a business located in the D.C. Zone that would qualify as a D.C. Zone business if it were separately incorporated. In addition, under a special rule applicable only for purposes of the tax-exempt financing rules, a business is not required to satisfy the requirements applicable to a D.C. Zone business until the end of a startup period if, at the beginning of the startup period, there is a reasonable expectation that the business will be a qualified D.C. Zone business at the end of the startup period and the business makes bona fide efforts to be such a business. With respect to each property financed by a bond issue, the startup period ends at the beginning of the first taxable year beginning more than two years after the later of (1) the date of the bond issue financing such property, or (2) the date the property was placed in service (but in no event more than three years after the date of bond issuance). In addition, if a business satisfies certain requirements applicable to a qualified D.C. Zone business for a three-year testing period following the end of the start-up period and thereafter continues to satisfy certain business requirements, then it will be treated as a qualified D.C. Zone business for all years after the testing period irrespective of whether it satisfies all of the requirements of a qualified D.C. Zone business.

***Zero-percent capital gains rate***

A zero-percent capital gains rate applies to capital gains from the sale of certain qualified D.C. Zone assets held for more than five years. For purposes of the zero-percent capital gains rate, the D.C. Enterprise Zone is defined to include all census tracts within the District of Columbia where the poverty rate is not less than 10 percent. Only capital gain that is attributable to the 10-year period beginning January 1, 1998, and ending December 31, 2007, is eligible for the zero-percent rate.

In general, qualified "D.C. Zone assets" mean stock or partnership interests held in, or tangible property held by, a D.C. Zone business. Such assets must generally be acquired after December 31, 1997, and before January 1, 2003. However, under a special rule, qualified D.C. Zone assets include property that was a qualified D.C. Zone asset in the hands of a prior owner, provided that at the time of acquisition, and during substantially all of the subsequent purchaser's holding period, either (1) substantially all of the use of the property is in a qualified D.C. Zone business, or (2) the property is an ownership interest in a qualified D.C. Zone business.

***First-time homebuyer tax credit***

First-time homebuyers of a principal residence in the District are eligible for a tax credit of up to $5,000 of the amount of the purchase price, except that the credit phases out for individual taxpayers with adjusted gross income ("AGI") between $70,000 and $90,000 ($110,000–$130,000 for joint filers). The credit is available with respect to property purchased after the date of enactment and before January 1, 2001. Any excess credit may be carried forward indefinitely to succeeding taxable years.

## *Explanation of Provision*

***Eligible census tracts***

The provision clarifies that the determination of whether a census tract in the District of Columbia satisfies the applicable poverty criteria for inclusion in the D.C. Enterprise Zone for purposes of the wage credit, expensing, and special tax-exempt financing incentives (poverty rate of not less than 20 percent) or for purposes of the zero-percent capital gains rate (poverty rate of not less than 10 percent) is based on 1990 decennial census data. Thus, data from the 2000 decennial census would not result in the expansion or other reconfiguration of the D.C. Enterprise Zone.

***Qualified D.C. Zone business***

The provision modifies section 1400B(c) to clarify that a proprietorship can constitute a D.C. Zone business for purposes of the zero-percent capital gains rate.

The provision also clarifies that qualified D.C. Zone businesses that take advantage of the special tax-exempt financing incentives do not become subject to a 35-percent zone resident requirement after the close of the testing period.

***Zero-percent capital gains rate***

The provision clarifies that there is no requirement that D.C. Zone business property be acquired by a subsequent purchaser prior to January 1, 2003, to be eligible for the special rule applicable to subsequent purchasers.

In addition, the provision clarifies that the termination of the D.C. Enterprise Zone designation at the end of 2002 will not, by itself, result in property failing to be treated as a qualified D.C. Zone asset for purposes of the zero-percent capital gains rate, provided that the property otherwise continues to qualify were the D.C. Zone designation in effect.

***First-time homebuyer credit***

The provision clarifies that, for purposes of the first-time homebuyer credit, a "first-time homebuyer" means any individual if such individual (and, if married, such individual's spouse) did not have a present ownership interest in a principal residence in the District of Columbia during the one-year period ending on the date of the purchase of the principal residence to which the credit applies.

The provision also clarifies that the phaseout of the credit for individual taxpayers with adjusted gross income between $70,000 and $90,000 ($110,000–$130,000 for joint filers) applies only in the year the credit is generated, and does not apply in subsequent years to which the credit may be carried over.

In addition, the provision clarifies that the term "purchase price" means the adjusted basis of the principal residence on the date the residence is purchased. Newly constructed residences are treated as purchased by the taxpayer on the date the taxpayer first occupies such residence.

The provision clarifies that the first-time homebuyer credit is a nonrefundable personal credit and provides that the first-time homebuyer credit is claimed after the credits described in Code sections 25 (credit for interest on certain home mortgages) and 23 (adoption credit).

Finally, the provision clarifies that the first-time homebuyer credit is available only for property purchased after August 4, 1997, and before January 1, 2001. Thus, the credit is available to first-time home purchasers who acquire title to a qualifying principal residence on or after August 5, 1997, and on or before December 31, 2000, irrespective of the date the purchase contract was entered into.

### *Effective Date*

The provision is effective as of August 5, 1997, the date of enactment of the 1997 Act.

## H. Amendments to Title IX of the 1997 Act Relating to Miscellaneous Provisions

### 1. Clarification of qualification for reduced rate of excise tax on certain hard ciders (sec. 6009(a) of the 1998 IRS Restructuring Act, sec. 908 of the 1997 Act, and sec. 5041 of the Code)

### *Present and Prior Law*

Distilled spirits are taxed at a rate of $13.50 per proof gallon; beer is taxed at a rate of $18 per barrel (approximately 58 cents per gallon); and still wines of 14 percent alcohol or less are taxed at a rate of $1.07 per wine gallon. The Code defines still wines as wines containing not more than 0.392 gram of carbon dioxide per hundred milliliters of wine. Higher rates of tax are applied to wines with greater alcohol content, to sparkling wines (e.g., champagne), and to artificially carbonated wines.

Certain small wineries may claim a credit against the excise tax on wine of 90 cents per wine gallon on the first 100,000 gallons of still wine produced annually (i.e., net tax rate of 17 cents per wine gallon on wines with an alcohol content of 14 percent or less). No credit is allowed on sparkling wines. Certain small breweries pay a reduced tax of $7.00 per barrel (approximately 22.6 cents per gallon) on the first 50,000 barrels of beer produced annually.

The 1997 Act provided a lower excise tax rate of 22.6 cents per gallon on hard cider. Hard cider is defined as a still wine fermented solely from apples or apple concentrate and water, containing no other fruit product and containing at least one-half of one percent and less than 7 percent alcohol by volume. Once fermented, eligible hard cider may not be altered by the addition of other fruit juices, flavor, or other ingredients that alter the flavor that results from the fermentation process. Qualifying small producers that produce 250,000 gallons or less of hard cider and other wines in a calendar year may claim a credit of 5.6 cents per wine gallon on the first 100,000 gallons of hard cider produced. (This credit produces an effective tax rate of 17 cents per gallon, the same effective rate as that applies to small producers of the still wines having an alcohol content of 14 percent or less.)

### *Explanation of Provision*

The provision clarifies that the 22.6-cents-per-gallon tax rate applies only to apple cider that otherwise would be a still wine subject to a tax rate of $1.07 per wine gallon, i.e., still wines having an alcohol content of 14 percent or less.

### *Effective Date*

The provision is effective as if included in the 1997 Act.

### 2. Election for 1987 partnerships to continue exception from treatment of publicly traded partnerships as corporations (sec. 6009(b) of the 1998 IRS Restructuring Act, sec. 964 of the 1997 Act, and sec. 7704 of the Code)

#### *Present and Prior Law*

##### *In general*

In the case of an electing 1987 partnership that elects to be subject to a 3.5-percent tax on gross income from the active conduct of a trade or business, the general rule treating a publicly traded partnership as a corporation does not apply. The 3.5-percent tax was intended to approximate the corporate tax the partnership would pay if it were treated as a corporation for Federal tax purposes.

##### *Tax on partnership*

The 3.5-percent tax is imposed on the electing 1987 partnership (sec. 7704(g)(3)). Prior law did not specifically make inapplicable, however, the general rule that a partnership as such is not subject to income tax, but rather, the partners are liable for the tax in their separate or individual capacities (sec. 701).

##### *Estimated tax payments*

Prior law did not specifically make applicable the requirements for payment of estimated tax that apply generally to payments of corporate tax.

#### *Explanation of Provision*

##### *Tax on partnership*

The provision clarifies that the 3.5-percent tax is paid by the partnership. The general rule of section 701(a) that a partnership as such is not subject to income tax, but rather, the partners are liable for the tax in their separate or individual capacities does not apply to the payment of the 3.5-percent tax by the partnership.

##### *Estimated tax payments*

The provision provides that the corporate estimated tax payment rules of section 6655 are applied to the 3.5-percent tax payable by an electing 1987 partnership in the same manner as if the partnership were a corporation and the tax were imposed under section 11 (relating to corporate tax rates). References in section 11 to taxable income are to be applied for this purpose as if they were references to gross income of the partnership for the taxable year from the active conduct of trades and businesses by the partnership.

#### *Effective Date*

##### *Tax on partnership*

The provision is effective as if enacted with the 1997 Act.

##### *Estimated tax payments*

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

### 3. Depreciation limitations for electric vehicles (sec. 6009(c) of the 1998 IRS Restructuring Act, sec. 971 of the 1997 Act, and sec. 280F of the Code)

#### *Present and Prior Law*

Annual depreciation deductions with respect to passenger automobiles are limited to specified dollar amounts, indexed for inflation. Any cost not recovered during the 6-year recovery period of such vehicles may be recovered during the years succeeding the recovery period, subject to similar limitations. The recovery-period limitations are trebled for vehicles that are propelled primarily by electricity.

#### *Explanation of Provision*

The depreciation limitations applicable to post-recovery periods under section 280F are trebled for vehicles that are propelled primarily by electricity.

#### *Effective Date*

The provision is effective for property placed in service after August 5, 1997 and before January 1, 2005.

### 4. Combined employment tax reporting demonstration project (sec. 6009(d) of the 1998 IRS Restructuring Act, sec. 976 of the 1997 Act, and sec. 6103 of the Code)

#### *Present and Prior Law*

Traditionally, Federal tax forms are filed with the Federal Government and State tax forms are filed with individual states. This necessitates duplication of items common to both returns. Some States have recently been working with the IRS to implement combined State and Federal reporting of certain types of items on one form as a way of reducing the burdens on taxpayers. The State of Montana and the IRS have cooperatively developed a system to combine State and Federal employment tax reporting on one form. The one form would contain exclusively Federal data, exclusively State data, and information common to both: the taxpayer's name, address, TIN, and signature.

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

Implementation of the combined Montana-Federal employment tax reporting project had been hindered under prior law because the IRS interpreted section 6103 to apply that provision's restrictions on disclosure to information common to both the State and Federal portions of the combined form, although these restrictions would not have applied to the State with respect to the State's use of State-requested information if that information were supplied separately to both the State and the IRS.

The 1997 Act permits implementation of a demonstration project to assess the feasibility and desirability of expanding combined reporting in the future. There are several limitations on the demonstration project. First, it is limited to the State of Montana and the IRS. Second, it is limited to employment tax reporting. Third, it is limited to disclosure of the name, address, TIN, and signature of the taxpayer, which is information common to both the Montana and Federal portions of the combined form. Fourth, it is limited to a period of five years.

### *Explanation of Provision*

The provision permits Montana to use this information as if it had collected it separately by eliminating Federal penalties for disclosure of this information. The provision also corrects a cross-reference to the provision.

### *Effective Date*

The provision is effective as of the date of enactment of the 1997 Act (August 5, 1997), and will expire on the date five years after the date of enactment of the 1997 Act.

## 5. Modification of operation of elective carryback of existing net operating losses of the National Railroad Passenger Corporation ("Amtrak") (sec. 6009(e) of the 1998 IRS Restructuring Act and sec. 977 of the 1997 Act)

### *Present and Prior Law*

The 1997 Act provided elective procedures that allow Amtrak to consider the tax attributes of its predecessors (i.e., those railroads that were relieved of their responsibility to provide intercity rail passenger service as a result of the Rail Passenger Service Act of 1970) in the use of Amtrak's net operating losses. The benefit allowable under these procedures is limited to the least of: (1) 35 percent of Amtrak's existing qualified carryovers, (2) the net tax liability for the carryback period, or (3) $2,323,000,000. One half of the amount so calculated will be treated as a payment of the tax imposed by chapter 1 of the Internal Revenue Code of 1986 for Amtrak's taxable year ending December 31, 1997, and a similar amount for Amtrak's taxable year ending December 31, 1998.

The availability of the elective procedures is conditioned on Amtrak (1) agreeing to make payments of one percent of the amount it receives to each of the non-Amtrak States to offset certain transportation related expenditures and (2) using the balance for certain qualified expenses. Non-Amtrak States are those States that are not receiving Amtrak service at any time during the period beginning on the date of enactment and ending on the date of payment.

### *Explanation of Provision*

The provision provides that the term "non-Amtrak State" means any State that is not receiving intercity passenger rail service from

Amtrak as of the date of enactment of the 1997 Act (August 5, 1997). Thus, a State does not lose its status as a non-Amtrak State with respect to any payment by reason of acquiring Amtrak service with any payment from Amtrak under the 1997 Act provision.

### *Effective Date*

The provision is effective as if included in section 977 of the 1997 Act.

## I. Amendments to Title X of the 1997 Act Relating to Revenue-Raising Provisions

### 1. Exception from constructive sales rules for certain debt positions (sec. 6010(a)(1) of the 1998 IRS Restructuring Act, sec. 1001(a) of the 1997 Act, and sec. 1259(b)(2) of the Code)

### *Present and Prior Law*

A taxpayer is required to recognize gain (but not loss) upon entering into a constructive sale of an "appreciated financial position," which generally includes an appreciated position with respect to any stock, debt instrument or partnership interest. An exception is provided for positions with respect to debt instruments that have an unconditionally payable principal amount, that are not convertible into the stock of the issuer or a related person, and the interest on which is either fixed, payable at certain variable rates or based on certain interest payments on a pool of mortgages.

### *Explanation of Provision*

The provision clarifies that, to qualify for the exception for positions with respect to debt instruments, the position would either have to meet the requirements as to unconditional principal amount, non-convertibility and interest terms or, alternatively, be a hedge of a position meeting these requirements. A hedge for purposes of the provision includes any position that reduces the taxpayer's risk of interest rate or price changes or currency fluctuations with respect to another position.

### *Effective Date*

The provision is generally effective for constructive sales entered into after June 8, 1997.

### 2. Definition of forward contract under constructive sales rules (sec. 6010(a)(2) of the 1998 IRS Restructuring Act, sec. 1001(a) of the 1997 Act, and sec. 1259(d)(1) of the Code)

### *Present and Prior Law*

A constructive sale of an appreciated financial position generally results when the taxpayer enters into a forward contact to deliver the same or substantially identical property. A forward contract for this purpose is defined as a contract that provides for delivery of a substantially fixed amount of property at a substantially fixed price.

### *Explanation of Provision*

The provision clarifies that the definition of a forward contract includes a contract that provides for cash settlement with respect to a substantially fixed amount of property at a substantially fixed price.

### *Effective Date*

The provision is generally effective for constructive sales entered into after June 8, 1997.

## 3. Treatment of mark-to-market gains of electing traders (sec. 6010(a)(3) of the 1998 IRS Restructuring Act, sec. 1001(b) of the 1997 Act, and sec. 475(f)(1)(D) of the Code)

### *Present and Prior Law*

Securities and commodities traders may elect application of the mark-to-market accounting rules. Gain or loss recognized by an electing taxpayer under these rules is treated as ordinary gain or loss.

Under the Self-Employment Contributions Act ("SECA"), a tax is imposed on an individual's net earnings from self-employment ("NESE"). Gain or loss from the sale or exchange of a capital asset is excluded from NESE.

A publicly-traded partnership generally is treated as a corporation for Federal tax purposes. An exception to this rule applies if 90 percent or more of the partnership's gross income consists of passive-type income, which includes gain from the sale or disposition of a capital asset.

### *Explanation of Provision*

The provision clarifies that gain or loss of a securities or commodities trader that is treated as ordinary solely by reason of election of mark-to-market treatment is not treated as other than gain or loss from a capital asset for purposes of determining NESE for SECA tax purposes, determining whether the passive-type income exception to the publicly-traded partnership rules is met or for purposes of any other Code provision specified by the Treasury Department in regulations.

### *Effective Date*

The provision applies to taxable years of electing securities and commodities traders ending after the date of enactment of the 1997 Act.

### 4. Special effective date for constructive sale rules (sec. 6010(a)(4) of the 1998 IRS Restructuring Act, sec. 1001(d) of the 1997 Act, and sec. 1259 of the Code)

#### *Present and Prior Law*

The constructive sales rules contain a special effective date provision for decedents dying after June 8, 1997, if (1) a constructive sale of an appreciated financial position occurred before such date, (2) the transaction remains open for not less than two years, (3) the transaction remains open at any time during the three years prior to the decedent's death, and (4) the transaction is not closed within the 30-day period beginning on the date of enactment of the 1997 Act. If the requirements of the special effective date provision are met, both the appreciated financial position and the transaction resulting in the constructive sale are generally treated as property constituting rights to receive income in respect of a decedent under section 691. However, gain with respect to a position in a constructive sale transaction that accrues after the transaction is closed is not included in income in respect of a decedent.

#### *Explanation of Provision*

The provision clarifies the special effective date rule to provide that the rule does not apply if the constructive sale transaction is closed at any time prior to the end of the 30th day after the date of enactment of the 1997 Act.

#### *Effective Date*

The provision is effective for decedents dying after June 8, 1997.

### 5. Gain recognition for certain extraordinary dividends (sec. 6010(b) of the 1998 IRS Restructuring Act, sec. 1011 of the 1997 Act, and sec. 1059 of the Code)

#### *Present and Prior Law*

A corporate shareholder generally can deduct at least 70 percent of a dividend received from another corporation. This dividends received deduction is 80 percent if the corporate shareholder owns at least 20 percent of the distributing corporation and generally 100 percent if the shareholder owns at least 80 percent of the distributing corporation.

Section 1059 of the Code requires a corporate shareholder that receives an "extraordinary dividend" to reduce the basis of the stock with respect to which the dividend was received by the nontaxed portion of the dividend. Whether a dividend is "extraordinary" is determined, among other things, by reference to the size of the dividend in relation to the adjusted basis of the shareholder's stock. In addition, dividends resulting from non pro rata redemptions, partial liquidations, and certain other redemptions are extraordinary dividends. Pursuant to a provision of the 1997 Act, gain is recognized to the extent the reduction in basis of stock exceeds the basis in the stock with respect to which an extraordinary dividend is received. Prior to the 1997 Act, the recognition of such gain generally was deferred until the stock to which the adjustment related was sold or disposed of.

The consolidated return regulations provide basis adjustment rules with respect to dividends paid within a consolidated group of corporations. These rules provide that a dividend paid from one member of a group to its parent reduces the parent's basis in the stock of the payor and if such reduction exceeds the parent's basis, an "excess loss account" is created or increased. Excess loss accounts generally are not restored to income until the occurrence of certain specified events (e.g., when the corporation to which the excess loss account relates leaves the consolidated group). Legislative history indicates that, except as provided in regulations, the extraordinary dividend provisions do not apply to result in a double reduction in basis in the case of distributions between members of an affiliated group filing consolidated returns or in the double inclusion of earnings and profits.

### *Explanation of Provision*

The provision provides the Treasury Department regulatory authority to coordinate the basis adjustment rules of section 1059 and the consolidated return regulations. Congress intended that, except as provided in regulations to be issued, section 1059 does not cause current gain recognition to the extent that the consolidated return regulations require the creation or increase of an excess loss account with respect to a distribution. Thus, current Treas. Reg. sec. 1.1059(e)–1(a) does not result in gain recognition with respect to distributions within a consolidated group to the extent such distribution results in the creation or increase of an excess loss account under the consolidated return regulations.

### *Effective Date*

The provision generally is effective for distributions after May 3, 1995.

## 6. Treatment of certain corporate distributions (sec. 6010(c) of the 1998 IRS Restructuring Act, sec. 1012 of the 1997 Act, and secs. 355, 358(c), 351(c) and 368(a) of the Code)

### *Present and Prior Law*

The 1997 Act (sec. 1012(a)) requires a distributing corporation ("distributing") to recognize corporate level gain on the distribution of stock of a controlled corporation ("controlled") under section 355 of the Code if, pursuant to a plan or series of related transactions, one or more persons acquire a 50-percent or greater interest (defined as 50 percent or more of the voting power or value of the stock) of either the distributing or controlled corporation (Code sec. 355(e)). Certain transactions are excepted from the definition of acquisition for this purpose, including, under section 355(e)(3)(A)(iv), the acquisition by a person of stock in a corporation if shareholders owning directly or indirectly stock possessing more than 50 percent of the voting power and more than 50 percent of the value of the stock in distributing or any controlled corporation before such acquisition own directly or indirectly stock possessing such vote and value in such distributing or controlled corporation after such acquisition.[83]

In the case of a 50-percent or more acquisition of either the distributing corporation or the controlled corporation, the amount of gain recognized is the amount that the distributing corporation would have recognized had the stock of the controlled corporation been sold for fair market value on the date of the distribution. The Conference Report to the 1997 Act states that no adjustment to the basis of the stock or assets of either corporation is allowed by reason of the recognition of the gain.[84]

The 1997 Act (sec. 1012(b)(1)) also provides that, except as provided in regulations, section 355 shall not apply to the distribution of stock from one member of an affiliated group of corporations (as defined in section 1504(a)) to another member of such group (an intragroup spin-off) if such distribution is part of a such a plan or series of related transactions pursuant to which one or more persons acquire stock representing a 50-percent or greater interest in a distributing or controlled corporation, determined after the application of the rules of section 355(e).

In addition, the 1997 Act (sec. 1012(b)(2)) provides that in the case of any distribution of stock of one member of an affiliated group of corporations to another member under section 355, the Treasury Department has regulatory authority under section 358(g) to provide adjustments to the basis of any stock in a corporation which is a member of such group, to reflect appropriately the proper treatment of such distribution.

The 1997 Act (sec. 1012(c)) also modified certain rules for determining control immediately after a distribution in the case of certain divisive transactions in which a controlled corporation is distributed and the transaction meets the requirements of section 355. In such cases, under section 351 and modified section 368(a)(2)(H) with respect to reorganizations under section 368(a)(1)(D), those shareholders receiving stock in the distributed corporation are treated as in control of the distributed corporation immediately after the distribution if they hold stock representing a greater than 50 percent interest in the vote and value of stock of the distributed corporation.

The effective date (1997 Act section 1012(d)(1)) states that the forgoing provisions of the 1997 Act apply to distributions after April 16, 1997, pursuant to a plan (or series of related transactions) which involves an acquisition occurring after such date (unless certain transition provisions apply).

### *Explanation of Provision*

#### *Acquisition of a 50-percent or greater interest*

The provision clarifies that the acquisitions described in Code section 355(e)(3)(A) are disregarded in determining whether there

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[83] This exception (as certain other exceptions) does not apply if the stock held before the acquisition was acquired pursuant to a plan (or series of related transactions) to acquire a 50-percent or greater interest in the distributing or a controlled corporation.

[84] The 1997 Act does not limit the otherwise applicable Treasury regulatory authority under section 336(e) of the Code. Nor does it limit the otherwise applicable provisions of section 1367 with respect to the effect on shareholder stock basis of gain recognized by an S corporation under this provision.

has been an acquisition of a 50-percent or greater interest in a corporation. However, other transactions that are part of a plan or series of related transactions could result in an acquisition of a 50-percent or greater interest.

In the case of acquisitions under section 355(e)(3)(A)(iv), the provision clarifies that the acquisition of stock in the distributing corporation or any controlled corporation is disregarded to the extent that the percentage of stock owned directly or indirectly in such corporation by each person owning stock in such corporation immediately before the acquisition does not decrease.

*Example:* Shareholder A owns 10 percent of the vote and value of the stock of corporation D (which owns all of corporation C). There are nine other equal shareholders of D. A also owns 100 percent of the vote and value of the stock of unrelated corporation P. D distributes C to all the shareholders of D. Thereafter, pursuant to a plan or series of related transactions, D (worth 100x) merges with corporation P (worth 900x). After the merger, each of the former shareholders of corporation D owns stock of the merged entity reflecting the vote and value attributable to that shareholder's respective 10 percent former stock ownership of D. Each of the former shareholders of D owns 1 percent of the stock of the merged corporation, except that shareholder A (who owned 100 percent of corporation P and 10 percent of corporation D before the merger) now owns 91 percent of the stock of the merged corporation. In determining whether a 50-percent or greater interest in D has been acquired, the interest of each of the continuing shareholders is disregarded only to the extent there has been no decrease in such shareholder's direct or indirect ownership. Thus, the 10-percent interest of A, and the 1-percent interest of each of the nine other former shareholder of D, is not counted. The remaining 81 percent ownership of the merged corporation, representing a decrease of nine percent in the interests of each of the nine former shareholders other than A, is counted in determining the extent of an acquisition. Therefore, a 50-percent or greater interest in D has been acquired.

### *Treasury regulatory authority*

The provision also clarifies that the regulatory authority of the Treasury Department under section 358(c) applies to distributions after April 16, 1997, without regard to whether a distribution involves a plan (or series of related transactions) which involves an acquisition. As stated in the Conference Report to the 1997 Act, with respect to the Treasury Department regulatory authority under section 358(c) as applied to intragroup spin-off transactions that are not part of a plan or series of related transactions that involve an acquisition of a 50-percent or greater interest under new section 355(f), it is expected that any Treasury regulations will be applied prospectively, except in cases to prevent abuse.

### *Section 351(c) and section 368(a)(2)(H) "control immediately after" requirement*

In general, the 1997 Act modifications to the control immediately after requirement of Section 351(c) and section 368(a)(2)(H) were intended to minimize certain differences in the results of a transaction involving a contribution of assets to controlled corporation prior to a section 355 spin-off that could occur depending on whether the distributing or controlled corporation were acquired subsequent to the spin-off.

The provision clarifies that in the case of certain divisive transactions in which a corporation contributes assets to a controlled corporation and then distributes the stock of the controlled corporation in a transaction that meets the requirements of section 355 (or so much of section 356 as relates to section 355), solely for purposes of determining the tax treatment of the transfers of property to the controlled corporation by the distributing corporation, the fact that the shareholders of the distributing corporation dispose of part or all of the distributed stock, or the fact that the corporation whose stock was distributed issues additional stock,[85] shall not be taken into account for purposes of the control immediately after requirement of section 351(a) or 368(a)(1)(D).

For purposes of determining the tax treatment of transfers of property to the controlled corporation by parties other than the distributing corporation, the disposition of part or all of the distributed stock continues to be taken into account, as under prior law, in determining whether the control immediately after requirement is satisfied.

*Example 1:* Distributing corporation D transfers appreciated business X to subsidiary C in exchange for 100 percent of C stock. D distributes its stock of C to D shareholders. As part of a plan or series of related transactions, C merges into unrelated acquiring corporation A, and the C shareholders receive 25 percent of the vote or value of A stock. If the requirements of section 355 are met with respect to the distribution, then the control immediately after requirement will be satisfied solely for purposes of determining the tax treatment of the transfers of property by D to C. Accordingly, the business X assets transferred to C and held by A after the merger will have a carryover basis from D. Section 355(e) will require D to recognize gain as if the C stock had been sold at fair market value.

*Example 2:* Distributing corporation D transfers appreciated business X to subsidiary C in exchange for 85 percent of C stock. Unrelated persons transfer appreciated assets to C in exchange for the remaining 15 percent of C stock. D distributes all its stock of C to D shareholders. As part of a plan or series of related transactions, C merges into acquiring corporation A; and the interests attributable to the D shareholders' receipt of C stock with respect to their D stock in the distribution represent 25 percent of the vote and value of A stock. If the requirements of section 355 are met with respect to the distribution, then the control immediately after requirement will be satisfied solely for purposes of determining the tax treatment of the transfers of property by D to C. Section 355(e) will require recognition of gain as if the C stock had been sold for fair market value. The business X assets transferred to C and held by A after the merger will have a carryover basis from D. The persons other than D who transferred assets to C for 15 percent of C

[85] This portion of the provision (relating to the fact that the corporation whose stock was distributed issues additional stock) reflects the technical correction enacted in section 4003(f) of the Tax and Trade Relief Extension Act of 1998, described in Part Three of this publication.

stock will recognize gain on the appreciation in their assets transferred to C if the control immediately after requirement is not satisfied after taking into account any post-spin-off dispositions that would have been taken into account under prior law.

*Example 3:* The facts are the same as in example 2, except that the interests attributable to the D shareholders' receipt of C stock with respect to their D stock in the distribution represent 55 percent of the vote and value of A stock in the merger. If the requirements of section 355 are met with respect to the distribution, then the control immediately after requirement will be satisfied solely for purposes of determining the tax treatment of the transfers by D to C. The business X assets in C (and in A after the merger) will therefore have a carryover basis from D. Because the D shareholders retain more than 50 percent of the stock of A, section 355(e) will not apply. The persons other than D who transferred property for the 15 percent of C stock will recognize gain on the appreciation in their assets transferred to C if the control immediately after requirement is not satisfied after taking into account any post-spin-off dispositions that would have been taken into account under prior law.

### *Effective Date*

The provision generally is effective for distributions after April 16, 1997.

### 7. Application of section 304 to certain international transactions (sec. 6010(d) of the 1998 IRS Restructuring Act, sec. 1013 of the 1997 Act, and sec. 304 of the Code)

### *Present and Prior Law*

Under section 304, if one corporation purchases stock of a related corporation, the transaction generally is recharacterized as a redemption. Under section 304(a), as amended by the 1997 Act, to the extent that a section 304 transaction is treated as a distribution under section 301, the transferor and the acquiring corporation are treated as if (1) the transferor had transferred the stock involved in the transaction to the acquiring corporation in exchange for stock of the acquiring corporation in a transaction to which section 351(a) applies, and (2) the acquiring corporation had then redeemed the stock it is treated as having issued. In the case of a section 304 transaction, both the amount which is a dividend and the source of such dividend is determined as if the property were distributed by the acquiring corporation to the extent of its earnings and profits and then by the issuing corporation to the extent of its earnings and profits (sec. 304(b)(2)). Section 304(b)(5), as added by the 1997 Act, provides special rules that apply if the acquiring corporation in a section 304 transaction is a foreign corporation. Under section 304(b)(5), the earnings and profits of the acquiring corporation that are taken into account are limited to the portion of such earnings and profits that (1) is attributable to stock of such acquiring corporation held by a corporation or individual who is the transferor (or a person related thereto) and who is a U.S. shareholder (within the meaning of sec. 951(b)) of such corporation and (2) was accumulated during periods in which such stock was owned by such person while such acquiring corporation was a controlled foreign corporation. For purposes of this rule, except as otherwise provided by the Secretary of the Treasury, the rules of section 1248(d) (relating to certain exclusions from earnings and profits) apply. The Secretary is to prescribe regulations as appropriate, including regulations determining the earnings and profits that are attributable to particular stock of the acquiring corporation.

For foreign tax credit purposes, under section 902, a U.S. corporation that receives a dividend from a foreign corporation in which it owns at least 10 percent of the voting stock is treated as if it had paid the foreign income taxes paid by the foreign corporation which are attributable to such dividend. The Internal Revenue Service issued rulings providing that a domestic corporation that is a transferor in a section 304 transaction may compute foreign taxes deemed paid under section 902 on the dividends from both a foreign acquiring corporation and a foreign issuing corporation. Rev. Rul. 92–86, 1992–2 C.B. 199; Rev. Rul. 91–5, 1991–1 C.B. 114. Both rulings involve section 304 transactions in which both the domestic transferor and the foreign acquiring corporation are wholly owned by a domestic parent corporation.

### *Explanation of Provision*

Under the provision, in the case of a section 304 transaction in which the acquiring corporation or the issuing corporation is a foreign corporation, the Secretary of the Treasury is to prescribe regulations providing rules to prevent the multiple inclusion of an item of income and to provide appropriate basis adjustments, including rules modifying the application of sections 959 and 961 in the case of a section 304 transaction. It is expected that such regulations will provide for an exclusion from income for distributions from earnings and profits of the acquiring corporation and the issuing corporation that represent previously taxed income under subpart F. It further is expected that such regulations will provide for appropriate adjustments to the basis of stock held by the corporation treated as receiving the distribution or by the corporation that had the prior inclusion with respect to the previously taxed income. No inference is intended regarding the treatment of previously taxed income in a section 304 transaction under prior law. The 1997 Act amendments to section 304, including the modifications under this provision, are not intended to change the foreign tax credit results reached in Rev. Rul. 92–86 and 91–5.

The provision also eliminates the cross-reference to the rules of section 1248(d) for purposes of determining the earnings and profits to be taken into account under section 304(b)(5).

### *Effective Date*

The provision generally is effective for distributions or acquisitions after June 8, 1997.

### 8. Certain preferred stock treated as "boot"—treatment of transferor (sec. 6010(e)(1) of the 1998 IRS Restructuring Act, sec. 1014 of the 1997 Act, and sec. 351(g) of the Code)

#### *Present and Prior Law*

The 1997 Act amended section 351 of the Code to provide that in the case of a person who transfers property to a controlled corporation and receives nonqualified preferred stock, section 351(b) will apply to such person. Section 351(b) provides that if section 351(a) of the Code would apply to an exchange but for the fact that there is received, in addition to stock permitted to be received under section 351(a), other property or money, then gain but no loss to such recipient shall be recognized. The Conference Report to the 1997 Act states that if nonqualified preferred stock is received, gain but not loss shall be recognized.

#### *Explanation of Provision*

The provision clarifies that section 351(b) applies to a transferor who transfers property in a section 351 exchange and receives nonqualified preferred stock in addition to stock that is not treated as "other property" under that section. Thus, if a transferor received only nonqualified preferred stock but the transaction in the aggregate otherwise qualified as a section 351 exchange, such a transferor would recognize loss and the basis of the nonqualified preferred stock and of the property in the hands of the transferee corporation would reflect the transaction in the same manner as if that particular transferor had received solely "other property" of any other type. As under the 1997 Act, the nonqualified preferred stock continues to be treated as stock received by a transferor for purposes of qualification of a transaction under section 351(a), unless and until regulations may provide otherwise.

#### *Effective Date*

The provision applies to transactions after June 8, 1997.

### 9. Certain preferred stock treated as "boot"—statute of limitations (sec. 6010(e)(2) of the 1998 IRS Restructuring Act, sec. 1014 of the 1997 Act, and sec. 354(a) of the Code)

#### *Present and Prior Law*

Under the 1997 Act, certain preferred stock received in otherwise tax-free transactions is treated as "other property." Exchanges of stock in certain recapitalizations of family-owned corporations are excepted from this rule. A family-owned corporation is defined as any corporation if at least 50 percent of the total voting power and value of the stock of such corporation is owned by the same family for five years preceding the recapitalization. In addition, a recapitalization does not qualify for the exception if the same family does not own 50 percent of the total voting power and value of the stock throughout the three-year period following the recapitalization.

### *Explanation of Provision*

The provision provides that the statutory period for the assessment of any deficiency attributable to a corporation failing to be a family-owned corporation shall not expire before the expiration of three years after the date the Secretary of the Treasury is notified by the corporation (in such manner as the Secretary may prescribe) of such failure, and such deficiency may be assessed before the expiration of such three-year period notwithstanding the provisions of any other law or rule of law which would otherwise prevent such assessment.

### *Effective Date*

The provision applies to transactions after June 8, 1997.

## 10. Establish IRS continuous levy and improve debt collection (sec. 6010(f) of the 1998 IRS Restructuring Act, secs. 1024, 1025, and 1026 of the 1997 Act, and secs. 6331 and 6334 of the Code)

### *Present and Prior Law*

If any person is liable for any internal revenue tax and does not pay it within 10 days after notice and demand by the IRS, the IRS may then collect the tax by levy upon all property and rights to property belonging to the person, unless there is an explicit statutory restriction on doing so. A levy is the seizure of the person's property or rights to property. A levy on salary and wages is continuous from the date it is first made until the date it is fully paid or becomes unenforceable.

The 1997 Act provided that a continuous levy is also applicable to non-means tested recurring Federal payments and specified wage replacement payments.

### *Explanation of Provision*

The provision clarifies that the IRS must approve the use of a continuous levy before it may take effect.

### *Effective Date*

The provision is effective for levies issued after the date of enactment of the 1997 Act (August 5, 1997).

## 11. Clarification regarding aviation gasoline excise tax (sec. 6010(g) of the 1998 IRS Restructuring Act, sec. 1031 of the 1997 Act, and sec. 6421 of the Code)

### *Present and Prior Law*

Before enactment of the 1997 Act, aviation gasoline was subject to a 19.3-cents-per-gallon tax rate, with 15 cents per gallon being deposited in the Airport and Airway Trust Fund and 4.3 cents per gallon being retained in the General Fund. The 1997 Act extended the 15-cents-per-gallon rate for 10 years, through September 30, 2007, and expanded deposits to the Trust Fund to include revenues from the 4.3-cents-per-gallon rate. The tax does not apply to fuel used in flight segments outside the United States or to flight segments from the United States to foreign countries.

### *Explanation of Provisions*

The provision clarifies the application of the gasoline tax refund provisions to aviation gasoline used in flight segments outside the United States and to flight segments from the United States to foreign countries.

A second provision clarifies of the rules under which aviation grade kerosene may be removed for use as aviation fuel without payment of the highway excise taxes.

### *Effective Date*

The provisions are effective as if included in the 1997 Act.

## 12. Clarification of requirement that registered fuel terminals offer dyed fuel (sec. 6010(h) of the 1998 IRS Restructuring Act, sec. 1032 of the 1997 Act and sec. 4101 of the Code)

### *Present and Prior Law*

The 1997 Act provides that fuel terminals are eligible to register to handle non-tax-paid diesel fuel and kerosene only if the terminal operator offers both undyed (taxable) and dyed (nontaxable) fuel.[86]

### *Explanation of Provision*

The provision clarifies that the Code requires terminals eligible to handle non-tax-paid diesel to offer dyed diesel fuel and terminals eligible to handle non-tax-paid kerosene (including diesel fuel #1 and kerosene-type aviation fuel) to offer dyed kerosene. The dyed fuel rule does not require that a terminal offer for sale kerosene as a condition of receiving diesel fuel on a non-tax-paid basis. Similarly, the dyed fuel rule does not require terminals that sell only kerosene to offer diesel fuel as a condition of receiving non-tax-paid kerosene.

### *Effective Date*

The provision is effective as if included in the 1997 Act.

## 13. Clarification of treatment of prepaid telephone cards (sec. 6010(i) of the 1998 IRS Restructuring Act, sec. 1034 of the 1997 Act, and sec. 4251 of the Code)

### *Present and Prior Law*

A 3-percent excise tax is imposed on amounts paid for local and toll (long-distance) telephone service and teletypewriter exchange service. The tax is collected by the provider of the service from the consumer. In the case of so-called "prepaid telephone cards," the tax is treated as paid when the card is transferred by any tele-

[86] The effective date of the requirement that terminals offer dyed fuel is delayed two years, to July 1, 2000, under section 9008 of the Transportation Equity Act for the 21st Century, described in Part One of this publication.

communications carrier to any person who is not a telecommunications carrier.

A "prepaid telephone card" is defined as any card or other similar arrangement which permits its holder to obtain communications services and pay for such services in advance.

### *Explanation of Provision*

The provision inserts the word "any" prior to "other similar arrangement" to clarify that payment to a telecommunications carrier from a third party such as a joint venture credit card company is treated as payment made by the holder of the credit card to obtain communication services and the tax is treated as paid in a manner similar to that applied to prepaid telephone cards. The tax applies to payments if the rights to telephone service for which payments are made can be used in whole or in part for telephone service that, if purchased directly, would be subject to the 3-percent excise tax on telephone service. Also, the tax applies without regard to whether telephone service ultimately is provided pursuant to the transferred rights.

### *Effective Date*

The provision is effective as if included in the 1997 Act.

## 14. Modify UBIT rules applicable to second-tier subsidiaries (sec. 6010(j) of the 1998 IRS Restructuring Act, sec. 1041 of the 1997 Act, and sec. 512(b)(13) of the Code)

### *Present and Prior Law*

In general, interest, rents, royalties and annuities are excluded from the unrelated business income ("UBI") of tax-exempt organizations. However, section 512(b)(13) treats otherwise excluded rent, royalty, annuity, and interest income as UBI if such income is received from a taxable or tax-exempt subsidiary that is controlled by the parent tax-exempt organization.

Under the provision, interest, rent, annuity, or royalty payments made by a controlled entity to a tax-exempt organization are subject to the unrelated business income tax to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity. In this regard, section 512(b)(13)(B)(i)(I) cross references a non-existent Code section.

The provision generally applies to taxable years beginning after the date of enactment. However, the provision does not apply to payments made during the first two taxable years beginning on or after the date of enactment if such payments are made pursuant to a binding written contract in effect as of June 8, 1997, and at all times thereafter before such payment.

### *Explanation of Provision*

The provision clarifies that rent, royalty, annuity, and interest income that would otherwise be excluded from UBI is included in UBI under section 512(b)(13) if such income is received or accrued from a taxable or tax-exempt subsidiary that is controlled by the parent tax-exempt organization. The provision further clarifies that the provision does not apply to any payment received or accrued during the first two taxable years beginning on or after the date of enactment if such payment is received or accrued pursuant to a binding written contract in effect on June 8, 1997, and at all times thereafter before such payment (but not pursuant to any contract provision that permits optional accelerated payments).

### *Effective Date*

The provision is effective as of August 5, 1997, the date of enactment of the 1997 Act.

### 15. Application of foreign tax credit holding period rule to RICs and clarification of exception from such rule for securities dealers (sec. 6010(k) of the 1998 IRS Restructuring Act, sec. 1053 of the 1997 Act, and secs. 853 and 901 of the Code)

### *Present and Prior Law*

Section 901(k), as added by the 1997 Act, generally imposes a holding period requirement for claiming foreign tax credits with respect to dividends. Under section 901(k), foreign tax credits with respect to a dividend from a foreign corporation or a regulated investment company (a "RIC") are disallowed if the shareholder has not held the stock for more than 15 days in the case of common stock or more than 45 days in the case of preferred stock. This disallowance applies both to foreign tax credits for foreign withholding taxes that are paid on the dividend where the dividend-paying stock is not held for the required period and to indirect foreign tax credits for taxes paid by a lower-tier foreign corporation or a RIC where any of the stock in the required chain of ownership is not held for the required period. Foreign taxes for which credits are disallowed under section 901(k) may be deducted.

Under section 853, a RIC may elect to flow through to its shareholders the foreign tax credits for foreign taxes paid by the RIC. Under this election, the RIC is not entitled to a deduction or credit for foreign taxes paid; the shareholders of an electing RIC are treated as having paid their proportionate shares of the foreign taxes paid by the RIC. Accordingly, foreign tax credits are claimed at the shareholder level and not at the RIC level.

Section 901(k)(4), "Exception for certain taxes paid by securities dealers," provides an exception from the section 901(k) holding period requirement for foreign tax credits with respect to certain dividends received on stock held in the active conduct of a securities business in a foreign country. The Ways and Means and Finance committee reports provide that the exception is available only for dividends received on "stock which the shareholder holds in its capacity as a dealer in securities." [87]

### *Explanation of Provision*

Under the provision, the flow-through election of section 853 does not apply to any foreign taxes paid by the RIC for which a credit

[87] H. Rept. 105–148, 105th Cong., 1st Sess. 546 (1997); S. Rept. 105–33, 105th Cong., 1st Sess. 176 (1997).

is disallowed under section 901(k) because the RIC did not satisfy the applicable holding period. Accordingly, such taxes are deductible at the RIC level. The election of section 853 applies only to foreign taxes with respect to which the RIC has satisfied any applicable holding period requirement.

The provision clarifies that the exception of section 901(k)(4) is available only for dividends received on stock that the shareholder holds in its capacity as a dealer in securities.

### *Effective Date*

The provision is effective for dividends paid or accrued more than 30 days after the date of enactment of the 1997 Act.

## 16. Clarification of provision expanding the limitations on deductibility of premiums and interest with respect to life insurance, endowment, and annuity contracts (sec. 6010(o) of the 1998 IRS Restructuring Act, sec. 1084 of the 1997 Act, and sec. 264 of the Code)

### *Present and Prior Law*

#### *Master contracts*

The 1997 Act provided limitations on the deductibility of interest and premiums with respect to life insurance, endowment and annuity contracts. Under the pro rata interest disallowance provision added by the Act, an exception is provided for any policy or contract owned by an entity engaged in a trade or business, covering an individual who is an employee, officer or director of the trade or business at the time first covered. The exception applies to any policy or contract owned by an entity engaged in a trade or business, which covers one individual who (at the time first insured under the policy or contract) is (1) a 20-percent owner of the entity, or (2) an individual (who is not a 20-percent owner) who is an officer, director or employee of the trade or business.[88] Prior law was silent as to the treatment of coverage of such an individual under a master contract.

#### *Reporting*

The provision does not apply to any policy or contract held by a natural person; however, if a trade or business is directly or indirectly the beneficiary under any policy or contract, the policy or contract is treated as held by the trade or business and not by a natural person. In addition, the provision includes a reporting requirement. Specifically, the provision provides that the Treasury Secretary shall require such reporting from policyholders and issuers as is necessary to carry out the rule applicable when the trade or business is directly or indirectly the beneficiary under any policy or contract held by a natural person. Any report required under this reporting requirement is treated as a statement referred to in Code section 6724(d)(1) (relating to information returns). Prior

[88] The exception also applies in the case of a joint-life policy or contract under which the sole insureds are a 20-percent owner and the spouse of the 20-percent owner. A joint-life contract under which the sole insureds are a 20-percent owner and his or her spouse is the only type of policy or contract with more than one insured that comes within the exception.

law did not specifically refer to Code section 6724(d)(2) (relating to payee statements).

### *Additional covered lives*

The 1997 Act provision limiting the deductibility of certain interest and premiums is effective generally with respect to contracts issued after June 8, 1997. To the extent of additional covered lives under a contract after June 8, 1997, the contract is treated as a new contract.

## *Explanation of Provision*

### *Master contracts*

The provision clarifies that if coverage for each insured individual under a master contract is treated as a separate contract for purposes of sections 817(h), 7702, and 7702A of the Code, then coverage for each such insured individual is treated as a separate contract, for purposes of the exception to the pro rata interest disallowance rule for a policy or contract covering an individual who is a 20-percent owner, employee, officer or director of the trade or business at the time first covered. A master contract does not include any contract if the contract (or any insurance coverage provided under the contract) is a group life insurance contract within the meaning of Code section 848(e)(2). No inference is intended that coverage provided under a master contract, for each such insured individual, is not treated as a separate contract for each such individual for other purposes under prior law.

### *Reporting*

The provision clarifies that the required reporting to the Treasury Secretary is an information return (within meaning of sec. 6724(d)(1)), and any reporting required to be made to any other person is a payee statement (within the meaning of sec. 6724(d)(2)). Thus, the $50-per-report penalty imposed under sections 6722 and 6723 of the Code for failure to file or provide such an information return or payee statement apply. It is clarified that the Treasury Secretary may require reporting by the issuer or policyholder of any relevant information either by regulations or by any other appropriate guidance (including but not limited to publication of a form).

### *Additional covered lives*

The provision clarifies that the treatment of additional covered lives under the effective date of the 1997 Act provision applies only with respect to coverage provided under a master contract, provided that coverage for each insured individual is treated as a separate contract for purposes of Code sections 817(h), 7702 and 7702A, and the master contract or any coverage provided thereunder is not a group life insurance contract within the meaning of Code section 848(e)(2).

## *Effective Date*

The provisions are effective as if included in the 1997 Act.

### 17. Clarification of allocation of basis of properties distributed to a partner by a partnership (sec. 6010(m) of the 1998 IRS Restructuring Act, sec. 1061 of the 1997 Act, and sec. 732(c) of the Code)

#### *Present and Prior Law*

Present law, as amended by the 1997 Act, provides rules for allocating basis to property in the hands of a partner that receives a distribution from a partnership. Under these rules, basis is first allocated to unrealized receivables and inventory items in an amount equal to the partnership's adjusted basis in each property. If the basis to be allocated is less than the sum of the adjusted bases of the properties in the hands of the partnership, then, to the extent a decrease is required to make the total adjusted bases of the properties equal the basis to be allocated, the decrease is allocated (as described below) for adjustments that are decreases. To the extent of any basis not allocated to inventory and unrealized receivables under the above rules, basis is allocated to other distributed properties, first to the extent of each distributed property's adjusted basis to the partnership. Any remaining basis adjustment, if an increase, is allocated among properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation (to the extent of each property's appreciation), and then in proportion to their respective fair market values. If the remaining basis adjustment is a decrease, it is allocated among properties with unrealized depreciation in proportion to their respective amounts of unrealized depreciation (to the extent of each property's depreciation), and then in proportion to their respective adjusted bases (taking into account the adjustments already made).

For purposes of these rules, "unrealized receivables" has the meaning set forth in section 751(c) (as provided in sec. 732(c)(1)(A)(i)). Section 751(c) provides that the term "unrealized receivables" includes certain accrued but unreported income. In addition, the last two sentences of section 751(c) provide that for purposes of certain specified partnership provisions (sections 731, 741 and 751), the term "unrealized receivables" includes certain property the sale of which will give rise to ordinary income (for example, depreciation recapture under sections 1245 or 1250), but only to the extent of the amount that would be treated as ordinary income on a sale of that property at fair market value.

#### *Explanation of Provision*

The provision clarifies that for purposes of the allocation rules of section 732(c), "unrealized receivables" has the meaning in section 751(c) including the last two sentences of section 751(c), relating to items of property that give rise to ordinary income. Thus, in applying the allocation rules of section 732(c) to property listed in the last two sentences of section 751(c), such as property giving rise to potential depreciation recapture, the amount of unrealized appreciation in any such property does not include any amount that would be treated as ordinary income if the property were sold at fair market value, because such amount is treated as a separate asset for purposes of the basis allocation rules.[89]

For example, assume that a partnership has 3 partners, A, C and D. The partnership has 6 assets. Three are capital assets each with adjusted basis equal to fair market value of $20,000. The other three are depreciable equipment each with adjusted basis of $5,000 and fair market value of $30,000. Each of the pieces of equipment would have $25,000 of depreciation recapture if sold by the partnership for its $30,000 value. A has a basis in its partnership interest of $60,000. Assume that one of the capital assets and one of the pieces of equipment is distributed to A in liquidation of its interest. A is treated as receiving three assets: (1) depreciation recapture (an unrealized receivable) with a basis to the partnership of zero and a value of $25,000; (2) a piece of equipment with a basis to the partnership of $5,000 and a value of $5,000 (its $30,000 value reduced by the $25,000 of depreciation recapture); and (3) a capital asset with a basis to the partnership of $20,000 and a value of $20,000.

Under the provision, A's $60,000 basis in its partnership interest is allocated as follows. First, basis is allocated to the depreciation recapture, an unrealized receivable, in an amount equal to the partnership's adjusted basis in it, or zero (sec. 732(c)(1)(A)(i)). Then basis is allocated to the extent of each of the other distributed properties' adjusted basis to the partnership, or $5,000 to the equipment (not including the depreciation recapture), and $20,000 to the capital asset. A's remaining $35,000 of basis is allocated next among properties (other than inventory and unrealized receivables) with unrealized appreciation, in proportion to their respective amounts of unrealized appreciation (to the extent of each property's appreciation), but neither of the distributed properties to which basis may be allocated has unrealized appreciation. Basis is then allocated then in proportion to the properties' respective fair market values ($5,000 for the equipment and $20,000 for the capital asset). Thus, of the remaining $35,000, $7,000 is allocated to the equipment, so that its total basis in the partner's hands is $12,000; and $28,000 is allocated to the capital asset, so that its total basis in the partner's hands is $48,000.

### *Effective Date*

The provision is effective as if enacted with the 1997 Act.

## 18. Clarification to the definition of modified adjusted gross income for purposes of the earned income credit phase-out (sec. 6010(p) of the 1998 IRS Restructuring Act, sec. 1085(d) of the 1997 Act, and sec. 32(c) of the Code)

### *Present and Prior Law*

The earned income credit ("EIC") is phased out above certain income levels. For individuals with earned income (or modified adjusted gross income ("modified AGI"), if greater) in excess of the be-

[89] Treasury regulations under section 751(b) provide for a similar bifurcation of assets among potential ordinary income amounts and other amounts in applying the definition of "unrealized receivables" for purposes of that section. Treas. Reg. 1.751–1(c)(4).

ginning of the phaseout range, the maximum credit amount is reduced by the phaseout rate multiplied by the amount of earned income (or modified AGI, if greater) in excess of the beginning of the phaseout range. For individuals with earned income (or modified AGI, if greater) in excess of the end of the phaseout range, no credit is allowed. The definition of modified AGI used for the phase out of the earned income credit is the sum of: (1) AGI with certain losses disregarded, and (2) certain nontaxable amounts not generally included in AGI. The losses disregarded are: (1) net capital losses (if greater than zero); (2) net losses from trusts and estates; (3) net losses from nonbusiness rents and royalties; (4) 75 percent of the net losses from business, computed separately with respect to sole proprietorships (other than in farming), sole proprietorships in farming, and other businesses.[90] The nontaxable amounts included in modified AGI which are generally not included in AGI are: (1) tax-exempt interest; and (2) nontaxable distributions from pensions, annuities, and individual retirement arrangements (but only if not rolled over into similar vehicles during the applicable rollover period).

### *Explanation of Provision*

The provision clarifies that the two nontaxable amounts that are added to adjusted gross income to compute modified AGI for purposes of the EIC phaseout are additions to adjusted gross income and not disregarded losses.

### *Effective Date*

The provision is effective for taxable years beginning after December 31, 1997.

## J. Amendments to Title XI of the 1997 Act Relating to Foreign Provisions

### 1. Application of attribution rules under PFIC provisions (sec. 6011(b)(2) of the 1998 IRS Restructuring Act, sec. 1121 of the 1997 Act, and sec. 1298 of the Code)

### *Present and Prior Law*

Special attribution rules apply to the extent that the effect is to treat stock of a passive foreign investment company ("PFIC") as owned by a U.S. person. In general, if 50 percent or more in value of the stock of a corporation is owned (directly or indirectly) by or for any person, such person is considered as owning a proportionate part of the stock owned directly or indirectly by or for such corporation, determined based on the person's proportionate interest in the value of such corporation's stock. However, this 50-percent limitation does not apply in the case of a corporation that is a PFIC. Accordingly, a person that is a shareholder of a PFIC is considered as owning a proportionate part of the stock owned directly or indi-

[90] The 1997 Act increased the amount of net losses from businesses, computed separately with respect to sole proprietorships (other than farming), sole proprietorships in farming, and other businesses disregarded from 50 percent to 75 percent.

rectly by or for such PFIC, without regard to whether such shareholder owns at least 50 percent of the PFIC's stock by value.

A corporation is not treated as a PFIC with respect to a shareholder during the qualified portion of the shareholder's holding period for the stock of such corporation. The qualified portion of the shareholder's holding period generally is the portion of such period which is after the effective date of the 1997 Act and during which the shareholder is a United States shareholder (as defined in sec. 951(b)) and the corporation is a controlled foreign corporation.

If a corporation is not treated as a PFIC with respect to a shareholder for the qualified portion of such shareholder's holding period, it was unclear whether the attribution rules that apply with respect to stock owned by or for such corporation apply without regard to the requirement that the shareholder own 50 percent or more of the corporation's stock.

### *Explanation of Provision*

The provision clarifies that the attribution rules apply without regard to the provision that treats a corporation as a non-PFIC with respect to a shareholder for the qualified portion of the shareholder's holding period. Accordingly, stock owned directly or indirectly by or for a corporation that is not treated as a PFIC for the qualified portion of the shareholder's holding period nevertheless will be attributed to such shareholder, regardless of the shareholder's ownership percentage of such corporation.

### *Effective Date*

The provision is effective for taxable years of U.S. persons beginning after December 31, 1997 and taxable years of foreign corporations ending with or within such taxable years of U.S. persons.

## 2. Treatment of PFIC option holders (sec. 6011(b)(1) of the 1998 IRS Restructuring Act, sec. 1121 of the 1997 Act, and secs. 1297 and 1298 of the Code)

### *Present and Prior Law*

Under the provisions of subpart F, a controlled foreign corporation (a "CFC") is defined generally as any foreign corporation if U.S. persons own more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only) (sec. 957). Stock ownership includes not only stock owned directly, but also stock owned indirectly through a foreign entity or constructively (sec. 958). Pursuant to the constructive ownership rules, a person that has an option to acquire stock generally is treated as owning such stock (secs. 958(b) and 318(a)(4)).

The U.S. 10-percent shareholders of a CFC are subject to current U.S. tax on their pro rata shares of certain income of the CFC and their pro rata shares of the CFC's earnings invested in certain U.S. property (sec. 951). For purposes of determining the U.S. shareholder's includible pro rata share of the CFC's income and earnings, only stock held directly or indirectly through a foreign entity (and not stock held constructively) is taken into account (secs. 951(b) and 958(a)).

A foreign corporation is a passive foreign investment company (a "PFIC") if it satisfies a passive income test or a passive assets test for the taxable year (sec. 1297). A U.S. shareholder of a PFIC generally is subject to U.S. tax, plus an interest charge, on distributions from a PFIC and gain realized upon a disposition of PFIC stock (sec. 1291). Alternatively, the U.S. shareholder may elect either to be subject to current U.S. tax on the shareholder's share of the PFIC's earnings or, in the case of PFIC stock that is marketable, to mark to market the PFIC stock (secs. 1293 and 1296). For purposes of the PFIC provisions, constructive ownership rules apply (sec. 1298(a)). Under these rules, an option to acquire stock is treated as stock for purposes of applying the interest charge regime to a disposition of such option, and the holding period for stock acquired pursuant to the exercise of an option includes the holding period for such option (sec. 1298(a)(4) and prop. Treas. reg. secs. 1.1291–1(d) and (h)(3)).

A corporation that is a CFC is also a PFIC if it meets the passive income test or the passive assets test. Under section 1297(e), as added by the 1997 Act, a corporation is not treated as a PFIC with respect to a shareholder during the period after December 31, 1997 in which the corporation is a CFC and the shareholder is a U.S. shareholder (within the meaning of sec. 951(b)) thereof. Under this rule eliminating the overlap between the PFIC and CFC provisions, a shareholder that is subject to the subpart F rules with respect to a corporation is not also subject to the PFIC rules with respect to such corporation.

### *Explanation of Provision*

Under the provision, the elimination of the overlap between the PFIC and the CFC provisions generally does not apply to a U.S. person with respect to PFIC stock that such person is treated as owning by reason of an option to acquire such stock. Accordingly, for example, the PFIC rules continue to apply to a U.S. person that holds only an option on stock of a corporation that is a CFC because such person does not own stock of such corporation directly or indirectly through a foreign entity and therefore is not subject to the current inclusion rules of subpart F with respect to such corporation. However, under the provision, the elimination of the overlap does apply to a U.S. person that holds an option on stock if such stock is held by a person that is subject to the current inclusion rules of subpart F with respect to such stock and is not a tax-exempt person. Accordingly, an option holder is not subject to the PFIC rules with respect to an option if the option is on stock that is held by a non-tax-exempt person that is subject to the current inclusion rules of subpart F with respect to such stock.

### *Effective Date*

The provision is effective for taxable years of U.S. persons beginning after December 31, 1997 and taxable years of foreign corporations ending with or within such taxable years of U.S. persons.

### 3. Application of PFIC mark-to-market rules to RICs (sec. 6011(c)(3) of the 1998 IRS Restructuring Act, sec. 1122 of the 1997 Act, and sec. 1296 of the Code)

#### *Present and Prior Law*

Under section 1296, as added by the 1997 Act, a shareholder of a passive foreign investment company (a "PFIC") may make a mark-to-market election with respect to the stock of the PFIC, provided that such stock is marketable. Under this election, the shareholder includes in income each year an amount equal to the excess, if any, of the fair market value of the PFIC stock as of the close of the taxable year over the shareholder's adjusted basis in such stock. The shareholder is allowed a deduction for the excess, if any, of the shareholder's adjusted basis in the PFIC stock over its fair market value as of the close of the taxable year, but only to the extent of any net mark-to-market gains with respect to such stock included by the shareholder under section 1296 for prior years.

The mark-to-market election of section 1296 is effective for taxable years of U.S. persons beginning after December 31, 1997 and taxable years of foreign corporations ending with or within such taxable years of U.S. persons. Prior to the enactment of section 1296, a proposed Treasury regulation provided for a mark-to-market election with respect to PFIC stock held by certain regulated investment companies ("RICs") (prop. Treas. reg. sec. 1.1291–8). Under this mark-to-market election, gains but not losses were recognized.

Section 1296(j) provides rules applicable in the case of a shareholder that makes a mark-to-market election under section 1296 later than the beginning of the shareholder's holding period for the PFIC stock. Special rules apply in the case of a RIC that makes such a mark-to-market election under section 1296 with respect to PFIC stock that the RIC had previously marked to market under the proposed Treasury regulation.

#### *Explanation of Provision*

Under the provision, for purposes of determining allowable deductions for any excess of the shareholder's adjusted basis in PFIC stock over the fair market value of the stock as of the close of the taxable year, deductions are allowed to the extent not only of prior mark-to-market inclusions under section 1296 but also of prior mark-to-market inclusions under the proposed Treasury regulation applicable to a RIC that holds stock in a PFIC.

#### *Effective Date*

The provision is effective for taxable years of U.S. persons beginning after December 31, 1997 and taxable years of foreign corporations ending with or within such taxable years of U.S. persons.

**4. Interaction between the PFIC provisions and other mark-to-market rules (sec. 6011(c)(2) of the 1998 IRS Restructuring Act, sec. 1122 of the 1997 Act, and secs. 1291 and 1296 of the Code)**

### *Present and Prior Law*

A U.S. shareholder of a passive foreign investment company (a "PFIC") generally is subject to U.S. tax, plus an interest charge, on distributions from a PFIC and gain realized upon a disposition of PFIC stock (sec. 1291). As an alternative to this interest charge regime, the U.S. shareholder may elect to be subject to current U.S. tax on the shareholder's share of the PFIC's earnings (sec. 1293). Section 1296, as added by the 1997 Act, provides another alternative available in the case of a PFIC the stock of which is marketable; under section 1296, a U.S. shareholder of a PFIC may make a mark-to-market election with respect to the stock of the PFIC.

The interest charge regime generally does not apply to distributions from, and dispositions of stock of, a PFIC for which the U.S. shareholder has made either a mark-to-market election under section 1296 or an election to include the PFIC's earnings in income currently (sec. 1291(d)(1)). However, special coordination rules provide for limited application of the interest charge regime in the case of a U.S. shareholder that makes a mark-to-market election under section 1296 later than the beginning of the shareholder's holding period for the PFIC stock (sec. 1296(j)).

Under section 475(a), a dealer in securities is required to mark to market certain securities held by the dealer. Under section 475(f), as added by the 1997 Act, a trader in securities may elect to mark to market securities held in connection with the person's trade or business as a trader in securities. Other provisions similarly allow stock to be marked to market (e.g., sec. 1092(b)(1) and temp. Treas. reg. Sec. 1.1092(b)–4T).

### *Explanation of Provision*

Under the provision, the interest charge regime generally does not apply to distributions from, and dispositions of stock of, a PFIC where the U.S. shareholder has marked to market such stock under section 475 or any other provision (in the same manner that such regime does not apply where the shareholder has marked to market such stock under sec. 1296). In addition, under the provision, coordination rules like those provided in section 1296(j) apply in the case of a U.S. shareholder that marks to market PFIC stock under section 475 or any other provision later than the beginning of the shareholder's holding period for the PFIC stock.

### *Effective Date*

The provision is effective for taxable years of U.S. persons beginning after December 31, 1997 and taxable years of foreign corporations ending with or within such taxable years of U.S. persons. No inference is intended regarding the treatment of PFIC stock that was marked to market prior to the effective date of the provision.

### 5. Information reporting with respect to certain foreign corporations and partnerships (sec. 6011(f) of the 1998 IRS Restructuring Act, sec. 1142 of the 1997 Act, and sec. 6038 of the Code)

*Present and Prior Law*

The 1997 Act added reporting rules that apply to controlled foreign corporations and foreign partnerships (sec. 6038).

*Explanation of Provision*

The provision clarifies that guidance relating to the furnishing of required information is to be provided by the Secretary of the Treasury (not specifically through regulations), and conforms the use of the defined term, foreign business entity.

*Effective Date*

The provision is effective as if included in the 1997 Act.

## K. Amendments to Title XII of the 1997 Act Relating to Simplification Provisions

### 1. Travel expenses of Federal employees participating in a Federal criminal investigation (sec. 6012(a) of the 1998 IRS Restructuring Act, sec. 1204 of the 1997 Act, and sec. 162 of the Code)

*Present and Prior Law*

Unreimbursed ordinary and necessary travel expenses paid or incurred by an individual in connection with temporary employment away from home (e.g., transportation costs and the cost of meals and lodging) are generally deductible, subject to the two-percent floor on miscellaneous itemized deductions. Travel expenses paid or incurred in connection with indefinite employment away from home, however, are not deductible. A taxpayer's employment away from home in a single location is indefinite rather than temporary if it lasts for one year or more; thus, no deduction is permitted for travel expenses paid or incurred in connection with such employment (sec. 162(a)). If a taxpayer's employment away from home in a single location lasts for less than one year, whether such employment is temporary or indefinite is determined on the basis of the facts and circumstances.

The 1997 Act provided that the one-year limitation with respect to deductibility of expenses while temporarily away from home does not include any period during which a Federal employee is certified by the Attorney General (or the Attorney General's designee) as traveling on behalf of the Federal Government in a temporary duty status to investigate or provide support services to the investigation of a Federal crime. Thus, expenses for these individuals during these periods are fully deductible, regardless of the length of the period for which certification is given (provided that the other requirements for deductibility are satisfied).

### *Explanation of Provision*

The provision clarifies that prosecuting a Federal crime or providing support services to the prosecution of a Federal crime is considered part of investigating a Federal crime.

### *Effective Date*

The provision is effective for amounts paid or incurred with respect to taxable years ending after the date of enactment of the 1997 Act.

## 2. Magnetic media returns for partnerships having more than 100 partners (sec. 6012(d) of the 1998 IRS Restructuring Act, sec. 1223 of the 1997 Act, and sec. 6724(c) of the Code)

### *Present and Prior Law*

The 1997 Act added rules providing that the Treasury Secretary is to require partnerships with more than 100 partners to file returns on magnetic media (sec. 6011(e)). These rules impose a penalty in the case of failure to meet magnetic media requirements.

### *Explanation of Provision*

The provision clarifies that the penalty under section 6724(c) for failure to comply with the requirement of filing returns on magnetic media applies to the extent such a failure occurs with respect to more than 100 information returns, in the case of a partnership with more than 100 partners.

### *Effective Date*

The provision is effective as if enacted in the 1997 Act.

## 3. Effective date for provisions relating to electing large partnerships, partnership returns required on magnetic media, and treatment of partnership items of individual retirement arrangements (sec. 6012(e) of the 1998 IRS Restructuring Act and sec. 1226 of the 1997 Act)

### *Present and Prior Law*

Rules for simplified flowthrough and simplified audit procedures for electing large partnerships, as well as a March 15 due date for furnishing information to partners of an electing large partnership, were added by the 1997 Act. The 1997 Act also added a rule providing that partnership returns are required on magnetic media, and modified the treatment of partnership items of individual retirement arrangements. The 1997 Act statement of managers provided that these provisions apply to partnership taxable years beginning after December 31, 1997. The statute provided that the rules for simplified flowthrough for electing large partnerships apply to partnership taxable years beginning after December 31, 1997 (1997 Act sec. 1221(c)), although the statute also provided that all the provisions apply to partnership taxable years ending on or after December 31, 1997 (1997 Act sec. 1226).

### *Explanation of Provision*

The provision provides that these provisions apply to partnership taxable years beginning after December 31, 1997.

### *Effective Date*

The provision is effective as if enacted in the 1997 Act.

## 4. Modification of distribution rules for REITs (sec. 6012(g) of the 1998 IRS Restructuring Act, sec. 1256 of the 1997 Act, and sec. 857 of the Code)

### *Present and Prior Law*

In general, a real estate investment trust ("REIT") is an entity that receives most of its income from passive real estate investments and meets certain other requirements. A REIT receives conduit treatment (i.e., one level of tax) for income distributed to its shareholders. A REIT generally must distribute 95 percent of its earnings (sec. 857(a)(1)). An entity loses its status as a REIT if it retains non-REIT earnings and profits (sec. 857(a)(2)). A REIT simplification provision in the 1997 Act provides that any distribution from a REIT will be deemed to first come from the earliest earnings and profits of the entity. As a result, in the case of a REIT with accumulated REIT earnings and profits that inherits subsequently earned non-REIT earnings and profits (e.g., by way of merger with a C corporation), that the entity must distribute both the accumulated REIT earnings and profits as well as the inherited non-REIT earnings and profits under the 1997 Act provision in order to retain its REIT status.

### *Explanation of Provision*

The provision amends the simplification provision to provide that any distribution from a REIT will be deemed to first come from earnings and profits that were generated when the entity did not qualify as a REIT. The provision does not change the requirement that a REIT must distribute 95 percent of its REIT earnings, or any other requirement.

### *Effective Date*

The provision is effective for taxable years beginning after August 5, 1997.

## L. Amendments to Title XIII of the 1997 Act Relating to Estate, Gift and Trust Simplification

## 1. Clarification of treatment of revocable trusts for purposes of the generation-skipping transfer tax (sec. 6013(a) of the 1998 IRS Restructuring Act, sec. 1305 of the 1997 Act, and secs. 2652 and 2654 of the Code)

### *Present and Prior Law*

The 1997 Act provided an irrevocable election to treat a qualified revocable trust as part of the decedent's estate for Federal income tax purposes. For this purpose, a qualified revocable trust is any trust (or portion thereof) which was treated as owned by the decedent with respect to whom the election is being made, by reason of a power in the grantor (i.e., trusts that are treated as owned by the decedent solely by reason of a power in a nonadverse party would not qualify). A conforming change was also made to section 2652(b) for generation-skipping transfer tax purposes.

#### *Explanation of Provision*

The provision clarifies that the election to treat a qualified revocable trust as part of the decedent's estate applies for generation-skipping transfer tax purposes only with respect to the application of section 2654(b) (describing when a single trust may be treated as two or more trusts). The election has no other effect for generation-skipping transfer tax purposes.

#### *Effective Date*

The provision applies to decedents dying after the date of enactment of the 1997 Act.

### 2. Provision of regulatory authority for simplified reporting of funeral trusts terminated during the taxable year (sec. 6013(b) of the 1998 IRS Restructuring Act, sec. 1309 of the 1997 Act and sec. 685(f) of the Code)

#### *Present and Prior Law*

The 1997 Act provided an election which allows the trustee of a qualified pre-need funeral trust to elect special tax treatment for such a trust, to the extent the trust would otherwise be treated as a grantor trust. As part of this provision, the Secretary of the Treasury was granted regulatory authority to prescribe rules for simplified reporting of all trusts having a single trustee.

#### *Explanation of Provision*

The provision clarifies that a pre-need funeral trust may continue to qualify for these special rules for the 60-day period after the decedent's death, even though the trust ceases to be a grantor trust during that time. In addition, the provision extends the Secretary's regulatory authority to include rules providing for the inclusion of trusts terminated during the year (e.g., in the event of the death of the beneficiary) in the simplified reporting.

#### *Effective Date*

The provision applies to decedents dying after the date of enactment of the 1997 Act.

## M. Amendment to Title XIV of the 1997 Act Relating to Excise Tax Simplification

### 1. Transfers of bulk imports of wine to wineries or beer to breweries (secs. 6014(a)(1) and (b)(1) of the 1998 IRS Restructuring Act, secs. 1421 and 1422 of the 1997 Act, and secs. 5043 and 5054 of the Code)

#### *Present and Prior Law*

Prior to the 1997 Act, imported beer and wine always were taxed upon importation (secs. 5043 and 5054). The 1997 Act added provisions for non-tax-paid transfers of bulk imports to breweries and wineries (secs. 5364 and 5418).

#### *Explanation of Provision*

The provision conforms the provisions imposing tax in all cases on importation to recognize these allowed transfers. Under the provision, liability for tax payment shifts to the brewery or winery when bulk imports are transferred with payment of tax, just as those parties are liable for payment of tax on domestically produced beer and wine.

#### *Effective Date*

The provision is effective as if included in the 1997 Act.

### 2. Refunds when wine returned to wineries or beer returned to breweries (sec. 6014(a)(2) and (b)(2) of the 1998 IRS Restructuring Act, secs. 1421 and 1422 of the 1997 Act, and secs. 5044 and 5056 of the Code)

#### *Present and Prior Law*

The 1997 Act added a provision that tax is refunded when tax-paid wine is returned to a winery or tax-paid beer is returned to a brewery (secs. 5044 and 5056). The Code provisions allowing these refunds speak of beverages produced in the United States. A separate provision of the 1997 Act provided that beer and wine imported "in bulk" would be taxed under the rules for domestically produced beverages.

#### *Explanation of Provision*

The provision coordinates the refund provisions with the provision on tax treatment of bulk imports.

#### *Effective Date*

The provision is effective as if included in the 1997 Act.

### 3. Clarification of the provision allowing wine imported in bulk to be transferred to a U.S. winery without payment of tax (sec. 6014(b)(3) of the 1998 IRS Restructuring Act, sec. 1422 of the 1997 Act, and sec. 5364 of the Code)

#### *Present and Prior Law*

Wine is subject to an excise tax ranging from $1.07 per gallon to $3.40 per gallon, depending on its alcohol content. Distilled spirits are subject to excise tax at a rate of $13.50 per proof gallon. A tax credit equal to the difference between the distilled spirits tax rate and the wine tax rate is allowed for wine that is blended into distilled spirits products (sec. 5010). The wine excise tax is imposed on removal of the beverage from a winery, or on importation. The 1997 Act included a provision allowing wine to be imported in bulk and transferred to a U.S. winery without payment of tax (generally until the wine is removed from the winery).

U.S. law defines wine generally as alcohol that is derived from fruit or fruit residues ("natural wine"). Natural wine may not be fortified with grain or other non-fruit derived alcohol if produced in the United States. Certain other countries allow wine that is marketed as a natural wine to be fortified with alcohol from other sources. U.S. law follows the laws of the country of origin in classifying imported wine.

#### *Explanation of Provision*

The provision clarifies that the provision of the 1997 Act liberalizing rules for bulk importation of wine applies only to alcohol that would qualify as a natural wine if produced in the United States.

#### *Effective Date*

The provision is effective as if included in the 1997 Act.

## N. Amendment to Title XV of the 1997 Act Relating to Pensions and Employee Benefits

### 1. Treatment of certain disability payments to public safety employees (sec. 6015(c) of the 1998 IRS Restructuring Act, sec. 1529 of the 1997 Act, and sec. 104 of the Code)

#### *Present and Prior Law*

Certain payments made on behalf of full-time employees of any police or fire department organized and operated by a State (or any political subdivision, agency, or instrumentality thereof) are excludable from income. This treatment applies to payments made on account of heart disease or hypertension of the employee and that were received in 1989, 1990, or 1991 pursuant to a State law as amended on May 19, 1992, which irrebuttably presumed that heart disease and hypertension are work-related illnesses (but only for employees separating from service before July 1, 1992). Claims for refund or credit for overpayments resulting from the provision may be filed up to 1 year after August 5, 1997, without regard to the otherwise applicable statute of limitations.

### *Explanation of Provision*

In order to address problems taxpayers were encountering with the IRS in seeking refunds under the prior-law provision, the provision clarifies the scope of the exclusion.

The provision provides that payments made on account of heart disease or hypertension of the employee and that were received in 1989, 1990, or 1991 pursuant to a State law as described under prior law, or received by an individual referred to in such State law under any other statute, ordinance, labor agreement, or similar provision as a disability pension payment or in the nature of a disability pension payment attributable to employment as a police officer or as a fireman is excludable from income.

### *Effective Date*

The provision is effective as if included in the Taxpayer Relief Act.

## O. Amendments to Title XVI of the 1997 Act Relating to Technical Corrections

### 1. Application of requirements for SIMPLE IRAs in the case of mergers and acquisitions (sec. 6016(a)(1) of the 1998 IRS Restructuring Act, sec. 1601(d)(1) of the 1997 Act, and sec. 408(p)(2) of the Code)

### *Present and Prior Law*

If an employer maintains a qualified plan and a SIMPLE IRA in the same year due to an acquisition, disposition or similar transaction, the SIMPLE IRA is treated as a qualified salary reduction arrangement for the year of the transaction and the following calendar year provided rules similar to the special coverage rules of section 410(b)(6)(C) apply. There is a similar provision with respect to an employer who, because of an acquisition, disposition or similar transaction, fails to be an eligible employer because such employer employs more than 100 employees. In this situation, the employer is treated as an eligible employer for two years following the transaction provided rules similar to the coverage rules of section 410(b)(6)(C)(i) apply.

### *Explanation of Provision*

The provision conforms the treatment applicable to SIMPLE IRAs upon acquisition, disposition or similar transaction for purposes of (1) the 100 employee limit, (2) the exclusive plan requirement, and (3) the coverage rules for participation. In the event of such a transaction, the employer is treated as an eligible employer and the arrangement is treated as a qualified salary reduction arrangement for the year of the transaction and the two following years, provided rules similar to the rules of section 410(b)(6)(C)(i)(II) are satisfied and the arrangement would satisfy the requirements to be a qualified salary reduction arrangement after the transaction if the trade or business that maintained the arrangement prior to the transaction had remained a separate employer.

*Effective Date*

The provision is effective as if included in the Small Business Job Protection Act of 1996.

**2. Treatment of Indian tribal governments under section 403(b) (sec. 6016(a)(2) of the 1998 IRS Restructuring Act, sec. 1601(d)(4)(A) of the 1997 Act, and sec. 403(b) of the Code)**

*Present and Prior Law*

Any 403(b) annuity contract purchased in a plan year beginning before January 1, 1995, by an Indian tribal government is treated as purchased by an entity permitted to maintain a tax-sheltered annuity plan. Such contracts may be rolled over into a section 401(k) plan maintained by the Indian tribal government in accordance with the rollover rules of section 403(b)(8). An employee participating in a 403(b) annuity contract of the Indian tribal government may roll over amounts from such contract to a section 401(k) plan maintained by the Indian tribal government whether or not the annuity contract is terminated.

*Explanation of Provision*

The provision clarifies that an employee participating in a 403(b)(7) custodial account of the Indian tribal government may roll over amounts from such account to a section 401(k) plan maintained by the Indian tribal government.

*Effective Date*

The provision is effective as if included in the Small Business Job Protection Act of 1996.

## *TECHNICAL CORRECTIONS TO OTHER TAX LEGISLATION*

### A. Amendments Related to Transportation Equity Act for the 21st Century ("TEA 21")

**1. Simplified refund provisions for tax on gasoline, diesel fuel and kerosene (sec. 6017 of the 1998 IRS Restructuring Act and sec. 6427(i)(2) of the Code)**

*Present and Prior Law*

TEA 21 included a provision combining the Code refund provisions for gasoline, diesel fuel, and kerosene and reducing the minimum claim amount. Under TEA 21, claims may be filed once a $750 threshold is reached for gasoline, diesel fuel, and kerosene combined, and overpayments attributable to multiple calendar quarters may be aggregated in determining whether this threshold is met (rather than claims being filed only with respect to a single calendar quarter).

### *Explanation of Provision*

The provision conforms a Code timing provision to reflect the portion of the TEA 21 provision that allows aggregation of multiple calendar quarters into a single refund claim.

### *Effective Date*

The provision is effective as if included in the amendments made by section 909 of the TEA 21.

## 2. Conforming changes to Highway Trust Fund expenditure authority (sec. 9015 of the 1998 IRS Restructuring Act)

### *Present and Prior Law*

TEA 21 authorized expenditures for Federal Highway and mass transit programs through September 30, 2003. These authorized expenditures are approved purposes under the Code's Highway Trust Fund expenditure provisions.

### *Explanation of Provision*

The Act made numerous non-tax corrections to the expenditure provisions of TEA 21 (secs. 9001–9016 of the Act), and also included necessary conforming amendments to the Code's Highway Trust Fund Expenditure authority.

# B. Amendment Related to the Small Business Job Protection Act of 1996

## 1. Treatment of adoption tax credit carryovers (sec. 6018 of the 1998 IRS Restructuring Act, sec. 1807(a) of the small business job protection act of 1996, and sec. 23 of the Code)

### *Present and Prior Law*

Taxpayers are allowed a maximum nonrefundable credit against income tax liability of $5,000 per child for qualified adoption expenses paid or incurred by the taxpayer. In the case of a special needs adoption, the maximum credit amount is $6,000 ($5,000 in the case of a foreign special needs adoption). To the extent the otherwise allowable credit exceeds the tax liability limitation of section 26 (reduced by other personal credits) the excess is carried forward as an adoption credit into the next taxable year, up to a maximum of five taxable years.

The credit is phased out ratably for taxpayers with modified adjusted gross income (AGI) above $75,000, and is fully phased out at $115,000 of modified AGI. For these purposes modified AGI is computed by increasing the taxpayer's AGI by the amount otherwise excluded from gross income under Code sections 911, 931, or 933 (relating to the exclusion of income of U.S. citizens or residents living abroad; residents of Guam, American Samoa, and the Northern Mariana Islands, and residents of Puerto Rico, respectively).

### *Explanation of Provision*

The provision clarifies that the AGI phaseout only applies in the year that the credit is generated and is not reapplied to further reduce any carryforward amounts.

### *Effective Date*

The provision is effective as if included in the Small Business Job Protection Act of 1996.

## C. Amendments Related to Taxpayer Bill of Rights 2

### 1. Disclosure requirements for apostolic organizations (sec. 6019(a) and (b) of the 1998 IRS Restructuring Act, sec. 1313 of the Taxpayer Bill of Rights 2, and sec. 6104 of the Code)

### *Present and Prior Law*

Section 501(d) provides tax-exempt status to certain religious or apostolic associations or corporations, if such associations or corporations have a common treasury or community treasury, even if such associations or corporations engage in business for the common benefit of the members, but only if the members thereof include (at the time of filing their returns) in their gross income their entire pro rata shares, whether distributed or not, of the taxable income of the association or corporation for such year.[91] Any amount so included in the gross income of a member is treated as a dividend received. The effect of section 501(d) is to exempt the religious and apostolic associations or corporations which conduct communal activities (such as farming) from the Federal corporate-level income tax and the undistributed-profits tax, provided that members claim their shares of the corporation's income on their own individual returns.

Section 6033 generally requires tax-exempt organizations to file annual information returns, and such information returns are available for public inspection under sections 6104(b) and 6104(e), except that public disclosure is not required of the identity of contributors to an organization. Section 501(d) entities must include with their annual information return (Form 1065) a Schedule K–1 that identifies the members of the association or corporation and their ratable portions of net income and expenses.

### *Explanation of Provision*

The provision amends sections 6104(b) and 6104(e) to provide that public disclosure is not required of a Schedule K–1 filed by a religious or apostolic organization described in section 501(d).

[91] Under section 501(d), the requirement of a "common treasury" or "community treasury" is satisfied when all of the income generated from property owned by the organization is placed into a common fund that is maintained by such organization and is used for the maintenance and support of its members, with all members having equal, undivided interests in this common fund, but no right to claim title to any part thereof. See *Twin Oaks Community, Inc.* v. *Commissioner,* 87 T.C. 1233, at 1254 (1986). See also Rev. Rul. 78–100, 1978–1 C.B. 162 (sec. 501(d) entity must be supported by internally operated business activities rather than merely being supported by wages of members who are engaged in outside employment).

### *Effective Date*

The provision is effective on the date of enactment.

**2. Disclosure of returns and return information (sec. 6019(c) of the 1998 IRS Restructuring Act and sec. 6103(e) of the Code)**

### *Present and Prior Law*

The rules regarding disclosure of returns and return information were amended in 1996 to permit certain disclosures in two additional circumstances. In the case of a deficiency with respect to a joint return of individuals who are no longer married or no longer residing in the same household, the Treasury Secretary is permitted to disclose to one such individual whether there has been an attempt to collect the deficiency from the other individual, the general nature of such collection activities, and the amount collected (sec. 6103(e)(8)). If the Treasury Secretary determines that a person is liable for a penalty for failure to collect and pay over tax, the Secretary is permitted to disclose to that person the name of any other person liable for that penalty, and whether there has been an attempt to collect the deficiency from the other individual, the general nature of such collection activities, and the amount collected (sec. 6103(e)(9)).

### *Explanation of Provision*

The provision clarifies that these disclosures, like certain other disclosures permitted under present law, may be made under section 6103(e)(6) to the duly authorized attorney in fact of the person making the disclosure request.

### *Effective Date*

The provision takes effect on date of enactment.

## D. Amendment Related to the Omnibus Budget Reconciliation Act of 1993

**1. Allow deduction for unused employer social security credit (sec. 6020 of the 1998 IRS Restructuring Act, sec. 13443 of the Omnibus Budget Reconciliation Act of 1993, and sec. 196 of the Code)**

### *Present and Prior Law*

The general business credit ("GBC") consists of various individual tax credits (including the employer social security credit of Code section 45B) allowed with respect to certain qualified expenditures and activities. In general, the various individual tax credits contain provisions that prohibit "double benefits," either by denying deductions in the case of expenditure-related credits or by requiring income inclusions in the case of activity-related credits. Unused credits may be carried back one year and carried forward 20 years. Section 196 allows a deduction to the extent that certain portions of the GBC expire unused after the end of the carry forward period. Section 196 does not allow a deduction to the extent that the portion of the GBC that expires unused after the end of the carry forward period relates to the employer social security credit.

### *Explanation of Provision*

The provision allows a deduction to the extent that the portion of the GBC relating to the employer social security credit expires unused after the end of the carry forward period.

### *Effective Date*

The provision is effective as if included in the Omnibus Budget Reconciliation Act of 1993.

## E. Amendment Related to the Revenue Reconciliation Act of 1990

### 1. Earned income credit qualification rules (sec. 6021 of the 1998 IRS Restructuring Act, sec. 11111(a) of the Revenue Reconciliation Act of 1990, as amended by sec. 742 of the Uruguay Round Agreements Act and sec. 451(a) of the Personal Responsibility and Work Opportunity Reconciliation Act of 1996, and sec. 32 of the Code)

### *Present and Prior Law*

#### *In general*

In order to claim the earned income credit ("EIC"), an individual must be an eligible individual. To be an eligible individual, an individual must include a taxpayer identification number ("TIN") for the taxpayer and the taxpayer's spouse and must either have a qualifying child or meet other requirements. In order to claim the EIC without a qualifying child, an individual must not be a dependent and must be over age 24 and under age 65.

#### *Qualifying child*

A qualifying child must meet a relationship test, an age test, an identification test, and a residence test. Under the relationship and age tests, an individual is eligible for the EIC with respect to another person only if that other person: (1) is a son, daughter, or adopted child (or a descendent of a son, daughter, or adopted child); a stepson or stepdaughter; or a foster child of the taxpayer (a foster child is defined as a person whom the individual cares for as the individual's child; it is not necessary to have a placement through a foster care agency); and (2) is under the age of 19 at the close of the taxable year (or is under the age of 24 at the end of the taxable year and was a full-time student during the taxable year), or is permanently and totally disabled. Also, if the qualifying child is married at the close of the year, the individual may claim the EIC for that child only if the individual may also claim that child as a dependent.

To satisfy the identification test, an individual must include on their tax return the name, age, and "TIN" of each qualifying child.

The residence test requires that a qualifying child must have the same principal place of abode as the taxpayer for more than one-half of the taxable year (for the entire taxable year in the case of a foster child), and that this principal place of abode must be located in the United States. For purposes of determining whether a qualifying child meets the residence test, the principal place of abode shall be treated as in the United States for any period during which a member of the Armed Forces is stationed outside the United States while serving on extended active duty.

### *Explanation of Provision*

The provision clarifies that the identification requirement is a requirement for claiming the EIC, rather than an element of the definitions of "eligible individual" and "qualifying child."

### *Effective Date*

The provision is effective as if included in the originally enacted related legislation.

## TITLE VII. REVENUE OFFSETS

### A. Employer Deductions for Vacation and Severance Pay (sec. 7001 of the Act and sec. 404 of the Code)

#### *Present and Prior Law*

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

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

The Tax Court recently addressed the issue of when vacation pay and severance pay are considered deferred compensation in *Schmidt Baking Co., Inc.*, 107 T.C. 271 (1996). In *Schmidt Baking,* the taxpayer was an accrual basis taxpayer with a fiscal year that ended December 28, 1991. The taxpayer funded its accrued vacation and severance pay liabilities for 1991 by purchasing an irrevocable letter of credit on March 13, 1992. The parties stipulated that the letter of credit represented a transfer of a substantially vested interest in property to employees for purposes of section 83, and that the fair market value of such interest was includible in the employees' gross incomes for 1992 as a result of the transfer.[92] The Tax Court held that the purchase of the letter of credit, and

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

the resulting income inclusion, constituted payment of the vacation and severance pay within the 2½ month period. Thus, the vacation and severance pay were treated as received by the employees within the 2½ month period and were not treated as deferred compensation. The vacation pay and severance pay were deductible by the taxpayer for its 1991 fiscal year pursuant to its normal accrual method of accounting.

### *Reasons for Change*

The Congress believed that the decision in *Schmidt Baking* reaches an inappropriate and unintended result. To permit methods such as that used in *Schmidt Baking* to be considered payment or receipt would allow taxpayers to avoid the 2½ month rule and inappropriately accelerate deductions. The Congress believed that the intent of the 2½ month rule clearly was to provide that a deduction for deferred compensation is not available for the current taxable year unless the compensation is actually paid to employees within 2½ months after the end of the year. Moreover, previous legislative histories reflect Congressional intent and understanding that compensation actually paid beyond the 2½ month period is deferred compensation.[93]

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

### *Explanation of Provision*

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

It is intended that similar arrangements, in addition to the letter of credit approach used in *Schmidt Baking,* do not constitute actual receipt by the employee, even if there is an income inclusion. Thus, for example, actual receipt does not include the furnishing of a note or letter or other evidence of indebtedness of the taxpayer, whether or not the evidence is guaranteed by any other instrument or by any third party. As a further example, actual receipt does not include a promise of the taxpayer to provide service or property in the future (whether or not the promise is evidenced by a contract

[93] See, e.g., the legislative history to sec. 10201 of the Omnibus Budget Reconciliation Act of 1987.

or other written agreement). In addition, actual receipt does not include an amount transferred as a loan, refundable deposit, or contingent payment. Amounts set aside in a trust for employees are not considered to be actually received by the employee.

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

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

The provision does not affect the determination of whether an item is includible in income. Thus, for example, using the mechanism in *Schmidt Baking* for vacation pay could still result in income inclusion to the employees, but the employer would not be entitled to a deduction for the vacation pay until actually paid to and received by the employees.

In light of the change being made and its effect on all cases involving this issue, it is intended that the Secretary consider whether, on a case-by-case basis, continued challenge of these arrangements for prior years represents the best use of litigation resources.

### *Effective Date*

The provision is effective for taxable years ending after the date of enactment (after July 22, 1998). Any change in method of accounting required by the provision is treated as initiated by the taxpayer with the consent of the Secretary of the Treasury. Any adjustment required by section 481 as a result of the change is taken into account over a three-year period beginning with the first year for which the provision is effective.

### *Revenue Effect*

The provision is estimated to increase Federal fiscal year budget receipts by $593 million in 1998, $893 million in 1999, $997 million in 2000, $456 million in 2001, $308 million in 2002, $156 million in 2003, $163 million in 2004, $172 million in 2005, $180 million in 2006, and $189 million in 2007.

## B. Freeze Grandfather Status of Stapled REITs (sec. 7002 of the Act)

### *Present and Prior Law*

A real estate investment trust ("REIT") is an entity that receives most of its income from passive real estate related investments and that essentially receives pass-through treatment for income that is distributed to shareholders. If an electing entity meets the qualifications for REIT status, the portion of its income that is distributed to the investors each year generally is taxed to the investors without being subjected to a tax at the REIT level. In general, a REIT must derive its income from passive sources and not engage in any active trade or business.

A REIT must satisfy a number of tests on a year-by-year basis that relate to the entity's: (1) organizational structure; (2) source of income; (3) nature of assets; and (4) distribution of income. Under the source-of-income tests, at least 95 percent of its gross income generally must be derived from rents, dividends, interest and certain other passive sources (the "95-percent test"). In addition, at least 75 percent of its income generally must be from real estate sources, including rents from real property and interest on mortgages secured by real property (the "75-percent test").

A REIT is permitted to have a wholly-owned subsidiary subject to certain restrictions (a "qualified REIT subsidiary"). All of the assets, liabilities, income, deductions and credits of a qualified REIT subsidiary are treated as attributes of the REIT.

In a stapled REIT structure, both the shares of a REIT and a C corporation may be traded, but are subject to a provision that they may not be sold separately. In the Deficit Reduction Act of 1984 (the "1984 Act"), Congress required that, in applying the tests for REIT status, all stapled entities are treated as one entity (sec. 269B(a)(3)). The 1984 Act included grandfather rules, one of which provided that certain then-existing stapled REITs were not subject to the new provision (sec. 136(c)(3) of the 1984 Act). That grandfather rule provided that the new provision did not apply to a REIT that was a part of a group of stapled entities if the group of entities was stapled on June 30, 1983, and included a REIT on that date.

### *Reasons for Change*

In the 1984 Act, Congress eliminated the tax benefits of the stapled REIT structure out of concern that it could effectively result in one level of tax on active corporate business income that would otherwise be subject to two levels of tax. Congress also believed that allowing a corporate business to be stapled to a REIT was inconsistent with the policy that led Congress to create REITs.

As part of the 1984 Act provision, Congress provided grandfather relief to the small number of stapled REITs that were already in existence. Since 1984, however, many of the grandfathered stapled REITs have been acquired by new owners. Some have entered into new lines of businesses, and most of the grandfathered REITs have used the stapled structure to engage in large-scale acquisitions of assets. As a result, Congress believed that such unlimited relief from a general tax provision by a handful of taxpayers raised new questions not only of fairness, but of unfair competition, because the stapled REITs are in direct competition with other companies that cannot use the benefits of the stapled structure.

Congress believed that it would be unfair to remove the benefit of the stapled REIT structure with respect to real estate interests that had already been acquired. On the other hand, Congress believed that future acquisitions of interests in real property by these grandfathered entities, or improvements of property that are tantamount to new acquisitions, should not be accorded the benefits of the stapled REIT structure. Accordingly, the rules of the Act generally apply with respect to real property interests acquired by the REIT or a stapled entity after March 26, 1998, pursuant to transactions not in progress on that date. Further, Congress was concerned that the some of the benefit of the stapled REIT structure could be derived through mortgages and interests in subsidiaries and partnerships. Accordingly, the Act provides rules for mortgages acquired after March 26, 1998, and indirect acquisitions of real property interests through entities after such date (with transition relief similar to that for direct acquisitions).

### *Explanation of Provision*

#### *Overview*

Under the Act, rules similar to the rules of prior law treating a REIT and all stapled entities as a single entity for purposes of determining REIT status (sec. 269B) apply to real property interests acquired after March 26, 1998, by an existing stapled REIT, a stapled entity, or a subsidiary or partnership in which a 10-percent or greater interest is owned by an existing stapled REIT or stapled entity (together referred to as the "stapled REIT group"), unless the real property interest is grandfathered as described below. Special rules apply to certain mortgages acquired by the stapled REIT group after March 26, 1998, where a member of the stapled REIT group performs services with respect to the property secured by the mortgage.

#### *Rules for real property interests*

*In general*

The Act generally applies to real property interests acquired by a member of the stapled REIT group after March 26, 1998. Real property interests that are acquired by a member of the REIT group after such date, and which are not grandfathered under the rules described below, are referred to as "nonqualified real property interests".

The Act treats activities and gross income of a stapled REIT group with respect to nonqualified real property interests held by any member of the stapled REIT group as activities and income of the REIT for certain purposes in the same manner as if the stapled REIT group were a single entity. This treatment applies for purposes of the following provisions that depend on a REIT's gross income: (1) the 95-percent test (sec. 856(c)(2)); (2) the 75-percent test (sec. 856(c)(3)); (3) the "reasonable cause" exception for failure to meet either test (sec. 856(c)(6)); and (4) the special tax on excess gross income for REITs with net income from prohibited transactions (sec. 857(b)(5)).

Thus, for example, where a stapled entity leases nonqualified real property from the REIT and earns gross income from operating the property, such gross income is subject to the Act. The REIT and the stapled entity are treated as a single entity, with the result that the lease payments from the stapled entity to the REIT are ignored. The gross income earned by the stapled entity from operating the property is treated as gross income of the REIT, with the result that either the 75-percent or 95-percent test might not be met and REIT status might be lost. Similarly, where a stapled entity leases property from a third party after March 26, 1998, and uses that property in a business, the gross income it derives is treated as income of the REIT because the lease is a nonqualified real property interest.

In the event that a stapled REIT group ceases to be stapled, the rules treating assets, activities and gross income of members of the stapled REIT group as attributes of the REIT apply only to the portion of the year in which the group was a stapled REIT group.

*Grandfathered real property interests*

Under the Act, all real property interests acquired by a member of the stapled REIT group after March 26, 1998, are treated as nonqualified real property interests subject to the general rules described above, unless they qualify under one of the grandfather rules. An option to acquire real property is generally treated as a real property interest for purposes of the Act. Real property acquired by exercise of a call option after March 26, 1998, is treated as a nonqualified real property interest, even though the call option was acquired before such date. However, real property acquired by exercise of a put option, buy-sell agreement or an agreement relating to a third party default that was binding on March 26, 1998, and at all times thereafter, is generally treated as a grandfathered real property interest. It is the intention of Congress that this rule apply only to substantive economic arrangements that are outside of the control of the stapled REIT group.

Under the Act, grandfathered real property interests include properties acquired by a member of the stapled REIT group after March 26, 1998, pursuant to a written agreement which was binding on March 26, 1998, and all times thereafter. Grandfathered properties also include certain properties the acquisition of which were described in a public announcement or in a filing with the Securities and Exchange Commission on or before March 26, 1998.

A real property interest does not generally lose its status as a grandfathered interest by reason of a repair to, an improvement of, or a lease of, the real property. Thus, if a REIT owns a grandfathered real property interest that is leased to a third party and, at the expiration of that lease, the REIT leases the property to a stapled entity, the interest would remain a grandfathered interest. Similarly, a lease or renewal of a lease of grandfathered property between members of the stapled REIT group, or a renewal of a lease of property from a third party to a member of the stapled REIT group, does not generally terminate grandfathered status, whether the renewal is pursuant to the terms of the lease or otherwise.[94] However, renewal of a lease can cause loss of grandfather status if the property is improved to the extent that grandfather status would be lost under the improvement rules described below. Moreover, for leases and renewals entered into after March 26, 1998 (whether from members of the stapled REIT group or third parties), grandfather status is lost if the rent on the lease or renewal exceeds an arm's length rate.

[94] In the case of a lease from a third party, a renewal will not qualify if there is a significant time period between the two tenancies.

An improvement of a grandfathered real property interest causes loss of grandfather status and becomes a nonqualified real property interest in certain circumstances. Any expansion beyond the boundaries of the land of the otherwise grandfathered interest occurring after March 26, 1998, is treated as a non-qualified real property interest to the extent of such expansion. Moreover, any improvement of an otherwise grandfathered real property interest (within its land boundaries) that is placed in service after December 31, 1999, is treated as a separate nonqualified real property interest in certain circumstances. Such treatment applies where (1) the improvement changes the use of the property and (2) its cost is greater than (a) 200 percent of the undepreciated cost of the property (prior to the improvement) or (b) in the case of property acquired where there is a substituted basis, the fair market value of the property on the date that the property was acquired by the stapled entity or the REIT. There is an exception for improvements placed in service before January 1, 2004, pursuant to a binding contract in effect on December 31, 1999, and at all times thereafter. The rule treating improvements as nonqualified real property interests could apply, for example, if a member of the stapled REIT group constructs a building after December 31, 1999, on previously undeveloped raw land that had been acquired on or before March 26, 1998.

*Ownership through entities*

If a REIT or stapled entity owns, directly or indirectly, a 10-percent-or-greater interest in a corporate subsidiary or partnership (or other entity described below) that owns a real property interest, the above rules apply with respect to a proportionate part of the entity's real property interests, activities and gross income. Thus, any real property interest acquired by such a subsidiary or partnership that is not grandfathered is treated as a nonqualified real property interest held by the REIT or stapled entity in the same proportion as its ownership interest in the entity. The same proportion of the subsidiary's or partnership's gross income from any nonqualified real property interest owned by it or another member of the stapled REIT group will be treated as income of the REIT under the rules described above. However, an interest in real property acquired by a grandfathered 10-percent-or-greater partnership or subsidiary is treated as grandfathered if such interest would be a grandfathered interest if held directly by the REIT or stapled entity. Thus, an interest in real property acquired by a 10-percent-or-greater partnership or subsidiary pursuant to a binding written agreement, public announcement, SEC filing, put option, buy-sell agreement or agreement relating to a third-party default (a "qualified transaction") is treated as grandfathered if such interest would be a grandfathered interest if acquired directly by the REIT or stapled entity.

Similar rules attributing the proportionate part of the subsidiary's or partnership's real property interests and gross income will apply when a REIT or a stapled entity acquires a 10-percent-or-greater interest (or in the case of a previously-owned entity, acquires an additional interest) after March 26, 1998, with exceptions for interests acquired by a member of the stapled REIT group pursuant to qualified transactions described above. Transition relief can apply to both an entity's assets and the interest in the entity under the above rules. Thus, if on March 26, 1998, and at all times thereafter, a stapled entity has a binding written contract to buy 10-percent or more of the stock of a corporation and the corporation also has a binding written contract to buy real property, no portion of the property will be treated as a nonqualified real property interest as a result of the transaction.

Under the above rules, gross income of a REIT or stapled entity with respect to a nonqualified real property interest held by a 10-percent-or-greater partnership or subsidiary is subject to the rules for nonqualified real property interests only in proportion to the interest held in the partnership or subsidiary. For example, assume that a stapled entity has a contract to manage a nonqualified real property interest held by a partnership in which the stapled entity owns an 85-percent interest. Under the above rules, for purposes of applying the gross income tests, 85 percent of the partnership's activities and gross income from the property are attributed to the REIT. As a result, 85 percent of the stapled entity's income from the management contract is ignored under the single-entity analysis described above. The remaining 15 percent of the management fee is not treated as gross income of the REIT because it is not income from a nonqualified real property interest held or deemed held by the REIT or a stapled entity.

Where a REIT's or stapled entity's interest in a partnership or subsidiary changes during the year, the rules treating a proportionate part of the assets, activities and gross income of the partnership or subsidiary as attributes of the REIT or stapled entity apply on a partial-year basis.

There is a provision intended to deal with the special situation of so-called "UPREIT" partnerships (see Treas. reg. 1.701–2(d)(example 4)), which generally treats 100 percent of the real property interests, mortgages, activities and gross income of such partnerships as interests, activities and gross income of the REIT or stapled entity that owns a partnership interest. The provision applies where (i) an exempt REIT or stapled entity owned directly or indirectly) at least a 60-percent interest in a partnership as of March 26, 1998, (ii) 90 percent or more of the interests in the partnership (other than those held by the exempt REIT or stapled entity) are or will be redeemable or exchangeable for consideration with a value determined with reference to the stock of the REIT or stapled entity or both. The provision also applies to an interest in a partnership formed after March 26, 1998, which meets the provision's other requirements, where the partnership was formed to mirror the stapling of an exempt REIT and a stapled entity in connection with an acquisition agreed to or announced on or before March 26, 1998. If, as of January 1, 1999, more than one partnership owned (directly or indirectly) by either an exempt REIT or stapled entity meets the requirements of the provision, only the largest such partnership (determined by aggregate asset bases) is treated as meeting such requirements.

*Intragroup transfers*

A transfer, direct or indirect, of a grandfathered real property interest between members of a stapled REIT group does not result in a loss of grandfather status if the total direct and indirect interests of both the exempt REIT and stapled entity in the real property interest does not increase as a result of the transfer. If the total direct and indirect interest of the exempt REIT and stapled entity increases, the transferred real property interest will be deemed to lose grandfather status only to the extent of such increase. The provision applies to all types of transfers of real property interests among group members, such as sales, contributions and distributions, whether taxable or tax-free. Moreover, the provision applies both to direct transfers of real property interests and transfers of such interests indirectly through transfer of interests in 10-percent-or-greater owned partnerships and subsidiaries. The application of the provision is illustrated by the following examples. First, assume that an exempt REIT sells a portion of a grandfathered real property interest to a stapled entity. The real property interest remains grandfathered because there is no increase in the total interests of the REIT and the stapled entity (100 percent both before and after the transfer). Second, assume that a grandfathered real property interest is contributed by a stapled entity to a partnership or subsidiary in which the stapled entity owns a 10-percent-or-greater interest (either prior to, or as a result of, the contribution) under the rules described above. The real property interest remains grandfathered because the previous total interests of the exempt REIT and stapled entity (the stapled entity's 100-percent interest) are not increased by the transfer.[95] Third, assume a REIT owns a 50-percent interest in a partnership that distributes a grandfathered real property interest to the REIT in complete liquidation of its interest. The 50-percent interest that was previously deemed owned by the REIT will continue to be grandfathered; the remaining 50-percent interest will become a non-grandfathered interest because it represents an increase in the total direct and indirect interests of the REIT and stapled entity in the real property interest. Fourth, assume that a partnership in which an exempt REIT or stapled entity owns a 10-percent or greater interest under the rules described above terminates as a result of a sale of 50 percent or more of the total partnership interests during a 12-month period that does not involve the REIT or a stapled entity (sec. 708(b)(1)(B)). Grandfather status of real property interests owned by the partnership is not lost in the transfer because, as a result of the termination, the partnership's assets are deemed contributed to a new partnership and interests in that partnership are deemed distributed to the purchasing and other partners in proportion to their interests (Treas. reg. sec. 1.708–1(b)(1)(iv)). Thus, there is no change in the total interest of the REIT and stapled entity in the partnership's assets.

### *Mortgage rules*

Under the Act, special rules apply where a member of the stapled REIT group holds a mortgage (that is not an existing obligation under the rules described below) that is secured by an interest

[95] Nevertheless, if the REIT's interest in the partnership or subsidiary increases as a result of the contribution, a portion of each of the entity's real property interests other than the interest contributed, reflecting the proportionate increase in the REIT's interest in the entity, will be treated as a non-grandfathered real property interest.

in real property, and a member of the stapled REIT group engages in certain activities with respect to that property. The activities that have this effect under the Act are activities that would result in impermissible tenant service income (as defined in sec. 856(d)(7)) if performed by the REIT with respect to property it held. In such a case, all interest on the mortgage that is allocable to that property and all gross income received by a member of the stapled REIT group from the activity will be treated as impermissible tenant service income of the REIT, which is not qualifying income under either the 75-percent or 95-percent tests. For example, assume that the REIT makes a mortgage loan on a hotel owned by a third party which is operated by a stapled entity under a management contract. Unless an exception applies, both the management fees earned by the stapled entity and the interest earned by the REIT will be treated as impermissible tenant services income of the REIT.

An exception to the above rules is provided for mortgages the interest on which does not exceed an arm's-length rate and which would be treated as interest for purposes of the REIT rules. An exception also is available for mortgages that are held by a member of the stapled REIT group on March 26, 1998, and at all times thereafter, and which are secured by an interest in real property on that date, and at all times thereafter (the "existing mortgage exception"). The existing mortgage exception ceases to apply if the mortgage is refinanced and the principal amount is increased in such refinancing.

In the case of a partnership or subsidiary in which the REIT or a stapled entity owns a 10-percent-or-greater interest, a proportionate part of the entity's mortgages, interest and gross income from activities would be attributed to the REIT or the stapled entity, subject to rules similar to those for nonqualified real property interests. Thus, if a REIT or a stapled entity acquires a 10-percent-or-greater interest in a partnership or corporation after March 26, 1998, no mortgage held by the partnership or subsidiary at such time would qualify for the existing mortgage exception. Similarly, if a REIT or stapled entity owns a 10-percent-or-greater interest in a partnership or subsidiary on March 26, 1998, and the REIT or the stapled entity subsequently acquires a greater interest, a portion of each of the partnership's or subsidiary's mortgages that is the same as the proportionate increase in the ownership interest would fail to qualify for the existing mortgage exception.

Under the Act's priority rules, the mortgage rules do not apply to any part of a real property interest that is owned or deemed owned by the REIT or a stapled entity under the rules for real property interests described above. Thus, for example, if the REIT makes a mortgage loan on real property owned by a stapled entity, the mortgage rules would not apply. If the property is a nonqualified real property interest, the interest on the mortgage would be ignored under the single-entity analysis described above, and the gross income of the stapled entity from the property would be treated as income of the REIT. Similarly, assume that a stapled entity owns 75 percent of the stock of a subsidiary and has a management contract to operate a hotel owned by the subsidiary. Assume also that the REIT makes a mortgage loan for the hotel. Under the real property interest rules, 75 percent of the hotel is treated as owned by the stapled entity. Thus, if the hotel is a nonqualified real property interest, 75 percent of the subsidiary's gross income from the hotel is treated as income of the REIT and 75 percent of the income on the management contract is ignored under the single-entity analysis. With respect to the remaining 25-percent interest in the subsidiary, the real property interest rules do not apply, but the mortgage rules would treat 25 percent of the mortgage interest and 25 percent of management contract income as impermissible tenant services income of the REIT.

For mortgages held on March 26, 1998, an increase in interest payable on a mortgage (except pursuant to an interest arrangement, such as variable interest, under the mortgage's terms as of March 26, 1998), or an increase in interest payable as a result of a refinancing, causes the mortgage to cease to qualify for the exception unless the new interest rate meets an arm's-length standard.

***Other rules***

For purposes of both the real property interest and mortgage rules, if a stapled REIT is not stapled as of March 26, 1998, and at all times thereafter, or if it fails to qualify as a REIT as of such date or any time thereafter, no assets of any member of the stapled REIT group would qualify under the grandfather rules. Thus, all of the real property interests held by the group would be nonqualified real property interests and none of the mortgages held by the group would qualify for the existing mortgage exception.

For a corporate subsidiary owned by a stapled entity, the 10-percent ownership test would be met if a stapled entity owns, directly or indirectly, 10 percent or more of the corporation's stock, by either vote or value.[96] For this purpose, any change in proportionate ownership that is attributable solely to fluctuations in the relative fair market values of different classes of stock is not taken into account. For interests in partnerships, the ownership test would be met if the share of capital or profits, whichever is larger, owned by the REIT or stapled entity is 10 percent or greater. Interests in other entities, such as trusts, are treated in the same manner as 10-percent-or-greater interests in partnerships or corporations if the REIT or a stapled entity owns, directly or indirectly, 10 percent or more of the beneficial interests in the entity.

In the case of a qualified REIT subsidiary (sec. 856(i)), all real property interests, mortgages, activities and gross income are treated as attributes of the REIT for purposes of the Act.

Under the Act, terms used that are also used in the stapled stock rules (sec. 269B) or the REIT rules (sec. 856) have the same meanings as under those rules.

The Secretary of the Treasury is given authority to prescribe such guidance as may be necessary or appropriate to carry out the purposes of the Act, including guidance to prevent the double counting of income and to prevent transactions that would avoid the purposes of the Act.

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[96] The Act does not apply to a stapled REIT's ownership of a corporate subsidiary, although the REIT would be subject to the normal restrictions on a REIT's ownership of stock in a corporation.

### *Effective Date*

The provision is effective for taxable years ending after March 26, 1998.

### *Revenue Effect*

The provision is estimated to increase Federal fiscal year budget receipts by $1 million in 1999, $3 million in 2000, $6 million in 2001, $10 million in 2002, $14 million in 2003, $19 million in 2004, $26 million in 2005, $35 million in 2006 and $45 million in 2007.

## C. Make Certain Trade Receivables Ineligible for Mark-to-Market Treatment (sec. 7003 of the Act and sec. 475 of the Code)

### *Present and Prior Law*

In general, a dealer in securities is required to use a mark-to-market method of accounting for securities. A dealer in securities is a taxpayer who regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business, or who regularly offers to enter into, assume, offset, assign, or otherwise terminate positions in certain types of securities with customers in the ordinary course of a trade or business. A security includes an evidence of indebtedness.

Treasury regulations provide that if a taxpayer would be a dealer in securities only because of its purchases and sales of debt instruments that, at the time of purchase or sale, are customer paper with respect to either the taxpayer or a corporation that is a member of the same consolidated group, the taxpayer will not normally be treated as a dealer in securities. However, the regulations allow such a taxpayer to elect out of this exception to dealer status.[97] For this purpose, a debt instrument is customer paper with respect to a person if: (1) the person's principal activity is selling non-financial goods or providing non-financial services; (2) the debt instrument was issued by the purchaser of the goods or services at the time of the purchase of those goods and services in order to finance the purchase; and (3) at all times since the debt instrument was issued, it has been held either by the person selling those goods or services or by a corporation that is a member of the same consolidated group as that person.

### *Reasons for Change*

Congress enacted the mark-to-market rules of section 475 to provide a more accurate reflection of the income of securities dealers. The Congress did not believe that the mark-to-market rules were intended to be used by taxpayers whose principal activity was the selling of goods and services to obtain a deduction earlier than would otherwise be permitted.

[97] Treas. reg. sec. 1.475(c)–1(b), issued December 23, 1996; the "customer paper election."

### *Explanation of Provision*

The provision makes certain trade receivables ineligible for mark-to-market treatment. A trade receivable is ineligible for mark-to-market treatment if it is a note, bond, debenture, or other evidence of indebtedness arising out of the sale of goods or services by a person the principal activity of which is selling or providing non-financial goods and services, and it is held by such person (or a related person) at all times since it was issued. A receivable meeting the above definition is not treated as a security for purposes of the mark-to-market rules (sec. 475). Thus, such a receivable is not marked-to-market, even if the taxpayer qualifies as a dealer in other securities.

The provision applies to trade receivables arising from services performed by independent contractors, as well as employees. Thus, for example, if a taxpayer's principal activity is selling non-financial services and some or all of such services are performed by independent contractors, no receivables that the taxpayer accepts for services can be marked-to-market under the provision. Congress intended that, pursuant to the authority granted by section 475(g)(1), the Secretary of the Treasury is authorized to issue regulations to prevent abuse of the trade receivables exception, including through independent contractor arrangements.

To the extent provided in Treasury regulations, trade receivables that are held as inventory for sale to customers by the taxpayer or a related person may be treated as "securities" for purposes of the mark-to-market rules, and transactions in such receivables could result in a taxpayer being treated as a dealer in securities (sec. 475(c)(1)). Unless this regulatory exception for trade receivables held as inventory applies, a taxpayer will not be treated as a dealer in securities as a result of sales of trade receivables covered by the provision.

It is the intention of Congress that, for trade receivables that are excepted from the statutory mark-to-market rules (sec. 475) under the provision, mark-to-market or lower-of-cost-or-market will not be permissible methods of accounting (see sec. 446(b)).

### *Effective Date*

The provision is effective for taxable years ending after the date of enactment (after July 22, 1998). Adjustments required under section 481 as a result of the change in method of accounting generally are required to be taken into account ratably over the four-year period beginning in the first taxable year for which the provision is in effect. However, where the taxpayer terminates its existence or ceases to engage in the trade or business that generated the receivables (except as a result of a tax-free transfer), any remaining balance of the section 481 adjustment is taken into account entirely in the year of such cessation or termination (see sec. 5.04(3)(c) of Rev. Proc. 97–37, 1997–33 I.R.B. 18).

### *Revenue Effect*

The provision is estimated to increase Federal budget receipts by $33 million in 1998, $317 million in 1999, $500 million in 2000, $333 million in 2001, $117 million in 2002, $70 million in 2003,

$73 million in 2004, $77 million in 2005, $81 million in 2006, and $85 million in 2007.

## D. Exclusion of Minimum Required Distributions from AGI for Roth IRA Conversions (sec. 7004 of the Act and sec. 408A of the Code)

### *Present and Prior Law*

Under present and prior law, uniform minimum distribution rules apply to qualified retirement plans and annuities, individual retirement arrangements ("IRAs") other than Roth IRAs, and tax-sheltered annuities (sec. 403(b)).

Under present and prior law, minimum required distributions must begin no later than the individual's required beginning date (sec. 401(a)(9)). In the case of an IRA, the required beginning date is April 1 of the calendar year following the calendar year in which the IRA owner attains age 70½. In general, minimum required distributions are includible in gross income in the year of distribution. An excise tax equal to 50 percent of the minimum required distribution applies to the extent a required distribution is not made.

Under present and prior law, taxpayers with adjusted gross income ("AGI") of $100,000 or less are eligible to convert all or any part of amounts in a deductible or nondeductible IRA into a Roth IRA. In the case of a married taxpayer, AGI is the combined AGI of the couple. Under prior law, minimum required distributions were included in the definition of AGI for purposes of determining eligibility to convert from an IRA to a Roth IRA. Married taxpayers filing a separate return are not eligible to make a conversion.

### *Explanation of Provision*

The provision amends section 408A(c)(3)(C)(i) to exclude minimum required distributions from IRAs (but not distributions from qualified plans) from the definition of AGI solely for purposes of determining eligibility to convert from a deductible or nondeductible IRA into a Roth IRA. Under present and prior law, the required minimum distribution is not eligible for conversion and is includible in gross income.

### *Effective Date*

The provision is effective for taxable years beginning after December 31, 2004.

### *Revenue Effect*

The provision is estimated to increase Federal fiscal year budget receipts by $2,362 million in 2005, $2,854 million in 2006, and $2,812 million in 2007.

## TITLE VIII. IDENTIFICATION OF LIMITED TAX BENEFITS UNDER THE LINE ITEM VETO ACT (sec. 8001 of the Act)

### *Present and Prior Law*

The Line Item Veto Act amended the Congressional Budget and Impoundment Act of 1974 to grant the President the limited authority to cancel specific dollar amounts of discretionary budget authority, certain new direct spending, and limited tax benefits. The Line Item Veto Act provides that the Joint Committee on Taxation is required to examine any revenue or reconciliation bill or joint resolution that amends the Internal Revenue Code of 1986 prior to its filing by a conference committee in order to determine whether or not the bill or joint resolution contains any limited tax benefits and to provide a statement to the conference committee that either (1) identifies each limited tax benefit contained in the bill or resolution, or (2) states that the bill or resolution contains no limited tax benefits. The Line Item Veto Act provides that the conferees determine whether or not to include the Joint Committee's statement in the conference report. If the conference report includes the information from the Joint Committee on Taxation identifying provisions that are limited tax benefits, then the President can cancel one or more of those, but only those, provisions that have been identified. If such a conference report contains a statement from the Joint Committee on Taxation that none of the provisions in the conference report are limited tax benefits, then the President has no authority to cancel any of the specific tax provisions, because there are no tax provisions that are eligible for cancellation under the Line Item Veto Act.

On June 25, 1998, the U.S. Supreme Court held that the cancellation procedures set forth in the Line Item Veto Act are unconstitutional. *Clinton* v. *City of New York,* 118 S. Ct. 2091 (June 25, 1998).

### *Explanation of Provision*

Pursuant to the provisions of the Line Item Veto Act as in effect at the time the Internal Revenue Service Restructuring and Reform Act was passed by the Congress, that Act contains a list of provisions that the Joint Committee on Taxation identified as limited tax benefits within the meaning of the Line Item Veto Act. These provisions are:

(1) Section 3105 (relating to administrative appeal of adverse IRS determination of tax-exempt status of bond issue); and

(2) Section 3445(c)(relating to State fish and wildlife permits).

# PART THREE: TAX AND TRADE RELIEF EXTENSION ACT OF 1998 (DIVISION J OF H.R. 4328, OMNIBUS CONSOLIDATED AND EMERGENCY SUPPLEMENTAL APPROPRIATIONS ACT, 1999) [98]

## TITLE I. EXTENSION OF EXPIRING PROVISIONS

### A. Extension of Research Tax Credit (sec. 1001 of the Act and sec. 41 of the Code)

#### *Present and Prior Law*

Section 41 provides for a research tax credit equal to 20 percent of the amount by which a taxpayer's qualified research expenditures for a taxable year exceeded its base amount for that year. The research tax credit expired and generally does not apply to amounts paid or incurred after June 30, 1998.

Except for certain university basic research payments made by corporations, the research tax credit applies only to the extent that the taxpayer's qualified research expenditures for the current taxable year exceed its base amount. The base amount for the current year generally is computed by multiplying the taxpayer's "fixed-base percentage" by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenditures and had gross receipts during each of at least three years from 1984 through 1988, then its "fixed-base percentage" is the ratio that its total qualified research expenditures for the 1984–1988 period bears to its total gross receipts for that period (subject to a maximum ratio of .16). All other taxpayers (so-called "start-up firms") are assigned a fixed-base percentage of 3 percent.

Taxpayers are allowed to elect an alternative incremental research credit regime. If a taxpayer elects to be subject to this alternative regime, the taxpayer is assigned a three-tiered fixed-base percentage (that is lower than the fixed-base percentage otherwise applicable under present law) and the credit rate likewise is reduced. Under the alternative credit regime, a credit rate of 1.65 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1 percent (i.e., the base amount equals 1 percent of the taxpayer's average gross receipts for the four preceding years) but do not exceed a base amount computed by using a fixed-

[98] P.L. 105–277. The revenue provisions of H.R. 4328 generally originated in H.R. 4738. H.R. 4738 was reported by the Committee on Ways and Means on October 12, 1998 (H. Rept. 105–817), and was passed by the House on October 12, 1998. Some provisions were included in S. 2260, as introduced by Senators Roth and Moynihan. The conference report on H.R. 4328 was filed on October 19, 1998 (H. Rept 105–825). The House passed the conference report on October 20, 1998, and the Senate passed it on October 21, 1998.
H.R. 4328 was signed by the President on October 21, 1998.

base percentage of 1.5 percent. A credit rate of 2.2 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1.5 percent but do not exceed a base amount computed by using a fixed-base percentage of 2 percent. A credit rate of 2.75 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 2 percent. An election to be subject to this alternative incremental credit regime may be made for any taxable year beginning after June 30, 1996, and such an election applies to that taxable year and all subsequent years (in the event that the credit subsequently is extended by Congress) unless revoked with the consent of the Secretary of the Treasury.

### *Reasons for Change*

The Congress believed that increasing technological knowledge ultimately will lead to new and better products produced at lower costs. New and better products and lower production costs are the genesis of economic growth. For this reason, the Congress believed it was important to extend the research and experimentation tax credit.

### *Explanation of Provision*

The provision extends the research credit for 12 months—i.e., generally, for the period July 1, 1998, through June 30, 1999.

In extending the credit, the Congress reaffirmed the scope of the term "qualified research." Section 41 targets the credit to research which is undertaken for the purpose of discovering information which is technological in nature and the application of which is intended to be useful in the development of a new or improved business component of the taxpayer. However, eligibility for the credit does not require that the research be successful—i.e., the research need not achieve its desired result. Moreover, evolutionary research activities intended to improve functionality, performance, reliability, or quality are eligible for the credit, as are research activities intended to achieve a result that has already been achieved by other persons but is not yet within the common knowledge (e.g., freely available to the general public) of the field (provided that the research otherwise meets the requirements of sec. 41, including not being excluded by subsection (d)(4)).

Activities constitute a process of experimentation, as required for credit eligibility, if they involve evaluation of more than one alternative to achieve a result where the means of achieving the result are uncertain at the outset, even if the taxpayer knows at the outset that it may be technically possible to achieve the result. Thus, even though a researcher may know of a particular method of achieving an outcome, the use of the process of experimentation to effect a new or better method of achieving that outcome may be eligible for the credit (provided that the research otherwise meets the requirements of sec. 41, including not being excluded by subsection (d)(4)).

Lastly, the Congress observed the lack of clarity in the interpretation of the distinction between internal-use software, the costs of which may be eligible for the credit if additional tests are met, and other software. The Congress emphasized that application of the definition of internal-use software should fully reflect Congressional intent.

### *Effective Date*

The extension of the research credit is effective for qualified research expenditures paid or incurred during the period July 1, 1998, through June 30, 1999.

### *Revenue Effect*

The provision is estimated to reduce Federal fiscal year receipts by $1,126 million in 1999, $505 million in 2000, $258 million in 2001, $184 million in 2002, $94 million in 2003, and $20 million in 2004.

## B. Extension of the Work Opportunity Tax Credit (sec. 1002 of the Act and sec. 51 of the Code)

### *Present and Prior Law*

#### *In general*

The work opportunity tax credit ("WOTC"), which expired on June 30, 1998, was available on an elective basis for employers hiring individuals from one or more of eight targeted groups. The credit equals 40 percent (25 percent for employment of 400 hours or less) of qualified wages. Qualified wages are wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual began work for the employer. For a vocational rehabilitation referral, however, the period begins on the day the individual began work for the employer on or after the beginning of the individual's vocational rehabilitation plan.

The maximum credit per employee is $2,400 (40 percent of the first $6,000 of qualified first-year wages). With respect to qualified summer youth employees, the maximum credit is $1,200 (40 percent of the first $3,000 of qualified first-year wages).

The employer's deduction for wages is reduced by the amount of the credit.

#### *Targeted groups eligible for the credit*

The eight targeted groups are: (1) families eligible to receive benefits under the Temporary Assistance for Needy Families ("TANF") Program; (2) high-risk youth; (3) qualified ex-felons; (4) vocational rehabilitation referrals; (5) qualified summer youth employees; (6) qualified veterans; (7) families receiving food stamps; and (8) persons receiving certain Supplemental Security Income ("SSI") benefits.

#### *Minimum employment period*

No credit is allowed for wages paid to employees who work less than 120 hours in the first year of employment.

### *Expiration date*

Under prior law, the credit expired for wages paid or incurred to an otherwise qualified individual who began work for an employer on or after July 1, 1998.

### *Reasons for Change*

The Congress believed the preliminary experience of the WOTC showed promise as an incentive for employers to hire individuals who are underskilled, undereducated, or who generally may be less desirable to employers. A temporary extension of this credit allows the Congress and the Treasury and Labor Departments to continue to monitor the effectiveness of the credit.

### *Explanation of Provision*

The Act extends the work opportunity tax credit for 12 months (through June 30, 1999).

### *Effective Date*

The provision is effective for wages paid or incurred to qualified individuals who begin work for the employer on or after July 1, 1998, and before July 1, 1999.

### *Revenue Effect*

The provision is estimated to reduce Federal fiscal year budget receipts by $191 million in 1999, $140 million in 2000, $73 million in 2001, $29 million in 2002, $10 million in 2003, and $2 million in 2004.

## C. Extension of the Welfare-To-Work Tax Credit (sec. 1003 of the Act and sec. 51A of the Code)

### *Present and Prior Law*

Employers are allowed a tax credit for eligible wages paid to qualified long-term family assistance recipients during the first two years of employment. The credit is 35 percent of the first $10,000 of eligible wages in the first year of employment and 50 percent of the first $10,000 of eligible wages in the second year of employment. The maximum credit is $8,500 per qualified employee.

Qualified long-term family assistance recipients are: (1) members of a family that have received family assistance for at least 18 consecutive months ending on the hiring date; (2) members of a family that have received family assistance for a total of at least 18 months (whether or not consecutive) after the date of enactment of this credit (August 5, 1997) if they are hired within 2 years after the date that the 18-month total is reached; and (3) members of a family who are no longer eligible for family assistance because of either Federal or State time limits, if they are hired within 2 years after the Federal or State time limits made the family ineligible for family assistance.

Eligible wages include cash wages paid to an employee plus amounts paid by the employer for the following: (1) educational assistance excludable under a section 127 program (or that would be excludable but for the expiration of sec. 127); (2) accident and health plan coverage for the employee, but not more than the applicable premium defined under the health care continuation rules (sec. 4980B(f)(4)); and (3) dependent care assistance excludable under section 129.

Under prior law, the welfare-to-work credit was effective for wages paid or incurred to a qualified individual who began work for an employer on or after January 1, 1998, and before May 1, 1999.

### *Reasons for Change*

When enacted in the Taxpayer Relief Act of 1997, the goals of the welfare-to-work credit were: (1) to provide an incentive to hire long-term welfare recipients; (2) to promote the transition from welfare to work by increasing access to employment; and (3) to encourage employers to provide these individuals with training, health coverage, dependent care and ultimately better job attachment. The Congress believed that the credit should be temporarily extended to provide the Congress and the Treasury and Labor Departments a better opportunity to assess the operation and effectiveness of the credit in meeting its goals.

### *Explanation of Provision*

The Act extends the welfare-to-work credit for an additional two months (through June 30, 1999).

### *Effective Date*

The provision is effective for wages paid or incurred to a qualified individual who begins work for an employer on or after May 1, 1999, and before July 1, 1999.

### *Revenue Effect*

The provision is estimated to reduce Federal fiscal year budget receipts by $4 million in 1999, $10 million in 2000, $7 million in 2001, $3 million in 2002, and $1 million in 2003.

## D. Make Permanent the Deduction Provided for Contributions of Appreciated Stock to Private Foundations; Public Inspection of Private Foundation Annual Returns

### 1. Make permanent the deduction provided for contributions of appreciated stock to private foundations (sec. 1004(a) of the Act and sec. 170(e)(5) of the Code)

### *Present and Prior Law*

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the fair market value of property contributed to a charitable organization.[99] However, in the case of a charitable contribution of short-term gain, inventory, or

[99] The amount of the deduction allowable for a taxable year with respect to a charitable contribution may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer (secs. 170(b) and 170(e)).

other ordinary income property, the amount of the deduction generally is limited to the taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, the deduction is limited to the taxpayer's basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose.

In cases involving contributions to a private foundation (other than certain private operating foundations), the amount of the deduction is limited to the taxpayer's basis in the property. However, under a special rule contained in section 170(e)(5), taxpayers are allowed a deduction equal to the fair market value of "qualified appreciated stock" contributed to a private foundation. Qualified appreciated stock is defined as publicly traded stock which is capital gain property. The fair-market-value deduction for qualified appreciated stock donations applies only to the extent that total donations made by the donor to private foundations of stock in a particular corporation did not exceed 10 percent of the outstanding stock of that corporation. For this purpose, an individual is treated as making all contributions that were made by any member of the individual's family.

Under prior law, the special rule contained in section 170(e)(5) expired on June 30, 1998.

### *Reasons for Change*

The Congress believed that, to encourage donations to charitable private foundations, it was appropriate to extend permanently the rule that allows a fair-market-value deduction for certain gifts of appreciated stock to private foundations.

### *Explanation of Provision*

The Act extends permanently the special rule contained in section 170(e)(5).

### *Effective Date*

The provision is effective for contributions of qualified appreciated stock to private foundations made on or after July 1, 1998.

### *Revenue Effect*

The provision is estimated to decrease Federal fiscal year budget receipts by $23 million in 1999, $56 million in 2000, $71 million in 2001, $83 million in 2002, $91 million in 2003, $95 million in 2004, $100 million in 2005, $104 million in 2006, and $109 million in 2007.

## 2. Public inspection of private foundation annual returns (sec. 1004(b) of the Act and secs. 6104(d) and (e) of the Code)

### *Present and Prior Law*

Tax-exempt organizations (other than churches and certain small organizations) are required to file an annual information return (Form 990) with the Internal Revenue Service ("IRS"), setting forth the organization's items of gross income and expenses attributable to such income, disbursements for tax-exempt purposes, plus certain other information for the taxable year.

Under prior law, private foundations were required to make the current year's annual information return (Form 990–PF) available for public inspection at the foundation's principal office during regular business hours (sec. 6104(d)). Such return was required to be made available for inspection by any citizen on request made within 180 days after the date of publication of notice of its availability. Notice had to be published, not later than the day the return was required to be filed, in a newspaper having general circulation in the county in which the principal office of the foundation was located. The notice was required to state that the annual return was available for public inspection by any citizen who requested it, and had to state the address and telephone number of the private foundation's principal office and the name of its principal manager.

Under present law, tax-exempt organizations (other than private foundations) that are required to file a Form 990, including public charities, are required to allow public inspection at the organization's principal office (and certain regional or district offices) of their Forms 990 for the three most recent taxable years (sec. 6104(e)).

The Taxpayer Bill of Rights 2, which was enacted in 1996, imposed additional public inspection requirements on tax-exempt organizations. All tax-exempt organizations, except private foundations, will be required to comply with requests made in person or in writing by individuals who seek a copy of the organization's Form 990 for any of the organization's three most recent taxable years. Upon such a request, the organization is required to supply copies without charge other than a reasonable fee for reproduction and mailing costs. If the request for copies is made in person, then the organization must immediately provide such copies. If the request for copies is made in writing, then copies must be provided within 30 days. In addition, all tax-exempt organizations, including private foundations, will be required to comply in the same manner with requests made in person or in writing by individuals who seek a copy of the organization's application for recognition of tax-exempt status and certain related documents. However, an organization may be relieved of its obligation to provide copies if, in accordance with regulations to be promulgated by the Secretary of Treasury, (1) the organization has made the requested documents widely available or (2) the Secretary of the Treasury determined, upon application by the organization, that the request is part of a harassment campaign and that compliance with such request is not in the public interest. These additional public inspection provisions enacted in 1996 apply to requests made no earlier than 60 days after the date on which the Treasury Department publishes regulations defining when requested documents have been made widely available or when a request is part of a harassment campaign.[100] While

[100] However, the legislative history of the provision indicates that Congress expected that organizations will comply voluntarily with the public inspection provisions prior to the issuance of such final regulations.

proposed regulations have been issued, final regulations have not been published; therefore, the provision is not yet in effect.[101]

Upon written request to the IRS, members of the general public also are permitted to inspect annual information returns of tax-exempt organizations and applications for recognition of tax-exempt status (and related documents) at the National Office of the IRS in Washington, D.C. A person making such a written request is notified by the IRS when the material is available for inspection at the National Office, where notes may be taken of the material open for inspection, photographs taken with the person's own equipment, or copies of such material obtained from the IRS for a fee (Treas. Reg. secs. 301.6104(a)–6 and 301.6104(b)–1).

### *Reasons for Change*

To enhance oversight and public accountability of non-profit organizations, the Congress believed that the disclosure provisions applicable to private foundations should be consistent with those applicable to public charities and other tax-exempt organizations. In addition, the Congress believed that this change will result in more efficient use of private foundation resources by eliminating the present-law publication requirements.

### *Explanation of Provision*

Under the Act, private foundations are subject to the same public inspection requirements that currently apply to public charities and all other tax-exempt organizations that file annual information returns.[102] Accordingly, private foundations will be required to comply with requests from individuals who seek a copy of the foundation's annual information return for any of the foundation's three most recent taxable years. The material private foundations must disclose to the public, however, remains the same as under prior law. Thus, private foundations will continue to be required to disclose their substantial contributors. Private foundations will no longer be subject to the publication requirements of section 6104(d).[103]

### *Effective Date*

The additional public inspection requirements apply to requests made after the later of: (1) the date which is 60 days after the date on which the Treasury Department publishes regulations defining when requested documents have been made widely available or when a request is part of a harassment campaign, or (2) December 31, 1998. The repeal of the prior-law publication requirement shall apply only to those returns the due date for filing of which is on

[101] Prop. Treas. Reg. secs. 301.6104(e)–1, –2, –3.

[102] A technical correction may be required to clarify that nonexempt charitable trusts described in section 4947(a)(1) and nonexempt private foundations are subject to the public disclosure requirements under section 6104(d), just as such organizations are subject to the information reporting requirements of section 6033 pursuant to section 6033(d).

[103] In the legislative history of the provision, the Congress noted that the length of annual information returns filed by certain private foundations may make duplication and mailing of the return expensive and administratively burdensome. The Congress expressed its expectation that the Treasury Department will publish regulations to address this issue (e.g., by permitting persons to request a copy of particular portions of the return).

or after the date the public inspection requirements become effective.

### *Revenue Effect*

The provision is estimated to have a negligible revenue effect on Federal fiscal year budget receipts.

## E. Exceptions Under Subpart F for Certain Active Financing Income (sec. 1005 of the Act and secs. 953 and 954 of the Code)

### *Present and Prior Law*

#### *In general*

Under the subpart F rules, certain U.S. shareholders of a controlled foreign corporation ("CFC") are subject to U.S. tax currently on certain income earned by the CFC, whether or not such income is distributed to the shareholders. The income subject to current inclusion under the subpart F rules includes, among other things, "foreign personal holding company income" and insurance income. The U.S. 10-percent shareholders of a CFC also are subject to current inclusion with respect to their shares of the CFC's foreign base company services income (i.e., income derived from services performed for a related person outside the country in which the CFC is organized).

Foreign personal holding company income generally consists of the following: (1) dividends, interest, royalties, rents and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and REMICs; (3) net gains from commodities transactions; (4) net gains from foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; and (7) payments in lieu of dividends.

Insurance income subject to current inclusion under the subpart F rules includes any income of a CFC attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the CFC's country of organization. Subpart F insurance income also includes income attributable to an insurance contract in connection with risks located within the CFC's country of organization, as the result of an arrangement under which another corporation receives a substantially equal amount of consideration for insurance of other-country risks. Investment income of a CFC that is allocable to any insurance or annuity contract related to risks located outside the CFC's country of organization is taxable as subpart F insurance income (Prop. Treas. Reg. sec. 1.953–1(a)).

Temporary exceptions from foreign personal holding company income and foreign base company services income apply for subpart F purposes for certain income that is derived in the active conduct of a banking, financing, insurance, or similar business. These exceptions (described below) are applicable only for taxable years beginning in 1998.

***Income from the active conduct of a banking, financing, or similar business***

A temporary exception from foreign personal holding company income applies to income that is derived in the active conduct of a banking, financing, or similar business by a CFC that is predominantly engaged in the active conduct of such business. For this purpose, income derived in the active conduct of a banking, financing, or similar business generally is determined under the principles applicable in determining financial services income for foreign tax credit limitation purposes. However, in the case of a corporation that is engaged in the active conduct of a banking or securities business, the income that is eligible for this exception is determined under the principles applicable in determining the income which is treated as nonpassive income for purposes of the passive foreign investment company provisions. In this regard, the income of a corporation engaged in the active conduct of a banking or securities business that is eligible for this exception is the income that is treated as nonpassive under the regulations proposed under section 1296(b) (as in effect prior to the enactment of the Taxpayer Relief Act of 1997). See Prop. Treas. Reg. secs. 1.1296–4 and 1.1296–6. The Secretary of the Treasury was directed to prescribe regulations applying look-through treatment in characterizing for this purpose dividends, interest, income equivalent to interest, rents and royalties from related persons.

For purposes of the temporary exception, a corporation is considered to be predominantly engaged in the active conduct of a banking, financing, or similar business if it is engaged in the active conduct of a banking or securities business or is a qualified bank affiliate or qualified securities affiliate. In this regard, a corporation is considered to be engaged in the active conduct of a banking or securities business if the corporation would be treated as so engaged under the regulations proposed under prior law section 1296(b) (as in effect prior to the enactment of the Taxpayer Relief Act of 1997); qualified bank affiliates and qualified securities affiliates are as determined under such proposed regulations. See Prop. Treas. Reg. secs. 1.1296–4 and 1.1296–6.

Alternatively, a corporation is considered to be engaged in the active conduct of a banking, financing, or similar business if more than 70 percent of its gross income is derived from such business from transactions with unrelated persons located within the country under the laws of which the corporation is created or organized. For this purpose, income derived by a qualified business unit ("QBU") of a corporation from transactions with unrelated persons located in the country in which the QBU maintains its principal office and conducts substantial business activity is treated as derived by the corporation from transactions with unrelated persons located within the country in which the corporation is created or organized. A person other than a natural person is considered to be located within the country in which it maintains an office through which it engages in a trade or business and by which the transaction is effected. A natural person is treated as located within the country in which such person is physically located when such person enters into the transaction.

***Income from the active conduct of an insurance business***

A temporary exception from foreign personal holding company income applies for certain investment income of a qualifying insurance company with respect to risks located within the CFC's country of creation or organization. These rules differ from the rules of section 953 of the Code, which determines the subpart F inclusions of a U.S. shareholder relating to insurance income of a CFC. Such insurance income under section 953 generally is computed in accordance with the rules of subchapter L of the Code.

The temporary exception applies for income (received from a person other than a related person) from investments made by a qualifying insurance company of its reserves or 80 percent of its unearned premiums. For this purpose, in the case of contracts regulated in the country in which sold as property, casualty or health insurance contracts, unearned premiums and reserves are defined as unearned premiums and reserves for losses incurred determined using the methods and interest rates that would be used if the qualifying insurance company were subject to tax under subchapter L of the Code. Thus, for this purpose, unearned premiums are determined in accordance with section 832(b)(4), and reserves for losses incurred are determined in accordance with section 832(b)(5) and 846 of the Code (as well as any other rules applicable to a U.S. property and casualty insurance company with respect to such amounts).

In the case of a contract regulated in the country in which sold as a life insurance or annuity contract, the following three alternative rules for determining reserves apply. Any one of the three rules can be elected with respect to a particular line of business.

First, reserves for such contracts can be determined generally under the rules applicable to domestic life insurance companies under subchapter L of the Code, using the methods there specified, but substituting for the interest rates in Code section 807(d)(2)(B) an interest rate determined for the country in which the qualifying insurance company was created or organized, calculated in the same manner as the mid-term applicable Federal interest rate ("AFR") (within the meaning of section 1274(d)).

Second, the reserves for such contracts can be determined using a preliminary term foreign reserve method, except that the interest rate to be used is the interest rate determined for the country in which the qualifying insurance company was created or organized, calculated in the same manner as the mid-term AFR. If a qualifying insurance company uses such a preliminary term method with respect to contracts insuring risks located in the country in which the company is created or organized, then such method is the method that applies for purposes of this election.

Third, reserves for such contracts can be determined to be equal to the net surrender value of the contract (as defined in section 807(e)(1)(A)).

In no event can the reserve for any contract at any time exceed the foreign statement reserve for the contract, reduced by any catastrophe or deficiency reserve. This rule applies whether the contract is regulated as a property, casualty, health, life insurance, annuity or any other type of contract.

A temporary exception from foreign personal holding company income also applies for income from investment of assets equal to: (1) one-third of premiums earned during the taxable year on insurance contracts regulated in the country in which sold as property, casualty, or health insurance contracts; and (2) the greater of 10 percent of reserves, or, in the case of a qualifying insurance company that is a startup company, $10 million. For this purpose, a startup company is a company (including any predecessor) that has not been engaged in the active conduct of an insurance business for more than five years. In general, the five-year period commences when the foreign company first is engaged in the active conduct of an insurance business. If the foreign company was formed before being acquired by the U.S. shareholder, the five-year period commences when the acquired company first was engaged in the active conduct of an insurance business. In the event of the acquisition of a book of business from another company through an assumption or indemnity reinsurance transaction, the five-year period commences when the acquiring company first engaged in the active conduct of an insurance business, except that if more than a substantial part (e.g., 80 percent) of the business of the ceding company is acquired, then the five-year period commences when the ceding company first engaged in the active conduct of an insurance business. Reinsurance transactions among related persons may not be used to multiply the number of five-year periods.

Under rules prescribed by the Secretary, income is allocated to contracts as follows. In the case of contracts that are separate account-type contracts (including variable contracts not meeting the requirements of sec. 817), only the income specifically allocable to such contracts is taken into account. In the case of other contracts, income not specifically allocable is allocated ratably among such contracts.

A qualifying insurance company is defined as any entity which: (1) is regulated as an insurance company under the laws of the country in which it is incorporated; (2) derives at least 50 percent of its net written premiums from the insurance or reinsurance of risks situated within its country of incorporation; and (3) is engaged in the active conduct of an insurance business and would be subject to tax under subchapter L if it were a domestic corporation.

The temporary exceptions do not apply to investment income (includable in the income of a U.S. shareholder of a CFC pursuant to sec. 953) allocable to contracts that insure related party risks or risks located in a country other than the country in which the qualifying insurance company is created or organized.

### *Anti-abuse rule*

An anti-abuse rule applies for purposes of these temporary exceptions. For purposes of applying these exceptions, items with respect to a transaction or series of transactions are disregarded if one of the principal purposes of the transaction or transactions is to qualify income or gain for these exceptions, including any change in the method of computing reserves or any other transaction or transactions one of the principal purposes of which is the acceleration or deferral of any item in order to claim the benefits of these exceptions.

### *Foreign base company services income*

A temporary exception from foreign base company services income applies for income derived from services performed in connection with the active conduct of a banking, financing, insurance or similar business by a CFC that is predominantly engaged in the active conduct of such business or is a qualifying insurance company.

## *Reasons for Change*

The subpart F rules historically have been aimed at requiring current inclusion by the U.S. shareholders of income of a CFC that is either passive or easily moveable. Under the subpart F rules, certain U.S. shareholders of a CFC are subject to U.S. tax on a current basis on certain income (including certain insurance income and foreign personal holding company income) earned by the CFC, whether or not such income is distributed to the shareholders. Prior to the enactment of the Tax Reform Act of 1986 (the "1986 Act"), exceptions from foreign personal holding company income were provided for income derived in the active conduct of a banking, financing, or similar business, or derived from certain investments made by an insurance company. The Congress recognized that the 1986 Act's repeal of these exceptions may be viewed as causing the subpart F rules to apply to income that is neither passive nor easily moveable, requiring inclusion of such income on a current basis by U.S. shareholders. In the Taxpayer Relief Act of 1997, a one-year temporary exception from foreign personal holding company income was enacted [104] for income from the active conduct of an insurance, banking, financing, or similar business. The Congress believed that it was appropriate to extend for one year these exceptions from subpart F, with certain modifications.

The Congress believed that modifications to the prior-law provision were appropriate, including changes designed to treat various types of businesses with active financing income more similarly to each other than did the prior-law provision. The Congress also believed that it was appropriate to modify the prior-law provision to require that eligible businesses conduct substantial activity with regard to their respective financial service businesses, and that the income eligible for the exceptions have a nexus with the business activities giving rise to such income. In the case of transactions conducted with persons located outside the home country of the CFC or its foreign branch (so-called "cross border" transactions), the Congress believed that it was appropriate to impose higher standards for qualifying under the provision due to the increased concerns with respect to the mobility of income from such transactions.

[104] The President canceled this provision in 1997 pursuant to the Line Item Veto Act. A modified version of the provision was included in H.R. 2513, which was passed by the House on November 8, 1997. See report of the House Committee on Ways and Means, H. Rept. 105–318, Part I, October 9, 1997. On June 25, 1998, the U.S. Supreme Court held that the cancellation procedures set forth in the Line Item Veto Act are unconstitutional. *Clinton* v. *City of New York,* 118 S. Ct. 2091 (June 25, 1998).

## *Explanation of Provision*

### *In general*

The Act extends and modifies the prior-law temporary exceptions from subpart F for income that is derived in the active conduct of a banking, financing, or similar business or in the conduct of an insurance business. These exceptions (as modified) are applicable only for taxable years beginning in 1999.

With respect to income derived in the active conduct of a banking, financing, or similar business, the Act differs from the prior-law temporary exceptions in the following significant respects. First, the Act requires a CFC to conduct substantial activity with respect to its business in order to qualify for the exceptions. Second, the Act adds certain nexus requirements which require that income which is derived by a CFC or QBU from transactions with customers is eligible for the exceptions if, among other things, substantially all of the activities in connection with such transactions are conducted directly by the CFC or QBU in its home country, and such income is treated as earned by the CFC or QBU in its home country for purposes of such country's tax laws. Third, the Act modifies the tests for determining whether a CFC is predominantly engaged in the active conduct of a banking, financing, or similar business, including modifications for income derived from a lending or finance business. Fourth, the Act extends the exceptions to income derived from certain cross border transactions, provided that certain requirements are met. Fifth, the determination of where a customer is treated as located is made under rules prescribed by the Secretary of the Treasury. Finally, the look-through rule that was included in the prior-law provision for purposes of determining the income eligible for the exceptions is eliminated.

In the case of insurance, the Act differs from prior law in the following significant respects. In addition to the exception for certain income of a qualifying insurance company with respect to risks located within the CFC's country of creation or organization that is provided under prior law, the Act provides additional exceptions. First, the Act provides temporary exceptions from insurance income and from foreign personal holding company income for certain income of a qualifying branch of a qualifying insurance company with respect to risks located within the home country of the branch, provided certain requirements are met under each of the exceptions. Further, the Act adds additional temporary exceptions from insurance income and from foreign personal holding company income for certain income of certain CFCs or branches with respect to risks located in any country other than the United States, provided that the requirements for these exceptions are met.

### *Income from the active conduct of a banking, financing, or similar business*

#### *Substantial activity requirement*

The Act modifies the exceptions from subpart F for income derived in the active conduct of a banking, financing, or similar business by, among other things, incorporating a substantial activity requirement. Under the Act, the subpart F exceptions apply to a

CFC that is an eligible controlled foreign corporation (an "eligible CFC"). An eligible CFC is defined as a CFC which is predominantly engaged in the active conduct of a banking, financing, or similar business, but only if it conducts substantial activity with respect to such business.

Whether a CFC is considered to conduct substantial activity with respect to a banking, financing, or similar business is determined under all the facts and circumstances. The Congress intended that as part of this facts and circumstances analysis in determining whether the activities conducted by the CFC are substantial, all relevant factors are taken into account, including the overall size of the CFC, the amount of its revenues and expenses, the number of its employees, the ratio of its revenues per employee, the amount of property it owns, and the nature, size, and relative significance of the applicable activities conducted by the CFC. Under the Act, the Treasury Secretary is granted the authority to prescribe regulations to carry out the purposes of these exceptions. The Congress intended that such authority includes the authority to prescribe rules relating to whether a CFC (or, as relevant, a QBU) is considered to conduct substantial activity.

The Congress also intended that as part of this facts and circumstances analysis, a CFC is required to conduct substantially all of the activities necessary for the generation of income with respect to the business, which generally include the following:

- Initial solicitation of customers (including vendors);
- Advising customers on financial needs, including funding and financial products;
- Providing financial and technical advice to customers;
- Designing or tailoring financial products to customers' needs;
- Negotiating terms with customers;
- Performing credit analysis on customers and evaluating non-credit risks;
- Providing related services to customers;
- Making loans, entering into leases, extending credit or entering into other transactions with customers that generate income that would be considered derived in the active conduct of a banking, financing, or similar business;
- Collecting from customers;
- Performing remarketing activities (including sales) following termination of transactions with customers;
- Responding to customers' failure to satisfy their obligations under transactions, including enforcement or renegotiation of terms, liquidation of collateral, foreclosure, and/or institution of litigation; and
- Holding collateral for transactions with customers.

The Congress intended that the performance of back-office functions (including accounting for income or loss, recordkeeping, and routine communicating with customers) not be taken into account in determining whether the substantial activity requirement is satisfied. The Congress also intended that the relevant activities of the business may be modified by Treasury regulation to take into account future changes in the operations of these businesses.

In general, the substantial activity requirement is applied based on the activities of the CFC as a whole, including the activities of any QBUs of the CFC. In determining whether the substantial activity requirement is satisfied, activities performed in the country in which the CFC is incorporated (or in the country in which the QBU has its principal office) by employees of a related person of the CFC are taken into account, but only to the extent that the related person is compensated on an arm's-length basis for the services of such employees and such compensation is includible in the related person's income in such country for purposes of such country's income tax laws. For this purpose, a related person has the meaning provided in section 954(d)(3), substituting "at least 80 percent" for "more than 50 percent." The Congress intended that the activities of such a related person are not again taken into account in determining whether another CFC or QBU (e.g., the related person) satisfies the substantial activity requirement.

*Predominantly engaged requirement*

The Act also modifies the rules for determining whether a CFC is predominantly engaged in the active conduct of a banking, financing, or similar business. Alternative rules apply for this purpose.

*Banking or securities business.*—The Act modifies the prior-law application of the banking or securities business tests for determining whether a CFC is predominantly engaged in the active conduct of a banking, financing, or similar business. Under the Act, a CFC is considered to be predominantly engaged in the active conduct of a banking, financing, or similar business if it is engaged in the active conduct of a banking business and is an institution licensed to do business as a bank in the United States (or is any other corporation not so licensed which is specified in regulations). In addition, a CFC is considered to be predominantly engaged in the active conduct of a banking, financing, or similar business if it is engaged in the active conduct of a securities business and is registered as a securities broker or dealer under applicable U.S. securities laws (or is any other corporation not so registered which is specified in regulations). The Congress generally intended that these requirements for the active conduct of a banking or securities business be interpreted in the manner provided in the regulations proposed under prior law section 1296(b) (as in effect prior to the enactment of the Taxpayer Relief Act of 1997). See Prop. Treas. Reg. secs. 1.1296–4 and 1.1296–6. Specifically, the Congress intended that these requirements include the requirements for foreign banks under Prop. Treas. Reg. sec. 1.1296–4 as currently drafted. However, the Congress did not intend that these requirements be considered to be satisfied by a CFC merely because it is a qualified bank affiliate or a qualified securities affiliate within the meaning of the proposed regulations under former section 1296(b).

*Lending or finance business.*—The Act modifies the prior-law 70-percent test for determining whether a CFC is predominantly engaged in the active conduct of a banking, financing, or similar business. Under the Act, a CFC is considered to be predominantly engaged in the active conduct of such business if more than 70 percent of its gross income is derived directly from the active and regular conduct of a lending or finance business from transactions with customers which are unrelated persons. For this purpose, the

Congress intended that transactions with customers located in the United States not be taken into account in determining whether the 70–percent test is satisfied.

For this purpose, a CFC is considered to be engaged in a lending or finance business if it is engaged in the business of:

(1) making loans;

(2) purchasing or discounting accounts receivable, notes (including loans), or installment obligations;

(3) engaging in leasing (including entering into leases and purchasing, servicing and disposing of leases and leased assets);

(4) issuing letters of credit and providing guarantees;

(5) providing charge and credit card services; or

(6) rendering services or making facilities available in connection with the foregoing activities carried on by the corporation rendering such services or facilities, or by another corporation which is a member of the same affiliated group.

For this purpose, whether two corporations are affiliated is determined by reference to section 1504 with one modification: the exclusion for foreign corporations is disregarded.

Whether any portion of a CFC's gross income is derived directly from the active and regular conduct of a lending or finance business is determined under all the facts and circumstances. Under the Act, the Treasury Secretary is granted the authority to prescribe regulations to carry out the purposes of these exceptions. The Congress intended that such authority includes the authority to prescribe rules relating to this determination.

*Qualified banking or financing income exempt from subpart F*

*In general.*—If a CFC is treated as an eligible CFC (i.e., it satisfies the substantial activity and predominantly engaged requirements), the subpart F exceptions apply to qualified banking or financing income of such corporation. Qualified banking or financing income is defined as income which is derived in the active conduct of a banking, financing, or similar business by an eligible CFC or a QBU of such CFC if: (1) the income is derived from transactions with customers not located in the United States, (2) substantially all of the activities in connection with such transactions are conducted directly by the corporation or unit in its home country, and (3) the income is treated as earned by such corporation or unit in its home country for purposes of such country's tax laws. For this purpose, income is considered to be earned by a CFC or a QBU in its home country if such income is sourced and allocable to such CFC or QBU in its home country for purposes of such country's tax laws. In addition, for this purpose, activities are considered to be conducted by a CFC or QBU if such activities are performed by employees of the CFC or QBU. Except as provided by regulations, a CFC's home country is defined as its country of creation or organization, and a QBU's home country is defined as the country in which the unit maintains its principal office. Moreover, income derived from transactions with customers apply only to transactions with customers acting in their capacity as such.

For this purpose, the Congress intended that income derived by an eligible CFC or QBU of such CFC from the following types of activities be considered to be income derived in the active conduct of a banking, financing, or similar business (provided that the other requirements for these exceptions are satisfied):

(1) regularly making personal, mortgage, industrial, or other loans in the ordinary course of the corporation's trade or business;

(2) factoring evidences of indebtedness for customers;

(3) purchasing, selling, discounting, or negotiating for customers notes, drafts, checks, bills of exchange, acceptances, or other evidences of indebtedness;

(4) issuing letters of credit and negotiating drafts drawn thereunder for customers;

(5) performing trust services, including as a fiduciary, agent, or custodian, for customers, provided such trust activities are not performed in connection with services provided by a dealer in stock, securities or similar financial instruments;

(6) arranging foreign exchange transactions (including any section 988 transaction within the meaning of section 988(c)(1)) for, or engaging in foreign exchange transactions with, customers;

(7) arranging interest rate or currency futures, forwards, options or notional principal contracts for, or entering into such transactions with, customers;

(8) underwriting issues of stock, debt instruments or other securities under best efforts or firm commitment agreements for customers;

(9) engaging in leasing (including entering into leases and purchasing, servicing and disposing of leases and leased assets);

(10) providing charge and credit card services for customers or factoring receivables obtained in the course of providing such services;

(11) providing traveler's check and money order services for customers;

(12) providing correspondent bank services for customers;

(13) providing paying agency and collection agency services for customers;

(14) maintaining restricted reserves (including money or securities) in a segregated account in order to satisfy a capital or reserve requirement imposed by a local banking or securities regulatory authority;

(15) engaging in hedging activities directly related to another activity described herein;

(16) repackaging mortgages and other financial assets into securities and servicing activities with respect to such assets (including the accrual of interest incidental to such activity);

(17) engaging in financing activities typically provided in the ordinary course by an investment bank, such as project financing provided in connection with construction projects, structured finance (including the extension of a loan and the sale of participations or interests in the loan to other financial in-

stitutions or investors), and leasing activities to the extent incidental to such financing activities;

(18) providing financial or investment advisory services, investment management services, fiduciary services, or custodial services;

(19) purchasing or selling stock, debt instruments, interest rate or currency futures or other securities or derivative financial products (including notional principal contracts) from or to customers and holding stock, debt instruments and other securities as inventory for sale to customers, unless the relevant securities or derivative financial products are not held in a dealer capacity;

(20) effecting transactions in securities for customers as a securities broker; and

(21) any other activity that the Secretary of the Treasury determines to be a financing activity conducted by active corporations in the ordinary course of their business.

Qualified banking or financing income of an eligible CFC or QBU of such CFC is determined separately for the CFC and each QBU, taking into account, in the case of an eligible CFC, only items of income, gain, deduction, loss or other items, as well as activities, of such CFC that are not properly allocable to any QBUs. Similarly, in the case of a QBU, qualified banking or financing income is determined by taking into account such applicable items (e.g., income and activities) that are properly allocable to such QBU. Under the Act, the Treasury Secretary is granted the authority to prescribe regulations to carry out the purposes of these exceptions. The Congress intended that such authority includes the authority to prescribe rules for properly allocating items and activities among branches or units of a CFC, and between the CFC and its branches or units.

*Income from local customer transactions.*—If the requirements above are satisfied, the exceptions apply to income that is derived from transactions with customers located in the CFC's home country. In addition, the exceptions apply to income that is derived by a QBU of an eligible CFC from transactions with customers located in the QBU's home country.

For example, assume that a CFC is incorporated in the United Kingdom and has operations in France that constitute a QBU. Also assume that the activities of the U.K. CFC's head office together with the activities of the French QBU satisfy the substantial activity requirement. Under the Act, income derived by the U.K. CFC from transactions with customers in the United Kingdom is eligible for the exceptions if substantially all of the activities in connection with the transaction are performed in the United Kingdom by employees of the U.K. CFC, and the income is treated as earned by the U.K. CFC in the United Kingdom for U.K. income tax purposes. In addition, income derived by the French QBU from transactions with customers in France is eligible for the exceptions if substantially all of the activities in connection with the transactions are performed in France by employees of the French QBU, and the income is treated as earned by the French QBU in France for French income tax purposes.

*Income from cross border transactions.*—If the requirements above are satisfied, the exceptions also apply to income from certain cross border transactions, but only if a higher standard with respect to the substantial activity requirement is satisfied. Under the Act, income derived by a CFC from transactions with customers not located in the CFC's home country or the United States is eligible for the exceptions if the CFC conducts substantial activity with respect to a banking, financing, or similar business in its home country. In addition, income derived by a QBU of an eligible CFC from transactions with customers not located in the QBU's home country or the United States is eligible for the exceptions, but only if the QBU conducts substantial activity with respect to such a business in its home country. For this purpose, the substantial activity requirement is applied by looking only at the activities of the applicable CFC or QBU on a stand-alone basis. Thus, income derived by a QBU from transactions with customers not located in its home country (or in the United States) is eligible for the exceptions if the activities of the QBU itself constitute substantial activities (provided that the other requirements are satisfied).

Consider again the U.K. CFC and the French QBU. If the head office of the U.K. CFC derives income from a transaction with a customer in Germany, the income is eligible for the exceptions if the activities of the CFC itself (without regard to those of the French QBU) satisfy the substantial activity requirement. Alternatively, if the French QBU derives income from a transaction with a German customer, the income is eligible for the exceptions if the activities of the French QBU itself satisfy the substantial activity requirement.

*Home country requirement for income earned with respect to a lending or finance business.*—In the case of a lending or finance business, in addition to the requirements described above, the Act includes an additional requirement to qualify for the exceptions in the case of income earned by a CFC which qualifies as an eligible CFC by satisfying the predominantly engaged requirement for an active lending or finance business. For such an eligible CFC, income derived by such CFC is eligible for the exceptions only if such CFC derives more than 30 percent of its gross income directly from the active and regular conduct of a lending or finance business from transactions with customers that are unrelated persons and that are located within the CFC's home country (the "home country" requirement). In addition, income derived by a QBU of such an eligible CFC is eligible for the exceptions only if such QBU derives more than 30 percent of its gross income directly from the active and regular conduct of a lending or finance business from transactions with customers that are unrelated persons and that are located within the QBU's home country. For this purpose, the Congress intended that transactions with customers located in the United States not be taken into account.

The home country requirement is applied on a stand-alone basis to the particular CFC or QBU. Thus, the 30-percent gross income test takes into account only the gross income of a particular CFC (without regard to the income of its QBUs) from transactions with its home-country unrelated customers. Similarly, in the case of a QBU, there is taken into account the gross income of the particular

QBU (without regard to the income of the CFC or other QBUs) from transactions with its home-country unrelated customers. Accordingly, if more than 70 percent of the CFC's gross income is derived directly from the active and regular conduct of a lending or finance business from transactions with unrelated customers, and one of the CFC's QBUs satisfies the home country requirement but another QBU does not satisfy such requirement, income derived by the QBU that satisfies the home country requirement is eligible for the exceptions from subpart F (provided that the other requirements are satisfied), but income derived by the other QBU is not eligible for the exceptions.

*Coordination with other rules.*—The Act provides that the exceptions under section 954(h) for income derived in the active conduct of a banking, financing, or similar business do not apply to income described in the dealer exception under section 954(c)(2)(C)(ii) (described below) for a dealer in securities which is an eligible CFC that satisfies the predominantly engaged requirement for a securities business.

In addition, the Congress expected that the Treasury Department and the Internal Revenue Service will issue timely guidance to make currently effective conforming changes to existing regulations in order to reflect the exceptions under section 954(h), including conforming changes to the regulations under section 954(c)(3).

***Exception for securities dealers***

The Act provides an additional exception from foreign personal holding company income for certain income derived by a securities dealer within the meaning of section 475 (the so-called "dealer exception"). The dealer exception applies to interest or dividends (or equivalent amounts described in sec. 954(c)(1)(E) or (G)) from any transaction (including a hedging transaction or a transaction consisting of a deposit of collateral or margin described in sec. 956(c)(2)(J)) entered into in the ordinary course of the dealer's trade or business as such a securities dealer, but only if the income is attributable to activities of the dealer in the country in which the dealer is created or organized (or, in the case of a QBU of the dealer, is attributable to activities of the QBU in the country in which the QBU both maintains its principal office and conducts substantial business activity). For this purpose, income is considered to be attributable to activities of the dealer in its country of incorporation (or to a QBU in the country in which the QBU both maintains its principal office and conducts substantial business activity), if such income is attributable to activities performed in such country by employees of the dealer (or QBU), and such income is treated as earned in such country by the dealer (or QBU) for purposes of such country's tax laws. For this purpose, income is considered to be earned in the country in which the dealer is created or organized (or, in the case of a QBU, in the country in which the QBU both maintains its principal office and conducts substantial business activity), if such income is sourced and allocable to such dealer (or QBU) in such country for purposes of such country's tax laws. The Congress intended that the dealer exception not apply to income from transactions with persons located in the United States with respect to U.S. securities. This reflects the understanding of the Congress that the exception from current inclusion under subpart F for income earned by dealers in securities does not apply to activities that would otherwise be conducted in the United States. In addition, the Congress intended that the dealer exception will apply to interest paid by customers to the dealer on margin loans in connection with sales of securities (provided that the other requirements of the provision are satisfied).

### ***Insurance income***

#### *In general*

The Act provides a temporary exception to insurance income under section 953. For purposes of the exception to insurance income, reserves for an exempt insurance or annuity contract are determined in the same manner as under the temporary exception, described below, for foreign personal holding company income relating to certain insurance contracts (sec. 954(i), as added by the Act). For purposes of these provisions, the Congress intended reserves to include discounted unpaid losses or losses incurred, as appropriate, for property and casualty contracts.

#### *Operation of the exception*

The Act provides an exception from insurance income for income derived by a qualifying insurance company that is attributable to the issuing (or reinsuring) of an exempt contract by the qualifying insurance company or a qualifying insurance company branch of such a company, and that is treated as earned by the company or branch in that company's, or branch's, home country for purposes of that country's tax laws. The exception from insurance income does not apply to income attributable to the issuing (or reinsuring) of an exempt contract as the result of any arrangement whereby another corporation receives a substantially equal amount of premiums or other consideration in respect of issuing (or reinsuring a contract that is not an exempt contract). An exempt contract is an insurance or annuity contract issued or reinsured by a qualifying insurance company or qualified insurance company branch in connection with property in, liability arising out of activity in, or the lives or health of residents of, a country other than the United States.

No contract is treated as an exempt contract unless the qualifying insurance company or branch derives more than 30 percent of its net written premiums from exempt contracts (determined without regard to this sentence) covering applicable home country risks, and with respect to which no policyholder, insured, annuitant, or beneficiary is a related person (within the meaning of sec. 954(d)(3)). Applicable home country risks are risks in connection with property in, liability arising out of activity in, or the lives or health of residents of, the home country of the qualifying insurance company or branch, as the case may be. In all cases, the 30-percent test is applied on a unit-by-unit basis. Accordingly, income derived by a qualifying insurance company branch of a CFC qualifies only if such branch alone satisfies the 30-percent test (without regard to the net written premiums of any other branch). Income derived by the CFC qualifies only if the CFC alone satisfies the 30-percent test without regard to the net written premiums of any other unit or branch of the CFC.

When determinations under the Act are made separately with respect to a qualifying insurance company and its qualifying insurance company branch or branches, then in the case of the qualifying insurance company, only income, gain, or loss and activities of the company not properly allocable or attributable to any qualifying insurance company branch are taken into account. In the case of a qualifying insurance company branch, only income, gain, or loss and activities of the branch that are properly allocable or attributable to it are taken into account. Under the Act, the Treasury Secretary is granted the authority to carry out the purposes of these exceptions. The Congress intended that such authority includes the authority to prescribe rules for properly allocating items and activities among branches or units of a CFC, and among the CFC and its branches or units.

The home country of a CFC is the country in which the CFC is created or organized. The home country of a QBU that is a qualifying insurance company branch of a qualifying insurance company means the country in which the principal office of such unit is located and in which such unit is licensed, authorized, or regulated by the applicable insurance regulatory body to sell insurance, reinsurance or annuity contracts to persons other than related persons (within the meaning of sec. 954(d)(3)) in that country.

*Qualifying insurance company*

A qualifying insurance company is a CFC that meets the following requirements, which are intended to distinguish firms that have a real business nexus with a foreign country or countries from firms that do not. The first requirement is that the CFC be subject to regulation as an insurance (or reinsurance) company by its home country, and that the CFC be licensed, authorized, or regulated by the applicable insurance regulatory body for its home country to sell insurance, reinsurance, or annuity contracts to persons other than related persons (within the meaning of sec. 954(d)(3)) in its home country.

The second requirement is that the CFC derive more than 50 percent of its aggregate net written premiums from the insurance or reinsurance by the CFC (on an aggregate basis, including qualifying insurance company branches) covering applicable home country risks (as described above) of the CFC or branch, as the case may be. For purposes of this rule, if a policyholder, insured, annuitant, or beneficiary is a related person, then the contract is treated as not covering home country risks. A related person has the meaning set forth in section 954(d)(3). In the case of a qualifying insurance company branch, premiums are taken into account under this second requirement only to the extent that the premiums are treated as earned by the branch in its home country for purposes of that country's tax laws.

The 50-percent test applies on an aggregate basis. For example, assume that a German CFC has a branch in France and a branch in Italy. Assume that $50 of net written premiums are properly allocable to the Italian branch, $100 of net written premiums are properly allocable to the French branch, and $100 of net written premiums are properly allocable to the CFC in Germany. For the Italian branch, assume $20 of the $50, or 40 percent, is from home country risks. For the French branch, assume that $80 of the $100, or 80 percent, is from home country risks. For the CFC in Germany, assume that $60 of the $100, or 60 percent, is from home country risks. Taking into account the respective amounts and percentages, the CFC has 64 percent of its net written premiums from home country risks on an aggregate basis.

The third requirement is that the CFC be engaged in the insurance business and that it would be subject to tax under subchapter L if it were a domestic corporation. A CFC is considered to be engaged in the insurance business, within the meaning of this provision of the Act, if it operates in a manner consistent with the operation of other bona fide commercial insurance companies that sell insurance products to unrelated parties in its home country, and conducts managerial activities in that country with respect to the major functions of the insurance business. A factor, among others, that could be considered in determining whether it conducts managerial activities in its home country with respect to the major functions of the insurance business may be whether in its home country it exercises key decision making in determining business strategy with respect to the major functions of the insurance business. For purposes of the requirement that the CFC be engaged in the insurance business, activities performed in the home country of the CFC by employees of the CFC and of a related person are taken into account, to the extent that the related person is compensated on an arm's-length basis for the services of such employees and such compensation is includible in the related person's income in such country for purposes of that country's tax laws. For this purpose, a related person has the meaning provided in section 954(d)(3), substituting "at least 80 percent" for "more than 50 percent." In determining whether a CFC is engaged in the insurance business, for example, an entity that is not engaged in regular and continuous transactions with persons that are not related persons (as described in the anti-abuse rules) is not considered as engaged in the insurance business.

*Qualifying insurance company branch*

A qualifying insurance company branch is a qualified business unit of a CFC that meets two requirements. A qualified business unit means any separate and clearly identified unit of a trade or business of a taxpayer which maintains separate books and records (within the meaning of sec. 989(a)). The first requirement is that the unit be licensed, authorized, or regulated by the applicable insurance regulatory body for its home country to sell insurance, reinsurance or annuity contracts to persons other than related persons (within the meaning of sec. 954(d)(3)) in that country. The Congress intended that the applicable insurance regulatory body be the regulatory body that has the authority to license, authorize, or regulate with respect to the insurance business in the country where the branch is located and a branch that is regulated by such a body be considered to be regulated in the country where the branch is located. The second requirement is that the CFC (of which the branch is a unit) be a qualifying insurance company, taking the unit into account for purposes of the applicable tests (above) as if it were a qualifying insurance company branch.

*Additional requirements in the case of cross border risks*

The Act imposes additional requirements with respect to any contract that covers cross border risks (that is, risks other than applicable home country risks), due to the increased concern about mobility of income in cross border business. A contract issued by a qualifying insurance company or qualifying insurance company branch that covers risks other than applicable home country risks is not treated as an exempt contract unless such company or branch, as the case may be, (1) conducts substantial activity in its home country with respect to the insurance business, and (2) performs in its home country substantially all of the activities necessary to give rise to the income generated by the contract.

Whether a CFC or unit thereof is considered to perform in its home country substantial activities with respect to the insurance business is determined under all the facts and circumstances. The Congress intended that as part of this facts and circumstances analysis in determining whether the activities conducted by the CFC or unit are substantial, all relevant factors are taken into account, including the overall size of the CFC or unit, the amount of its revenues and expenses, the number of its employees, the ratio of its revenues per employee, the amount of property it owns, and the nature, size and relative significance of the applicable activities conducted by the CFC or unit. Under the Act, the Treasury Secretary is granted the authority to carry out the purposes of these exceptions. The Congress intended that such authority includes the authority to prescribe regulations relating to whether a CFC or unit is considered to conduct substantial activity.

The Congress also intended that as part of this facts and circumstances analysis, a CFC or unit is required to conduct substantially all of the activities necessary for the generation of income with respect to the insurance business. Such activities of an insurance business generally depend on the line of business, and could include:

- Designing or tailoring insurance products to meet market or customer requirements;
- Performing actuarial analysis with respect to insurance products;
- Determining investment options for separate account-type products;
- Performing underwriting functions with respect to insurance products;
- Performing analysis for purposes of risk assessment;
- Performing analysis for purposes of setting premium rates;
- Performing analysis for purposes of calculating reserves;
- Performing claims management and adjustment functions;
- Developing marketing strategies, advertising and other public image activities;
- Making (or arranging for) sales to customers;
- Maintaining reserves and surplus (other than excess surplus);
- Making (or arranging for) investments; and
- Collecting from customers.

The Congress further intended that the performance of back-office functions (including accounting for income or loss, recordkeeping, and routine communicating with customers) not be taken into account in determining whether the substantial activity requirement is satisfied. The Congress also intended that the relevant activities of the business may be modified by Treasury regulation to take into account the actual operation of lines of insurance business and future changes in the operation of lines of insurance business.

The Congress further intended that activities performed in the CFC's or unit's home country by employees of a related person (within the meaning of sec. 954(d)(3), substituting "at least 80 percent" for "more than 50 percent") be taken into account, to the extent that the related person is compensated on an arm's-length basis for the services of such employees and such compensation is includible in the related person's income in that country for purposes of such country's tax laws. The Congress also intended that the activities of such a related person are not again taken into account in determining whether another CFC or unit (e.g., the related person) satisfies the substantial activity requirement.

In addition, with respect to a contract issued by a qualifying insurance company or qualifying insurance company branch that covers risks other than applicable home country risks, the qualifying insurance company or qualifying insurance company branch is required to perform in its home country substantially all of the activities necessary to give rise to the income generated by the contract.

***Foreign personal holding company income with respect to insurance***

The Act provides a temporary exception from foreign personal holding company income for certain investment income derived by a qualifying insurance company and by certain qualifying insurance company branches.

The exception applies to income (received from a person other than a related person) from investments made by a qualifying insurance company or qualifying insurance company branch of its reserves allocable to exempt contracts or 80 percent of its unearned premiums from exempt contracts. For this purpose, an exempt contract has the meaning provided under the Act.

In the case of exempt contracts that are property, casualty, or health insurance contracts, unearned premiums and reserves mean unearned premiums and reserves for losses incurred determined using the methods and interest rates that would be used if the qualifying insurance company or qualifying insurance company branch were subject to tax under subchapter L of the Code, with certain modifications. For this purpose, unearned premiums and losses incurred are determined in accordance with section 832(b) and 846 of the Code (as well as any other rules applicable to a U.S. property and casualty insurance company with respect to such amounts). However, in applying these rules, the Act substitutes for the applicable Federal interest rate the interest rate determined for the functional currency of the company or branch and which (except as provided by the Treasury Secretary) is calculated in the same manner as the Federal mid-term rate under section 1274(d). In addition, the Act substitutes for the loss payment pattern under section 846 the appropriate foreign loss payment pattern determined by the Treasury Secretary for the line of business. In the case of health insurance contracts, the Congress intended that appropriate foreign mortality and morbidity tables be used for this purpose. In the case of disability contracts (other than credit disability) which are subject to section 846(f)(6)(A), the Congress intended that mortality and morbidity tables reasonably reflect appropriate experience and foreign mortality and morbidity factors.

In the case of an exempt contract that is a life insurance or annuity contract, reserves for such contracts are determined as follows. The reserves equal the greater of: (1) the net surrender value of the contract (as defined in sec. 807(e)(1)(A)), including in the case of pension plan contracts; or (2) the amount determined by applying the tax reserve method that would apply if the qualifying insurance company were subject to tax under Subchapter L of the Code, with the following modifications. First, the Act substitutes for the applicable Federal interest rate an interest rate determined for the functional currency of the qualifying insurance company's home country, calculated (except as provided by the Treasury Secretary in order to address insufficient data and similar problems) in the same manner as the mid-term applicable Federal interest rate ("AFR") (within the meaning of sec. 1274(d)). Second, the Act substitutes for the prevailing State assumed rate the highest assumed interest rate permitted to be used for purposes of determining statement reserves in the foreign country for the contract. Third, in lieu of U.S. mortality and morbidity tables, the Act applies mortality and morbidity tables that reasonably reflect the current mortality and morbidity risks in the foreign country. Fourth, the Treasury Secretary may provide that the interest rate and mortality and morbidity tables of a qualifying insurance company may be used for one or more of its branches when appropriate.

In no event may the reserve for any contract at any time exceed the foreign statement reserve for the contract, reduced by any catastrophe, equalization, or deficiency reserve or any similar reserve. In the case of a contract that is a property, casualty, or health insurance contract, the Congress intended that this limitation applies with respect to unpaid losses by line of business (similar to sec. 846(a)(3)). These rules apply whether the contract is regulated as a property, casualty, health, life insurance, annuity, or any other type of contract.

The Act also provides an exception from foreign personal holding company income for income from investment of assets equal to (1) one-third of premiums earned during the taxable year on exempt contracts regulated in the country in which sold as property, casualty, or health insurance contracts, and (2) 10 percent of reserves (determined for purposes of the provision) for contracts regulated in the country in which sold as life insurance or annuity contracts. In no event does the exception from foreign personal holding company income apply to investment income with respect to excess surplus.

To prevent the shifting of relatively high-yielding assets to generate investment income that qualifies under this temporary exception, the Act provides that, except as provided by the Treasury Secretary, income is allocated to contracts as follows. In the case of a separate account-type contract (including a variable contract not meeting the requirements of sec. 817), the income credited under the contract is allocable only to that contract. Income not so allocated generally is allocated ratably among all contracts that are not separate account-type contracts, subject to the anti-abuse rules (described below).

### *Other definitions and anti-abuse rules relating to insurance*

The Act provides that the prior-law statutory definition of a life insurance contract (under secs. 7702 or 101(f)), as well as the distribution on death requirement of section 72(s) and the diversification requirement of section 817(h), do not apply for purposes of determining reserves for a life insurance or annuity contract under sections 953 and 954 of the Code, provided that neither the policyholders, the insureds or annuitants, nor the beneficiaries with respect to the contract are U.S. persons.

The Act provides a rule coordinating the exception to insurance income with the prior-law special rule for certain captive insurance companies (sec. 953(c)). Under the coordination rule, the scope of the prior-law rule that related party insurance income is treated as subpart F income is retained. The exception under the Act from the definition of insurance income does not include income derived from exempt contracts that cover risks other than applicable home country risks, for purposes of the rules of section 953(c).

The anti-abuse rules applicable under the subpart F exceptions provided in section 954(h) (other than sec. 954(h)(7)(B)) (as added by the Act) apply to these exceptions for insurance. In addition, the Act provides anti-abuse rules applicable under the exceptions from subpart F income relating to insurance.

The Act provides that there shall be disregarded any item of income, gain, loss, or deduction of, or derived from, an entity which is not engaged in regular and continuous transactions with persons that are not related persons. The Congress intended that this rule, for example, will address the use of fronting companies or similar entities (that are not engaged in regular and continuous transactions with persons that are not related persons) to reinsure risks in a manner to cause a CFC or branch to qualify as a qualifying insurance company or qualifying insurance company branch by meeting percentage requirements with respect to home country risks that it would not otherwise meet.

The Act provides that there shall be disregarded any change in the method of computing reserves or any other transaction or transactions one of the principal purposes of which is the acceleration or deferral of any item in order to claim the benefits of these exceptions.

The Act also provides that a contract is not treated as an exempt contract (as described above), if any policyholder, insured or annuitant, or beneficiary is a resident of the United States, the contract was marketed to the U.S. resident, and was written to cover a risk outside the United States.

The Act also provides that a contract is not treated as an exempt contract, if the contract covers risks located both within and outside the United States, and the qualifying insurance company or branch does not maintain such records, and file such reports, with respect to the contract as the Treasury Secretary requires. The Congress intended that documentation that is contemporaneous with the issuance of the contract be maintained by the qualifying insurance company or branch.

The Act also provides that the Treasury Secretary may prescribe rules for the allocation of contracts (and income from contracts) among two or more qualifying insurance company branches of a qualifying insurance company in order to clearly reflect the income of such branches.

The Act also provides that premiums from a contract are treated as not covering home country risks (and are treated as covering risks other than home country risks) for purposes of the tests for 30 percent and 50 percent, respectively, of net written premiums if the contract reinsures a contract issued or reinsured by a related person (within the meaning of sec. 954(d)(3)).

The Act also provides that the Treasury Secretary may prescribe regulations as may be necessary or appropriate to carry out the purposes of the exceptions from insurance income and foreign personal holding company income provided under sections 953(e) and 954(i) (as added by the Act).

***Other anti-abuse rules***

The Act generally includes the anti-abuse rules of the prior-law provision, with certain further refinements. Under the Act, the anti-abuse rules provide that items with respect to a transaction or series of transactions are disregarded if one of the principal purposes of the transaction or transactions is to qualify income or gain for these exceptions, including any transaction or a series of transactions a principal purpose of which is the acceleration or deferral of any item in order to claim the benefits of these exceptions. In addition, the anti-abuse rules provide that items of an entity which is not engaged in regular and continuous transactions with customers which are not related persons are disregarded. Moreover, items with respect to a transaction or series of transactions are disregarded if one of the principal purposes of the transaction or transactions is to qualify income or gain for these exceptions, including utilizing or doing business with: (1) one or more entities in order to satisfy any home country requirement, or (2) a special purpose entity or arrangement, including a securitization or financing arrangement or any similar entity or arrangement. Finally, the anti-abuse rules provide that a related person, officer, director, or employee with respect to any CFC (or QBU) which otherwise would be treated as a customer of such corporation or unit with respect to any transaction is not treated as a customer, if a principal purpose of such transaction is to satisfy any requirement for these exceptions.

***Sale of assets of an active financing business***

The Act includes a modification to address the treatment of sales of assets of an active financing business. In general, foreign personal holding company income includes net gains from the sale or exchange of property that gives rise to dividends, interest, royalties, rents, or annuities. The Act provides an exception from this rule for income that qualifies for the exception from subpart F for income derived in the active conduct of a banking, financing, or similar business. Under the Act, foreign personal holding company income does not include net gains from the sale or exchange of property that gives rise to dividends, interest, royalties, rents, or annuities if such property gives rise to income not treated as foreign personal holding company income for the taxable year by reason of the exceptions under section 954(h) or (i) (as added by the Act) for income derived in the active conduct of a banking, financing, or similar business or in the conduct of an insurance business. The Congress intended that this exception applies only to the extent that, prior to its disposition, the property was held to generate or generated income which qualifies for the exceptions under section 954(h) or (i) (and such property was not so held for a principal purpose of taking advantage of such exception).

***Exceptions from foreign base company services income***

The prior-law provision includes a corresponding exception from foreign base company services income for income derived by a CFC from the performance of services that are directly related to a transaction entered into by the CFC that gives rise to income that is eligible for these exceptions from subpart F. Under the Act, foreign base company services income does not include income that is not treated as foreign personal holding company income by reason of the exceptions under section 954(h) or 954(i) or the securities dealer exception under section 954(c)(2)(C)(ii), or treated as exempt insurance income by reason of section 953(e) (as added by the Act).

***Other matters***

Nothing in this provision is intended to alter the Treasury Department's agreement, as reflected in Notice 98–35, not to finalize regulations regarding so-called hybrid entities prior to January 1, 2000, in order to allow the Congress the opportunity to fully consider the tax policy issues involved.

### *Effective Date*

The provision applies only to taxable years of foreign corporations beginning in 1999, and to taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

### *Revenue Effect*

The provision is estimated to decrease Federal fiscal year budget receipts by $117 million in 1999 and $378 million in 2000.

## F. Disclosure of Return Information to Department of Education in Connection with Income Contingent Loans (sec. 1006 of the Act and sec. 6103(l)(13) of the Code)

### *Prior Law*

Under section 6103(l)(13) of the Code, the Secretary of the Treasury was authorized to disclose to the Department of Education certain return information with respect to any taxpayer who has received an "applicable student loan." An "applicable student loan" is any loan made under (1) part D of title IV of the Higher Education Act of 1965 or (2) parts B or E of title IV of the Higher Education Act of 1965 which is in default and has been assigned to the Department of Education, if the loan repayment amounts are based in whole or in part on the taxpayer's income. The Secretary was permitted to disclose only taxpayer identity information and the adjusted gross income of the taxpayer. The Department of Education may use the information only to establish the appropriate income contingent repayment amount for an applicable student loan.

The disclosure authority under section 6103(l)(13) terminated with respect to requests made after September 30, 1998.

### *Reasons for Change*

The Congress believed it was appropriate to extend the disclosure authority with respect to applicable student loans during the period in which the applicable loan programs are extended.

### *Explanation of Provision*

The Act reinstates the disclosure authority under section 6103(l)(13) with respect to requests made after the date of enactment and before October 1, 2003.

### *Effective Date*

The disclosure authority under section 6103(l)(13) applies to requests made after the date of enactment (October 21, 1998) and before October 1, 2003.

### *Revenue Effect*

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

# TITLE II. OTHER PROVISIONS

## Subtitle A.—Provisions Relating to Individuals

### A. Personal Credits Fully Allowed Against Regular Tax Liability During 1998 (sec. 2001 of the Act and sec. 26 of the Code)

#### *Present and Prior Law*

Present law and prior law provide for certain nonrefundable personal tax credits (i.e., the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child tax credit, the credit for interest on certain home mortgages, the HOPE Scholarship and Lifetime Learning credits, and the D.C. homebuyer's credit). Generally, these credits are reduced or eliminated for individuals with adjusted gross incomes above specified amounts and these credits are allowed only to the extent that the individual's regular income tax liability exceeds the individual's tentative minimum tax, determined without regard to the AMT foreign tax credit ("the sec. 26(a) limitation").

An individual's tentative minimum tax is an amount equal to (1) 26 percent of the first $175,000 ($87,500 in the case of a married individual filing a separate return) of alternative minimum taxable income ("AMTI") in excess of a phased-out exemption amount and (2) 28 percent of the remaining AMTI. The maximum tax rates on net capital gain used in computing the tentative minimum tax are the same as under the regular tax. AMTI is the individual's taxable income adjusted to take account of specified preferences and adjustments. The exemption amounts are: (1) $45,000 in the case of married individuals filing a joint return and surviving spouses; (2) $33,750 in the case of other unmarried individuals; and (3) $22,500 in the case of married individuals filing a separate return, estates and trusts. The exemption amounts are phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds (1) $150,000 in the case of married individuals filing a joint return and surviving spouses, (2) $112,500 in the case of other unmarried individuals, and (3) $75,000 in the case of married individuals filing separate returns or an estate or a trust. These amounts are not indexed for inflation.

For families with three or more qualifying children, a refundable child credit is provided, up to the amount by which the liability for social security taxes exceeds the amount of the earned income credit (sec. 24(d)). The refundable child credit is reduced by the amount of the individual's minimum tax liability (i.e., the amount by which the tentative minimum tax exceeds the regular tax liability).

### *Reasons for Change*

The alternative minimum tax was enacted by Congress to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions, and credits.[105] The Congress believed that allowing middle-income families to use the nonrefundable personal tax credits to offset the regular tax in full would not undermine the policy of the minimum tax, and would promote the important social policies underlying each of the credits.

The Congress further believed that allowing these credits to offset the regular tax in full would result in significant simplification. Substantially fewer taxpayers will need to complete the minimum tax form (Form 6251) and the worksheets accompanying the credits can be greatly simplified.

### *Explanation of Provision*

The provision allows the nonrefundable personal credits to offset the individual's regular tax liability in full for taxable years beginning during 1998 (as opposed to only the amount by which the regular tax liability exceeds the tentative minimum tax, as under prior law).

The provision that reduces the refundable child credit by the amount of an individual's AMT does not apply for taxable years beginning during 1998.

The following examples illustrate the application of this provision for taxable years beginning during 1998:

*Example 1:* Assume a married couple has an adjusted gross income of $65,400, they do not itemize deductions, and they have four dependent children. Also assume they are entitled to an $800 child credit for two of the children, a $3,000 HOPE scholarship credit with respect to the other two children, and a $960 dependent care tax credit—for a total amount of tax credits of $4,760. The couple's net tax liability under prior law [106] and under the 1998 law are computed as follows:

| | Prior law | 1998 law |
|---|---|---|
| Adjusted gross income ............................ | $65,400 | $65,400 |
| Less Standard deduction ....................... | 7,100 | 7,100 |
| Less Personal exemptions (6 @ $2,700) | 16,200 | 16,200 |
| Taxable income ................................ | 42,100 | 42,100 |
| Regular tax (15% of $42,100) ................ | 6,315 | 6,315 |
| Tentative minimum tax (26% of $20,400) .............................................. | 5,304 | 5,304 |
| Pre-limitation credits ($800+$3,000+ $960) .................................................. | 4,760 | 4,760 |

[105] See H. Rept. 99–426, pp. 305–306, and S. Rept. 99–313, p. 518.

[106] "Prior law" for purposes of this discussion means the law which would have been effective in 1998 without the amendments made by section 2001 of the Tax and Trade Relief Extension Act of 1998 ("1998 Act"), and "1998 law" means the law as amended by that section.

| | Prior law | 1998 law |
|---|---|---|
| Section 26(a) limit on nonrefundable credits: | | |
| Regular tax | 6,315 | 6,315 |
| Less tentative minimum tax for sec. 26(a)(2) | 5,304 | 0 |
| Maximum nonrefundable credits allowable | 1,011 | 6,315 |
| Total credits allowed | 1,011 | 4,760 |
| Net tax | 5,304 | 1,555 |
| Net tax reduction—1998 Act | | 3,749 |

*Example 2:* Assume the same facts as Example 1, except the couple has five dependent children, three of whom qualify for the child tax credit, and their adjusted gross income is $68,100. Thus, the couple is eligible for tax credits totaling $5,160. Also assume the couple paid $5,000 in social security taxes for purposes of determining the refundable child tax credit for three or more qualifying children. The couple's net tax liability under prior law and under the 1998 law are computed as follows:

| | Prior law | 1998 law |
|---|---|---|
| Adjusted gross income | $68,100 | $68,100 |
| Less Standard deduction | 7,100 | 7,100 |
| Less Personal exemptions (7 @ $2,700) | 18,900 | 18,900 |
| Taxable income | 42,100 | 42,100 |
| Regular tax (15% of $42,100) | 6,315 | 6,315 |
| Tentative minimum tax (26% of $23,100) | 6,006 | 6,006 |
| Pre-limitation credits ($1,200+$3,000+ $960) | 5,160 | 5,160 |
| Section 26(a) limit on nonrefundable credits: | | |
| Regular tax | 6,315 | 6,315 |
| Less tentative minimum tax for sec. 26(a)(2) | 6,006 | 0 |
| Maximum nonrefundable credits allowable | 309 | 6,315 |
| Total nonrefundable credits allowed | 309 | 5,160 |
| Section 24(d) refundable child credit [107] | 1,200 | 0 |
| Total credits allowed | 1,509 | 5,160 |
| Net tax | 4,806 | 1,155 |

| | Prior law | 1998 law |
|---|---|---|
| Net tax reduction—1998 Act .......... | | 3,651 |

[107] Section 24(d) provides for a refundable child credit for families with three or more eligible children. The section 24(d) credit is the lesser of (1) the amount by which allowable credits would increase if the social security taxes were added to the section 26(a) limit or (2) the amount of the child tax credit, determined without regard to the section 26(a) limitation. Under prior law, the section 24(d) child credit would have been $1,200 (the lesser of $1,200 or the amount that the total credits would have been increased if the section 26(a) limit had been increased by the $5,000 social security taxes paid). Because the credits are allowed in full under the section 26(a) limitation as amended by the 1998 Act, the couple's section 24(d) child credit is zero under the 1998 Act.

In addition to the tax savings under the 1998 Act, the couple is no longer required to compute the tentative minimum tax or the section 24(d) refundable child credit to determine their net tax liability.

*Example 3:* Assume the same facts as Example 2, except the couple has six dependent children, four of whom are eligible for the child credit, and their adjusted gross income is $70,800. Thus, the couple is eligible for tax credits totaling $5,560. The couple's net tax liability under prior law and under the 1998 law are computed as follows:

| | Prior law | 1998 law |
|---|---|---|
| Adjusted gross income ........................... | $70,800 | $70,800 |
| Less Standard deduction ...................... | 7,100 | 7,100 |
| Less Personal exemptions (8 @ $2,700) | 21,600 | 21,600 |
| Taxable income ............................... | 42,100 | 42,100 |
| Regular tax (15% of $42,100) ............... | 6,315 | 6,315 |
| Tentative minimum tax (26% of $25,800) ............................................. | 6,708 | 6,708 |
| Minimum tax ($6,708 less $6,315) ........ | 393 | 393 |
| Pre-limitation credits ($1,600+$3,000+ $960) .................................................. | 5,560 | 5,560 |
| Section 26(a) limit on nonrefundable credits: | | |
| Regular tax .................................... | 6,315 | 6,315 |
| Less tentative minimum tax for sec. 26(a)(2) ................................ | 6,708 | 0 |
| Maximum nonrefundable credits allowable ..................................... | 0 | 6,315 |
| Total nonrefundable credits allowed ..... | 0 | 5,560 |
| Section 24(d) refundable child credit [108] | 1,207 | 0 |
| Total credits allowed ............................. | 1,207 | 5,560 |
| Net tax ($6,315 plus $393 less credits) | 5,501 | 1,148 |

| | Prior law | 1998 law |
|---|---|---|
| Net tax reduction—1998 Act .......... | | 4,353 |

[108] Under prior law, the $1,207 section 24(d) refundable child credit would have been $1,600 less the $393 minimum tax liability. Because the credits are allowed in full under the section 26(a) limitation as amended by the 1998 Act, the couple's section 24(d) child credit is zero under the 1998 Act.

In addition to the tax savings under the 1998 Act, the couple is no longer required to compute the tentative minimum tax or the section 24(d) refundable child credit to compute their net tax liability.

*Example 4:* Assume a married couple has an adjusted gross income of $62,700, they do not itemize deductions, and they have three dependent children who qualify for the child tax credit. Also assume the couple is entitled to a dependent care credit of $960. Thus, the couple is eligible for $2,160 of credits. Also, assume the couple paid $4,000 in social security taxes for purposes of determining the refundable child credit for three or more qualifying children. The couple's net tax liability under prior law and under the 1998 law are computed as follows:

| | Prior law | 1998 law |
|---|---|---|
| Adjusted gross income ........................... | $62,700 | $62,700 |
| Less Standard deduction ...................... | 7,100 | 7,100 |
| Less Personal exemptions (5 @ $2,700) | 13,500 | 13,500 |
| Taxable income ............................... | 42,100 | 42,100 |
| Regular tax (15% of $42,100) ............... | 6,315 | 6,315 |
| Tentative minimum tax (26% of $17,700) ............................................. | 4,602 | 4,602 |
| Pre-limitation credits ($1,200+$960) ..... | 2,160 | 2,160 |
| Section 26(a) limit on nonrefundable credits: | | |
| Regular tax .................................... | 6,315 | 6,315 |
| Less tentative minimum tax for sec. 26(a)(2) ................................ | 4,602 | 0 |
| Maximum nonrefundable credits allowable ..................................... | 1,713 | 6,315 |
| Total nonrefundable credits allowed ..... | 1,713 | 2,160 |
| Section 24(d) refundable child credit [109] | 447 | 0 |
| Total credits allowed ............................ | 2,160 | 2,160 |
| Net tax .................................................. | 4,155 | 4,155 |
| Net tax reduction—1998 Act .......... | | 0 |

[109] Under prior law, this would have been the amount (not in excess of the $1,200 child tax credit) by which the nonrefundable credits would have been increased if the social security taxes were added to the section 26(a) limitation ($2,160 total credits less $1,713 credits otherwise allowable).

Although there is no net tax reduction under the 1998 Act, the couple is no longer required to compute the tentative minimum tax or the section 24(d) refundable child credit to determine their net tax liability.

### *Effective Date*

The provision is effective for taxable years beginning during 1998.

### *Revenue Effect*

The provision is estimated to reduce Federal fiscal year budget receipts by $474 million in 1999.

## B. Increase Deduction for Health Insurance Expenses of Self-Employed Individuals (sec. 2002 of the Act and sec. 162(l) of the Code)

### *Present and Prior Law*

Under present and prior law, self-employed individuals are entitled to deduct a portion of the amount paid for health insurance, including (within certain limits) long-term care insurance, for the self-employed individual and the individual's spouse and dependents. The deduction for health insurance expenses of self-employed individuals is not available for any month in which the taxpayer is eligible to participate in a subsidized health plan maintained by the employer of the taxpayer or the taxpayer's spouse.[110] The deduction is available in the case of self insurance as well as commercial insurance. The self-insured plan must in fact be insurance (e.g., there must be appropriate risk shifting) and not merely a reimbursement arrangement.

Under present and prior law, the portion of health insurance expenses of self-employed individuals that is deductible is 45 percent for taxable years beginning in 1998. Under prior law, the portion of health insurance expenses of self-employed individuals that is deductible was scheduled to be 45 percent for taxable years beginning in 1999, 50 percent for taxable years beginning in 2000 and 2001, 60 percent for taxable years beginning in 2002, 80 percent for taxable years beginning in 2003, 2004, and 2005, 90 percent for taxable years beginning in 2006, and 100 percent for taxable years beginning in 2007 and thereafter.

Under present and prior law, employees can exclude from income 100 percent of employer-provided health insurance. For an individual who has to pay for any portion of his or her health insurance (e.g., the individual's employer does not provide health insurance or pays only part of the premium), the individual's cost is deductible only to the extent that all of the individual's medical expenses exceed 7.5 percent of his or her adjusted gross income.

### *Reasons for Change*

The Congress believed it appropriate to accelerate the scheduled increase in the deduction for health insurance expenses of self-employed individuals in order to reduce the disparity of treatment between such expenses and employer-provided health insurance and to help make health insurance more affordable for self-employed individuals.

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[110] This rule is applied separately to long-term care insurance and other health insurance.

### *Explanation of Provision*

The provision increases the deduction for health insurance expenses of self-employed individuals to 60 percent of such expenses for taxable years beginning in 1999 through 2001, to 70 percent for taxable years beginning in 2002, and to 100 percent for taxable years beginning in 2003 and thereafter.

### *Effective Date*

The provision is effective for taxable years beginning after December 31, 1998.

### *Revenue Effect*

The provision is estimated to reduce Federal fiscal year budget receipts by $105 million in 1999, $289 million in 2000, $235 million in 2001, $251 million in 2002, $384 million in 2003, $637 million in 2004, $680 million in 2005, $602 million in 2006, and $257 million in 2007.

## C. Modification of Individual Estimated Tax Safe Harbors (sec. 2003 of the Act and sec. 6654 of the Code)

### *Present and Prior Law*

Under present law, an individual taxpayer generally is subject to an addition to tax for any underpayment of estimated tax. An individual generally does not have an underpayment of estimated tax if he or she makes timely estimated tax payments at least equal to: (1) 100 percent of the tax shown on the return of the individual for the preceding year (the "100 percent of last year's liability safe harbor") or (2) 90 percent of the tax shown on the return for the current year. The 100 percent of last year's liability safe harbor is generally modified to be a 110 percent of last year's liability safe harbor for any individual with an AGI of more than $150,000 as shown on the return for the preceding taxable year, except that it is 105 percent of last year's liability for taxable years beginning in 1999, 2000, and 2001, and 112 percent of last year's liability for taxable years beginning in 2002. If a married individual files a separate return for the year for which an estimated tax installment payment was due, the $150,000 amount becomes $75,000.

### *Reasons for Change*

The Congress believed it was appropriate to modify the applicability of these rules.

### *Explanation of Provision*

For taxable years beginning in 2000 and 2001, the 105 percent of last year's liability safe harbor for any individual with an AGI of more than $150,000 as shown on the return for the preceding taxable year is modified to be a 106 percent of last year's liability safe harbor.

### *Effective Date*

The provision is effective for taxable years beginning in 2000 and 2001.

### *Revenue Effect*

The provision is estimated to increase Federal fiscal year budget receipts by $525 million in 2000 and to decrease receipts by $525 million in 2002.

## Subtitle B.—Provisions Relating to Farmers

### A. Permanent Extension of Income Averaging for Farmers (sec. 2011 of the Act and sec. 1301 of the Code)

### *Present and Prior Law*

In general, an individual taxpayer may elect to compute his or her current year tax liability by averaging, over the prior three-year period, all or a portion of his or her taxable income from the trade or business of farming.

The provision operates such that an electing taxpayer (1) designates all or a portion of his or her taxable income attributable to any farming business [111] of the taxpayer from the current year as "elected farm income," [112] (2) allocates one-third of such "elected farm income" to each of the prior three taxable years, and (3) determines his or her current year section 1 tax liability by determining the sum of (a) his or her current year section 1 liability without the elected farm income allocated to the three prior taxable years plus (b) the increases in the section 1 tax for each of the three prior taxable years by taking into account the allocable share of the elected farm income for such years.[113] If a taxpayer elects the income averaging provision for a taxable year, then the allocation of elected farm income to the three prior taxable years shall apply for purposes of any income averaging election in a subsequent taxable year.

Taxable income attributable to any farming business may include gain from the sale or other disposition of property (other than land) regularly used by the taxpayer in his or her farming business for a substantial period.

The provision does not apply for employment tax purposes, or to an estate or a trust. Further, the provision does not apply for purposes of the alternative minimum tax under section 55. Finally, the provision does not require the recalculation of the tax liability of any other taxpayer, including a minor child required to use the tax rates of his or her parents under section 1(g).

The election is in the manner prescribed by the Secretary of the Treasury and, except as provided by the Secretary, shall be irrevocable. In addition, the Secretary of the Treasury shall prescribe

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[111] The term "farming business" has the same meaning given such term by section 263A(e)(4).

[112] The amount of elected farm income of a taxpayer for a taxable year may not exceed the taxable income attributable to any farming business for the year.

[113] The provision does not affect the individual taxpayer's amount of adjusted gross income (either in the year the farm income is earned or in the prior taxable years to which such income is allocated).

such regulations as are necessary to carry out the purposes of the provision.

Under prior law, the election to use the income averaging provision would not have been available for taxable years beginning after December 31, 2000.

### *Reasons for Change*

Income from a farming business can fluctuate significantly from year to year due to circumstances beyond the farmer's control. Allowing farmers an election to average their income over a period of years mitigates the adverse tax consequences that could result from fluctuating income levels. The Congress believed that the election by farmers to average their income should be made permanent.

### *Explanation of Provision*

The provision allowing farmers to elect income averaging is permanently extended.

### *Effective Date*

The provision is effective for taxable years beginning after December 31, 2000.

### *Revenue Effect*

The provision is estimated to reduce Federal fiscal year budget receipts by $2 million in 2001, $21 million in 2002, $22 million in both 2003 and 2004, $23 million in 2005, and $24 million in both 2006 and 2007.

## B. Farm Production Flexibility Payments (sec. 2012 of the Act)

### *Present and Prior Law*

A taxpayer generally is required to include an item in income no later than the time of its actual or constructive receipt, unless such amount properly is accounted for in a different period under the taxpayer's method of accounting. If a taxpayer has an unrestricted right to demand the payment of an amount, the taxpayer is in constructive receipt of that amount whether or not the taxpayer makes the demand and actually receives the payment.

The Federal Agriculture Improvement and Reform Act of 1996 (the "FAIR Act") provides for production flexibility contracts between certain eligible owners and producers and the Secretary of Agriculture. These contracts generally cover crop years from 1996 through 2002. Annual payments are made under such contracts at specific times during the Federal government's fiscal year. Section 112(d)(2) of the FAIR Act provides that one-half of each annual payment is to be made on either December 15 or January 15 of the fiscal year, at the option of the recipient.[114] This option to receive

[114] For legislative background of this provision, see H.R. 4579, The Taxpayer Relief Act of 1998, as reported by the House Committee on Ways and Means on September 23, 1998, sec. 212; H. Rept. 105–739, pp. 57–59.

the payment on December 15 potentially would have resulted in the constructive receipt (and thus potential inclusion in income) of one-half of the annual payment at that time, even if the option to receive the amount on January 15 was elected. This rule applies to fiscal years after 1996. For fiscal year 1996, this payment was to be made not later than 30 days after the production flexibility contract was entered into.

The remaining one-half of the annual payment must be made no later than September 30 of the fiscal year. The Emergency Farm Financial Relief Act of 1998 added section 112(d)(3) to the FAIR Act which provides that all payments for fiscal year 1999 are to be paid at such time or times during fiscal year 1999 as the recipient may specify. Thus, the one-half of the annual amount that would otherwise be required to be paid no later than September 30, 1999 can be specified for payment in calendar year 1998. This potentially would have resulted in the constructive receipt (and thus required inclusion in taxable income) of such amounts in calendar year 1998, whether or not the amounts actually were received or the right to their receipt was fixed.

### *Reasons for Change*

The Congress determined that allowing the year in which a production flexibility contract payment is included in income to be determined without regard to the statutory options to accelerate the receipt of such income will provide necessary relief for farmers, contribute to simplification and allow for more efficient administration of the tax laws.

### *Explanation of Provision*

The time a production flexibility contract payment under the FAIR Act properly is includible in income is to be determined without regard to the options granted by section 112(d)(2) (allowing receipt of one-half of the annual payment on either December 15 or January 15 of the fiscal year) or section 112(d)(3) (allowing the acceleration of all payments for fiscal year 1999) of that Act.

### *Effective Date*

The provision is effective for production flexibility contract payments made under the FAIR Act in taxable years ending after December 31, 1995.

### *Revenue Effect*

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

## C. Extend the Net Operating Loss Carryback Period for Farmers (sec. 2013 of the Act and sec. 172 of the Code)[115]

### *Present and Prior Law*

A net operating loss ("NOL") is, generally, the amount by which business deductions of a taxpayer exceed business gross income. In general, an NOL may be carried back two years and carried forward 20 years to offset taxable income in such years.[116] A carry back of an NOL results in the refund of Federal income tax for the carryback year. A carry forward of an NOL reduces Federal income tax for the carryforward year.

In the case of an NOL (1) arising from casualty or theft losses of individual taxpayers, or (2) attributable to Presidentially declared disasters for taxpayers engaged in a farming business or a small business, the NOL can be carried back three years. Under prior law, other than the three-year carryback period for NOLs attributable to Presidentially declared disaster areas, there were no special carryback rules for taxpayers who have a net operating loss attributable to a farming business.[117]

### *Reasons for Change*

The NOL carryback and carryforward rules allow taxpayers to smooth out swings in business income (and Federal income taxes thereon) that result from business cycle fluctuations and unexpected financial losses. Farmers are particularly vulnerable to such fluctuations and losses. The Congress believed that farmers who suffer losses from their farming business should have an extended period in which to use such losses to offset taxable income in prior years.

### *Explanation of Provision*

The provision provides a special five-year carryback period for a farming loss, regardless of whether the loss was incurred in a Presidentially declared disaster area. The carryforward period remains at 20 years. A "farming loss" is defined as the amount of any net operating loss attributable to a farming business (as defined in sec. 263A(e)(4)). A farming loss cannot exceed the taxpayer's NOL for the taxable year. In calculating the amount of a taxpayer's NOL carrybacks, the portion of the NOL that is attributable to a farming loss is treated as a separate NOL and is taken into account after the remaining portion of the NOL for the taxable year.

A taxpayer can elect to forgo the five-year carryback period for a farming loss. The election to forgo the five-year carryback period is made in the manner prescribed by the Secretary of the Treasury and must be made by the due date of the return (including extensions) for the year of the loss. The election is irrevocable. If a taxpayer elects to forgo the five-year carryback period, then the farm-

[115] For legislative background of this provision, see H.R. 4579, The Taxpayer Relief Act of 1998, as reported by the House Committee on Ways and Means on September 23, 1998, sec. 212; H. Rept. 105–739, pp. 57–59.

[116] A taxpayer may elect to forgo the carryback of an NOL.

[117] Special carryback rules apply to real estate investment trusts (no carrybacks), specified liability losses (10-year carryback), and excess interest losses (no carrybacks).

ing loss is subject to the rules that otherwise would have applied absent the five-year rule. The three-year carryback period continues to apply to an NOL incurred in a Presidentially declared disaster area if the NOL is not eligible for the five-year carryback period.

### *Effective Date*

The provision is effective for NOLs arising in taxable years beginning after December 31, 1997.

### *Revenue Effect*

The provision is estimated to reduce Federal fiscal year budget receipts by $73 million in 1999, $66 million in 2000, $60 million in 2001, $55 million in 2002, $50 million in 2003, $46 million in 2004, $42 million in 2005, $39 million in 2006, and $36 million in 2007.

## Subtitle C.—Miscellaneous Provisions

## A. Increase State Volume Limits on Private Activity Tax-Exempt Bonds (sec. 2021 of the Act and sec. 146 of the Code)

### *Present and Prior Law*

Interest on bonds issued by State and local governments is excluded from income if the proceeds of the bonds are used to finance activities conducted and paid for by the governmental units (Code sec. 103). Interest on bonds issued by these governmental units to finance activities carried out and paid for by private persons ("private activity bonds") is taxable unless the activities are specified in the Internal Revenue Code. Private activity bonds on which interest may be tax-exempt include bonds for privately operated transportation facilities (e.g., airports, docks and wharves, mass transit, and high speed rail facilities), privately owned and/or provided municipal services (e.g., water, sewer, solid waste disposal, and certain electric and heating facilities), economic development (e.g., small manufacturing facilities and redevelopment in economically depressed areas), and certain social programs (e.g., low-income rental housing, qualified mortgage bonds, student loan bonds, and exempt activities of charitable organizations described in Code sec. 501(c)(3)).

The volume of tax-exempt private activity bonds that States and local governments may issue for most of these purposes in each calendar year is restricted by State-wide volume limits. Under prior law (and, as described below, present law through 2002), the annual volume limit for any State is $50 per resident of the State or $150 million if greater. The volume limits do not apply to private activity bonds to finance airports, docks and wharves, certain governmentally owned, but privately, operated solid waste disposal facilities, certain high speed rail facilities, or exempt activities of section 501(c)(3) organizations, and to certain types of private activity tax-exempt bonds that are subject to other limits on their volume (qualified veterans' mortgage bonds, certain "new" empowerment zone and enterprise community bonds.

### *Reasons for Change*

The Congress believed that a delayed increase for future years in the annual State private activity bond volume limits to levels comparable to the dollar limits that first applied after enactment of the Tax Reform Act of 1986 is appropriate. Such an adjustment will assist States in meeting long-range infrastructure needs and encouraging economic development and will facilitate continuation of future privatization efforts regarding municipal services such as solid waste disposal, water, and sewer services without reversing the general policy of limiting the use of this Federal subsidy for conduit borrowing in transactions that distort market choice and efficiency.

### *Explanation of Provision*

The Act increases the annual State private activity bond volume limits to $75 per resident of each State or $225 million (if greater) beginning in calendar year 2007. The increase is phased-in as follows, beginning in calendar year 2003:

| *Calendar year* | *Volume limit* |
| --- | --- |
| 2003 | $55 per resident ($165 million if greater) |
| 2004 | $60 per resident ($180 million if greater) |
| 2005 | $65 per resident ($195 million if greater) |
| 2006 | $70 per resident ($210 million if greater) |

### *Effective Date*

The provision is effective beginning in calendar year 2003.

### *Revenue Effect*

The provision is estimated to reduce Federal fiscal year budget receipts by $11 million in 2003, $44 million in 2004, $111 million in 2005, $117 million in 2006, and $252 million in 2007.

## B. Comprehensive Study of Recovery Periods and Depreciation Methods Under Section 168 (sec. 2022 of the Act)

### *Present and Prior Law*

A taxpayer is allowed to deduct a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property that is used in a trade or business or is held for the production of income. For most tangible personal and real property placed in service after 1986, the amount of the deductible allowance is determined using a statutorily prescribed recovery period, depreciation method, and convention (sec. 168).

For some types of assets, the recovery period of an asset is provided in section 168. In other cases, the recovery period of an asset is determined by reference to its class life. The class life of an asset may be provided by section 168, or may be determined with regard to the list of class lives provided by the Treasury Department that was in effect on January 1, 1986. The Treasury Department is required to monitor and analyze actual experience with respect to all depreciable assets.

The depreciation method determines the rate at which the cost of the property is recovered. In general, the depreciation method specified in section 168 varies with the recovery period of the property. For property with a recovery period of 10 years or less, the depreciation method is the 200 percent declining balance method, switching to straight-line in the first year in which that method yields a larger allowance. The 150 percent declining balance, (switching to straight-line) is the method prescribed for property with a recovery period of 15 or 20 years, as well as for all property used in the trade or business of farming. The straight-line method must be used for property with a longer recovery period, as well as for certain specified types of property.

The convention determines the point of time during the year that the property is considered placed in service. Statutorily prescribed conventions include the mid-year, the mid-quarter and the mid-month conventions.

### *Reasons for Change*

The Congress was concerned that the present-law depreciation rules may measure income improperly, may create competitive disadvantages, and may result in an inefficient allocation of investment capital in certain cases. The Congress believed that the manner in which recovery periods and methods are determined should be examined to determine if improvements could be made.

### *Explanation of Provision*

The Secretary of the Treasury (or his delegate) is directed to conduct a comprehensive study of the recovery periods and depreciation methods under section 168 of the Code, and to provide recommendations for determining these periods and methods in a more rational manner. The Secretary of the Treasury (or his delegate) is directed to submit the results of the study and recommendations to the House Committee on Ways and Means and the Senate Finance Committee by March 31, 2000.

### *Effective Date*

The provision is effective on the date of enactment (October 21, 1998).

### *Revenue Effect*

The provision is estimated to have no effect on Federal fiscal year budget receipts.

## C. State Election to Exempt Student Employees From Social Security (sec. 2023 of the Act)

### *Present and Prior Law*

The Social Security Amendments of 1972 provided an opportunity for States to obtain exemptions from Social Security coverage for student employees of public schools, colleges, and universities. States choosing to opt out had to do so prior to January 1, 1974. Most States did. Student employees in these States do not have to pay FICA taxes on their wages, allowing them to keep more of their earnings.

### *Reasons for Change*

Three States chose not to seek an exemption from Social Security coverage. The Congress believed that this provision would provide the opportunity for all student employees to be treated equally under Social Security law and would assist student employees who are working to advance their education.

### *Explanation of Provision*

The Act allows a limited window of time (January 1 through March 31, 1999) for States to modify existing State agreements to exempt students (including graduate assistants) from Social Security coverage who are employed by a public school, university, or college in a nonexempted State.

### *Effective Date*

The provision permitting States to modify existing agreement is effective with respect to earnings after June 30, 2000.

### *Revenue Effect*

The provision is estimated to reduce Federal fiscal year budget receipts by $5 million in 2000, $47 million in 2001, $49 million in 2002, $51 million in 2003, $52 million in 2004, $54 million in 2005, $56 million in 2006, and $58 million in 2007.[118]

[118] The estimate for this provision was provided by the Congressional Budget Office.

## TITLE III. REVENUE OFFSET PROVISIONS

### A. Treatment of Certain Deductible Liquidating Distributions of Regulated Investment Companies and Real Estate Investment Trusts (sec. 3001)

#### *Present and Prior Law*

Regulated investment companies ("RICs") and real estate investment trusts ("REITs") are allowed a deduction for dividends paid to their shareholders. The deduction for dividends paid includes amounts distributed in liquidation which are properly chargeable to earnings and profits, as well as, in the case of a complete liquidation occurring within 24 months after the adoption of a plan of complete liquidation, any distribution made pursuant to such plan to the extent of earnings and profits. Rules that govern the receipt of dividends from RICs and REITs generally provide for including the amount of the dividend in the income of the shareholder receiving the dividend that was deducted by the RIC or REIT. Generally, any shareholder realizing gain from a liquidating distribution of a RIC or REIT includes the amount of gain in the shareholder's income. However, in the case of a liquidating distribution to a corporation owning at least 80-percent of the stock of the distributing corporation, a separate rule generally provided that the distribution is tax-free to the parent corporation. The parent corporation succeeds to the tax attributes, including the adjusted basis of assets, of the distributing corporation. Under these rules, a liquidating RIC or REIT might be allowed a deduction for amounts paid to its parent corporation, without a corresponding inclusion in the income of the parent corporation, resulting in income being subject to no tax.

A RIC or REIT may designate a portion of a dividend as a capital gain dividend to the extent the RIC or REIT itself has a net capital gain, and a RIC may designate a portion of the dividend paid to a corporate shareholder as eligible for the 70-percent dividends-received deduction to the extent the RIC itself received dividends from other corporations. If certain conditions are satisfied, a RIC also is permitted to pass through to its shareholders the tax-exempt character of the RIC's net income from tax-exempt obligations through the payment of "exempt interest dividends," though no deduction is allowed for such dividends.

#### *Reasons for Change*

The Congress believes that RICs and REITs are important investment vehicles, particularly for small investors. The RIC and REIT rules are designed to encourage investors to pool their resources and achieve the type of investment opportunities, subject to a single level of tax, that otherwise would be available only to a larger investor. Nonetheless, it appeared that some corporations had attempted to use the "dividends paid deduction" for a RIC or REIT in combination with the separate rule that allows a corporate parent to receive property from an 80 percent subsidiary without tax when the subsidiary is liquidating, and had argued that the combination of these two rules permitted income deducted by the RIC or REIT and paid to the parent corporation to be entirely tax free during the period of liquidation of the RIC or REIT. The Congress believed that income of a RIC or REIT which is not taxable to the RIC or REIT because of the dividends paid deduction also should not be excluded from the income of the RIC's or REIT's shareholders as a liquidating distribution to a parent shareholder. The legislation would not affect the intended beneficiaries of the RIC and REIT rules.

### *Explanation of Provision*

Any amount which a liquidating RIC or REIT may take as a deduction for dividends paid with respect to an otherwise tax-free liquidating distribution to an 80-percent corporate owner is includible in the income of the recipient corporation. The includible amount is treated as a dividend received from the RIC or REIT. The liquidating corporation may designate the amount distributed as a capital gain dividend or, in the case of a RIC, a dividend eligible for the 70-percent dividends received deduction or an exempt interest dividend, to the extent provided by the RIC or REIT provisions of the Code.

The provision does not otherwise change the tax treatment of the distribution to the parent corporation or to the RIC or REIT. Thus, for example, the liquidating corporation will not recognize gain (if any) on the liquidating distribution and the recipient corporation will hold the assets at a carryover basis, even where the amount received is treated as a dividend.

### *Effective Date*

The provision is effective for distributions on or after May 22, 1998, regardless of when the plan of liquidation was adopted.

No inference is intended regarding the treatment of such transactions under prior law.

### *Revenue Effect*

The provision is estimated to increase Federal budget receipts by $2.425 billion in 1999, $1.109 billion in 2000, $723 million in 2001, $640 million in 2002, $672 million in 2003, $705 million in 2004, $741 million in 2005, $778 million in 2006, and $817 million in 2007.

## B. Add Vaccines Against Rotavirus Gastroenteritis to the List of Taxable Vaccines (sec. 3002 of the Act and sec. 4132 of the Code)

### *Present and Prior Law*

A manufacturer's excise tax is imposed at the rate of 75 cents per dose on the following vaccines routinely recommended for administration to children: diphtheria, pertussis, tetanus, measles, mumps, rubella, polio, HIB (haemophilus influenza type B), hepatitis B, and varicella (chicken pox). Amounts equal to net revenues from this excise tax are deposited in the Vaccine Injury Compensation Trust Fund.

### *Reasons for Change*

Rotavirus gastroenteritis is a highly contagious disease among young children that can lead to life-threatening diarrhea, cramps, vomiting, and can result in death. In the United States, more than 50,000 children are hospitalized and more than 100 die annually from rotavirus gastroenteritis. The Food and Drug Administration has approved a vaccine against the disease and the Centers for Disease Control have recommended the vaccine for routine inoculation of children. The Congress believed American children would benefit from wide use of this new vaccine. The Congress believed that, by including the new vaccine with those presently covered by the Vaccine Injury Compensation Trust Fund, greater application of the vaccine would be promoted. The Congress, therefore, believed it was appropriate to add the vaccine against rotavirus gastroenteritis to the list of taxable vaccines.

### *Explanation of Provision*

The provision expands prior law by adding any vaccine against rotavirus gastroenteritis to the list of taxable vaccines.[119]

### *Effective Date*

The provision is effective for vaccines sold by a manufacturer or importer after October 21, 1998 (the date of enactment). No floor stocks tax was imposed for amounts held for sale on that date. For sales on or before the date of enactment for which delivery is made after the date of enactment, the delivery date is deemed to be the sale date.

### *Revenue Effect*

The provision is estimated to increase Federal fiscal year budget receipts by $1 million in 1999, $2 million in 2000, $3 million in 2001, $4 million in 2002, $5 million in 2003, $6 million in 2004, $6 million in 2005, $6 million in 2006, and $7 million in 2007.

[119] Title XV of the Omnibus Consolidated and Emergency Supplemental Appropriations Act, 1999, "The Vaccine Injury Compensation Program Modification Act," included a provision that substantially, but incorrectly, duplicated this tax provision and Code Trust Fund amendments included in a technical correction (sec. 4003(d) of the Tax and Trade Relief Extension Act of 1998). A further technical correction may be needed to clarify that the provisions as included in the Tax and Trade Relief Extension Act of 1998 are intended to become the provisions of permanent law where in conflict.

## C. Clarify and Expand Mathematical Error Procedures (sec. 3003 of the Act and sec. 6213(g)(2) of the Code)

### *Present and Prior Law*

#### *Taxpayer identification numbers ("TINs")*

The IRS may deny a personal exemption for a taxpayer, the taxpayer's spouse or the taxpayer's dependents if the taxpayer fails to provide a correct TIN for each person for whom the taxpayer claims an exemption. This TIN requirement also indirectly effects other tax benefits currently conditioned on a taxpayer being able to claim a personal exemption for a dependent (e.g., head-of-household filing status and the dependent care credit). Other tax benefits, including the adoption credit, the child tax credit, the Hope Scholarship credit and Lifetime Learning credit, and the earned income credit also have TIN requirements. For most individuals, their TIN is their Social Security Number ("SSN"). The mathematical and clerical error procedure applies to the omission of a correct TIN for purposes of personal exemptions and all of the credits listed above except for the adoption credit.

#### *Mathematical or clerical errors*

The IRS may summarily assess additional tax due as a result of a mathematical or clerical error without sending the taxpayer a notice of deficiency and giving the taxpayer an opportunity to petition the Tax Court. Where the IRS uses the summary assessment procedure for mathematical or clerical errors, the taxpayer must be given an explanation of the asserted error and a period of 60 days to request that the IRS abate its assessment. The IRS may not proceed to collect the amount of the assessment until the taxpayer has agreed to it or has allowed the 60-day period for objecting to expire. If the taxpayer files a request for abatement of the assessment specified in the notice, the IRS must abate the assessment. Any reassessment of the abated amount is subject to the ordinary deficiency procedures. The request for abatement of the assessment is the only procedure a taxpayer may use prior to paying the assessed amount in order to contest an assessment arising out of a mathematical or clerical error. Once the assessment is satisfied, however, the taxpayer may file a claim for refund if he or she believes the assessment was made in error.

### *Reasons for Change*

The Congress believed that it was appropriate to provide additional guidance to the Internal Revenue Service with respect to the application of the TIN requirement. The Congress further believed that it also would improve compliance to allow the IRS to use date of birth data from the Social Security Administration to determine ineligibility for the dependent care credit, the child tax credit and the earned income credit. Once this determination was made, the Congress believed that the IRS should use the mathematical and clerical error procedure to correctly assess the tax due with respect to affected tax returns.

### *Explanation of Provision*

The Act provides that in the application of the mathematical and clerical error procedure, a correct TIN is a TIN that was assigned by the Social Security Administration (or in certain limited cases, the IRS) to the individual identified on the return. For this purpose, the IRS is authorized to determine that the individual identified on the tax return corresponds in every aspect (including, name, age, date of birth, and SSN) to the individual to whom the TIN is issued. The IRS also is authorized to use the mathematical and clerical error procedure to deny eligibility for the dependent care tax credit, the child tax credit, and the earned income credit even though a correct TIN has been supplied if the IRS determines that the statutory age restriction for eligibility for any of the respective credits is not satisfied (e.g., the TIN issued for the child claimed as the basis of the child tax credit identifies the child as over the age of 17 at the end of the taxable year).

### *Effective Date*

The provision is effective for taxable years ending after the date of enactment (after October 21, 1998).

### *Revenue Effect*

The provision is estimated to increase Federal fiscal year budget receipts by $12 million in 1999, $25 million in 2000, $26 million in 2001, $27 million in 2002, $28 million in 2003, $29 million in 2004, $30 million in 2005, $31 million in 2006, and $32 million in 2007.

## D. Restrict 10-Year Net Operating Loss Carryback Rules for Specified Liability Losses (sec. 3004 of the Act and sec. 172(f) of the Code)

### *Present and Prior Law*

The portion of a net operating loss that qualifies as a "specified liability loss" may be carried back 10 years rather than being limited to the general two-year carryback period. A specified liability loss includes amounts allowable as a deduction with respect to product liability, and also certain liabilities that arise under Federal or State law or out of any tort of the taxpayer. In the case of a liability arising out of a Federal or State law, the act (or failure to act) giving rise to the liability must occur at least 3 years before the beginning of the taxable year. In the case of a liability arising out of a tort, the liability must arise out of a series of actions (or failures to act) over an extended period of time a substantial portion of which occurred at least three years before the beginning of the taxable year. A specified liability loss cannot exceed the amount of the net operating loss, and is only available to taxpayers that used an accrual method of accounting throughout the period that the acts (or failures to act) occurred.

### *Reasons for Change*

The proper interpretation of the specified liability loss provisions has been the subject of controversy. The Congress considered it desirable to lessen controversy by providing a definitive list of items for which the 10-year specified liability loss carryback is available.

### *Explanation of Provision*

Under the provision, specified liability losses are limited to (1) product liability losses and (2) amounts allowable as a deduction (other than a deduction under sec. 468(a)(1) or sec. 468A(a)) that are in satisfaction of a liability under a Federal or State law requiring the reclamation of land, decommissioning of a nuclear power plant (or any unit thereof), dismantlement of a drilling platform, remediation of environmental contamination, or a payment under any workers compensation act (within the meaning of sec. 461(h)(2)(C)(i)), if the act (or failure to act) giving rise to such liability occurs at least 3 years before the beginning of the taxable year. As under prior law, the specified liability loss (as redefined) cannot exceed the amount of the net operating loss and is only available to taxpayers that used an accrual method of accounting throughout the period that the act (or failure to act) giving rise to the liability occurred. No inference regarding the interpretation of the specified liability loss carryback rules under prior law is intended.

### *Effective Date*

The provision is effective for net operating losses arising in taxable years ending after the date of enactment (after October 21, 1998).

### *Revenue Effect*

The provision is estimated to increase Federal budget receipts by $14 million in 1999, $21 million in 2000, $29 million in 2001, $39 million in 2002, $42 million in 2003, $40 million in 2004, $40 million in 2005, $40 million in 2006, and $42 million in 2007.

## E. Tax Treatment of Prizes and Awards (sec. 5301 of the Act) [120]

### *Present and Prior Law*

A taxpayer generally is required to include an item in income no later than the time of its actual or constructive receipt, unless the item properly is accounted for in a different period under the taxpayer's method of accounting. If a taxpayer has an unrestricted right to demand the payment of an amount, the taxpayer is in constructive receipt of that amount whether or not the taxpayer makes the demand and actually receives the payment.

Under the principle of constructive receipt, the winner of a contest who is given the option of receiving either a lump-sum distribution or an annuity is required to include the value of the award in gross income, even if the annuity option is exercised. Alternatively, the principle of constructive receipt does not apply if, prior to the declaration of a winner (such as at the time of pur-

[120] This provision is in Title V of Division J ("Tax and Trade Relief Extension Act of 1998") of H.R. 4328, and is a revenue offset to the Medicare provisions of Title V.

chase of a lottery ticket), a taxpayer designates whether he or she chooses to receive a lump-sum distribution or an annuity. This is the case because the taxpayer does not have an unrestricted right to demand the payment of the winnings, since the taxpayer has not yet in fact won.

### *Explanation of Provision*

The existence of a "qualified prize option" is disregarded in determining the taxable year for which any portion of a qualified prize is to be included in income. A qualified prize option is an option that entitles a person to receive a single cash payment in lieu of a qualified prize (or portion thereof), provided such option is exercisable not later than 60 days after the prize winner becomes entitled to the prize. Thus, a qualified prize winner who is provided the option to choose either cash or an annuity not later than 60 days after becoming entitled to the prize is not required to include amounts in gross income immediately if the annuity option is exercised merely by reason of having the option. This provision applies with respect to any qualified prize to which a person first becomes entitled after the date of enactment.

In addition, the provision also applies to any qualified prize to which a person became entitled on or before the date of enactment if the person has an option to receive a lump-sum cash payment only during some portion of the 18-month period beginning on July 1, 1999. This is intended to give previous prize winners a one-time option to alter previous payment arrangements.

Qualified prizes are prizes or awards from contests, lotteries, jackpots, games or similar arrangements that provide a series of payments over a period of at least 10 years, provided that the prize or award does not relate to any past services performed by the recipient and does not require the recipient to perform any substantial[121] future service. The provision applies to individuals on the cash receipts and disbursements method of accounting. Income and deductions resulting from this provision retain their character as ordinary, not capital. In addition, the Secretary is to provide for the application of this provision in the case of a partnership or other pass-through entity consisting entirely of individuals on the cash receipts and disbursements method of accounting.

Any offer of a qualified prize option must include disclosure of the methodology used to compute the single cash payment, including the discount rate that makes equivalent the present values of the prize to which the prize winner is entitled (or relevant portion thereof) and the single cash payment offered. Any offer of a qualified prize option must also clearly indicate that the prize winner is under no obligation to accept any offer of a single cash payment and may continue to receive the payments to which he or she is entitled under the terms of the qualified prize.

### *Effective Date*

The provision applies with respect to any qualified prize to which a person first becomes entitled after the date of enactment (after

[121] Appearing in advertising relating to the prize or award is not (in and of itself) substantial.

October 21, 1998). In addition, the provision also applies to any qualified prize to which a person became entitled on or before the date of enactment if the person has an option to receive a lump-sum payment only during some portion of the 18-month period beginning on July 1, 1999.

***Revenue Effect***

The provision is estimated to increase Federal fiscal year budget receipts by $170 million in 1999 and by $1,618 million in 2000, and to reduce receipts by $99 million in 2001, $348 million in 2002, $397 million in 2003, $384 million in 2004, $367 million in 2005, $346 million in 2006, and by $321 million in 2007.

## TITLE IV. TAX TECHNICAL CORRECTIONS

Except as otherwise provided, the technical corrections contained in the Tax and Trade Relief Extension Act of 1998 generally are effective as if included in the originally enacted related legislation.

### A. Technical Corrections to the 1998 IRS Restructuring Act

#### 1. Burden of proof (sec. 4002(b) of the Tax and Trade Relief Extension Act of 1998, sec. 3001 of the 1998 IRS Restructuring Act, and sec. 7491(a)(2)(C) of the Code)[122]

*Present and Prior Law*

The Treasury Secretary has the burden of proof in any court proceeding with respect to a factual issue if the taxpayer introduces credible evidence with respect to any factual issue relevant to ascertaining the taxpayer's tax liability, provided specified conditions are satisfied (sec. 7491). One of these conditions is that corporations, trusts, and partnerships must meet certain net worth limitations. These net worth limitations do not apply to individuals or to estates.

*Explanation of Provision*

The provision removes the net worth limitation from certain revocable trusts for the same period of time that the trust would have been treated as part of the estate had the trust made the election under section 645 to be treated as part of the estate.

#### 2. Relief for innocent spouses (sec. 4002(c) of the Tax and Trade Relief Extension Act of 1998, sec. 3201 of the 1998 IRS Restructuring Act, and secs. 6015(e) and 7421(a) of the Code)[123]

*Present and Prior Law*

A taxpayer who is no longer married to, is separated from, or has been living apart for at least 12 months from the person with whom he or she originally joined in filing a joint Federal income tax return may elect to limit his or her liability for a deficiency arising from such joint return to the amount of the deficiency that is attributable to items that are allocable to such electing spouse. The election is limited to deficiency situations and only affects the amount of the deficiency for which the electing spouse is liable. Thus, the election cannot be used to generate a refund, to direct a refund to one spouse or the other, or to allocate responsibility for

[122] Section 3001 of the 1998 IRS Restructuring Act is described, as clarified by this provision, in Part Two of this publication.

[123] Section 3201 of the 1998 IRS Restructuring Act is described, as clarified by this provision, in Part Two of this publication.

payment where a balance due is reported on, but not paid with, a joint return.

In addition to the election to limit the liability for deficiencies, a taxpayer may be eligible for innocent spouse relief. Innocent spouse relief allows certain taxpayers who joined in the filing of a joint return to be relieved of liability for an understatement of tax that is attributable to items of the other spouse to the extent that the taxpayer did not know or have reason to know of the understatement. The Secretary is also authorized to provide equitable relief in situations where, taking into account all of the facts and circumstances, it is inequitable to hold an individual responsible for all or a part of any unpaid tax or deficiency arising from a joint return. Under certain circumstances, it is possible that a refund could be obtained under this authority.

### *Explanation of Provision*

The provision clarifies that the ability to obtain a credit or refund of Federal income tax is limited to situations where the taxpayer qualifies for innocent spouse relief or where the Secretary exercises his authority to provide equitable relief.

## 3. Interest netting (sec. 4002(d) of the Tax and Trade Relief Extension Act of 1998 and sec. 3301(c)(2) of the 1998 IRS Restructuring Act) [124]

### *Present and Prior Law*

For calendar quarters beginning after July 22, 1998, a net interest rate of zero applies where interest is payable and allowable on equivalent amounts of overpayment and underpayment of any tax imposed by the Internal Revenue Code. In addition, the net interest rate of zero applies to periods on or before July 22, 1998, providing (1) the statute of limitations has not expired with respect to either the underpayment or overpayment, (2) the taxpayer identifies the periods of underpayment and overpayment where interest is payable and allowable for which the net interest rate of zero would apply, and (3) on or before December 31, 1999, the taxpayer asks the Secretary to apply the net zero rate.

### *Explanation of Provision*

The provision restores language originally included in the Senate amendment that clarifies that the applicability of the zero net interest rate for periods on or before July 22, 1998 is subject to any applicable statute of limitations not having expired with regard to either a tax underpayment or overpayment.

[124] Section 3301(c)(2) of the 1998 IRS Restructuring Act is described, as clarified by this provision, in Part Two of this publication.

### 4. Effective date for elimination of 18-month holding period for capital gains (sec. 4002(i) of the Tax and Trade Relief Extension Act of 1998, sec. 5001 of the 1998 IRS Restructuring Act, and sec. 1(h) of the Code) [125]

#### *Present and Prior Law*

The 1998 IRS Restructuring Act repealed the provision in the 1997 Act providing a maximum 28-percent rate for the long-term capital gain attributable to property held more than one year but not more than 18 months. Instead, the 1998 IRS Restructuring Act treated this gain in the same manner as gain from property held more than 18 months. The provision in the 1998 IRS Restructuring Act is effective for amounts properly taken into account after December 31, 1997. For gains taken into account by a pass-thru entity, such as a partnership, S corporation, trust, estate, RIC or REIT, the date that the entity properly took the gain into account is the appropriate date in applying this provision. Thus, for example, amounts properly taken into account by a pass-thru entity after July 28, 1997, and before January 1, 1998, with respect to property held more than one year but not more than 18 months which are included in income on an individual's 1998 return are taken into account in computing 28-percent rate gain.

#### *Explanation of Provision*

Under the provision, in the case of a capital gain dividend made by a RIC or REIT after 1997, no amount will be taken into account in computing the net gain or loss in the 28-percent rate gain category by reason of property being held more than one year but not more than 18 months. This rule does not apply to amounts taken into account by the RIC or REIT from other pass-thru entities (other than (1) from structures, such as a "master-feeder structure", in which the RIC invests a substantial portion of its assets in one or more partnerships holding portfolio securities and having the same taxable year as the RIC, and (2) generally from another RIC or a REIT).

For example, if a RIC sold stock held more than one year but not more than 18 months on November 15, 1997, for a gain, and makes a capital gain dividend in 1998, the gain is not taken into account in computing 28-percent rate gain for purposes of determining the taxation of the 1998 dividend. (Thus, all the netting and computations made by the RIC need to be redone with respect to all post-1997 capital gain dividends, whether or not dividends of 28-percent rate gain.) If, however, the gain was taken into account by a RIC by reason of holding an interest in a calendar year 1997 partnership which itself sold the stock, the gain will not be recharacterized by reason of this provision (unless the RIC's investment in the partnership satisfies the exception for master-feeder structures). If the gain was taken into account by a RIC be reason of holding an interest in a REIT and the gain was excluded from 28-percent rate gain by reason of the application of this provision to the REIT, the

[125] Section 5001 of the 1998 IRS Restructuring Act is described, as clarified by this provision, in Part Two of this publication.

gain will be excluded from 28-percent rate gain in determining the tax of the RIC shareholders.

The provision also corrects a cross reference.

## B. Technical Corrections to the 1997 Act

### 1. Treatment of interest on qualified education loans (sec. 4003(a) of the Tax and Trade Relief Extension Act of 1998, sec. 202 of the 1997 Act, and secs. 221 and 163(h) of the Code)

#### *Present and Prior Law*

Certain individuals who have paid interest on qualified education loans may claim an above-the-line deduction for such interest expense, up to a maximum dollar amount per year ($1,000 for taxable years beginning in 1998), subject to certain requirements (sec. 221). The maximum deduction is phased out ratably for individual taxpayers with modified AGI between $40,000 and $55,000 ($60,000 and $75,000 for joint returns). In the case of a taxpayer other than a corporation, no deduction is allowed for personal interest (sec. 163(h)). For this purpose, personal interest means any interest allowable as a deduction, other than certain types of interest listed in the statute. This provision did not specifically provide that otherwise deductible qualified education loan interest is not treated as personal interest.

A qualified education loan does not include any indebtedness owed to a person who is related (within the meaning of sec. 267(b) or 707(b)) to the taxpayer (sec. 221(e)(1)).

#### *Explanation of Provision*

The provision clarifies that otherwise deductible qualified education loan interest is not treated as nondeductible personal interest.

The provision also clarifies that, for purposes of section 221, modified AGI is determined after application of section 135 (relating to income from certain U.S. saving bonds) and section 137 (relating to adoption assistance programs).

The provision also provides that a qualified education loan does not include any indebtedness owed to any person by reason of a loan under any qualified employer plan (as defined in sec. 72(p)(4)) or under any contract purchased under a qualified employer plan (as described in sec. 72(p)(5)).

### 2. Capital gain distributions of charitable remainder trusts (secs. 4002(i)(3) and 4003(b) of the Tax and Trade Relief Extension Act of 1998, sec. 311 of the 1997 Act and sec. 5001 of the 1998 IRS Restructuring Act, and sec. 1(h) of the Code) [126]

#### *Present and Prior Law*

The income beneficiary of a charitable remainder trust ("CRT") includes the trust's capital gain in income when the gains are distributed to the beneficiary (sec. 664(b)(2)). Internal Revenue Service Notice 98–20 provides guidance with respect to the categorization of long-term capital gain distributions from a CRT under the capital gain rules enacted by the 1997 Act. Under the Notice, long-term capital gains properly taken into account by the trust before January 1, 1997, are treated as falling in the 20-percent group of gain (i.e., gain not in the 28-percent rate gain or unrecaptured sec. 1250 gain). Long-term capital gains properly taken into account by the trust after December 31, 1996, and before May 7, 1997, are included in 28-percent rate gain. Long-term capital gains properly taken into account by the trust after May 6, 1997, are treated as falling into the category which would apply if the trust itself were subject to tax.

#### *Explanation of Provision*

The provision provides that, in the case of a capital gain distribution by a CRT after December 31, 1997, with respect to amounts properly taken into account by the trust during 1997, amounts will not be included in the 28-percent rate gain category solely by reason of being properly taken into account by the trust before May 7, 1997, or by reason of the property being held not more than 18 months. Thus, for example, gain on the sale of stock by a CRT on February 1, 1997, will not be taken into account in determining 28-percent rate gain where the gain is distributed after 1997.[127]

#### *Effective Date*

The provision applies to taxable years beginning after December 31, 1997.

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[126] Section 5001 of the 1998 IRS Restructuring Act is described, as clarified by this provision, in Part Two of this publication.

[127] The Tax and Trade Relief Extension Act of 1998 contains a similar amendment to section 1(h)(13), as amended by section 5001 of the 1998 IRS Restructuring Act, to provide that, for purposes of taxing the recipient of a distribution made after 1997 by a CRT, amounts will not be taken into account in computing 28-percent rate gain by reason of being properly taken into account before May 7, 1997, or by reason of the property being held for not more than 18 months. Thus, no amount distributed by a CRT after 1997 will be treated as in the 28-percent category (other than by reason of the disposition of collectibles or small business stock).

### 3. Gifts may not be revalued for estate tax purposes after expiration of statute of limitations (sec. 4003(c) of the Tax and Trade Relief Extension Act of 1998, sec. 506 of the 1997 Act, and sec. 2001(f)(2) of the Code)

#### *Present and Prior Law*

*Basic structure of Federal estate and gift taxes.*—The Federal estate and gift taxes are unified so that a single progressive rate schedule is applied to an individual's cumulative gifts and bequests. The tax on gifts made in a particular year is computed by determining the tax on the sum of the taxable gifts made in that year and in all prior years and then subtracting the tax on the prior years taxable gifts and the unified credit. Similarly, the estate tax is computed by determining the tax on the sum of the taxable estate and prior taxable gifts and then subtracting the tax on taxable gifts, the unified credit, and certain other credits.

This structure raises two different, but related, issues: (1) what is the period beyond which additional gift taxes cannot be assessed or collected—generically referred to as the "period of limitations"—and (2) what is the period beyond which the amount of prior transfers cannot be revalued for the purpose of determining the amount of tax on subsequent transfers.

*Gift and estate tax period of limitations.*—Section 6501(a) provides the general rule that any tax (including gift and estate tax) must be assessed, or a proceeding begun in a court for the collection of such tax without assessment, within three years after the return is filed by the taxpayer. Under section 6501(e)(2), the period for assessments of gift or estate tax is increased to six years where there is more than a 25 percent omission in the amount of the total gifts or gross estate disclosed on the gift or estate tax return. Section 6501(c)(9) provides an exception to these rules under which gift tax may be assessed, or a proceeding in a court for collection of gift tax may be begun, at any time unless the gift is disclosed on a gift tax return or a statement attached to a gift tax return.

*Revaluation of gifts for estate tax purposes.*—The value of a gift is its value as finally determined under the rules for purposes of determining the applicable estate tax bracket and available unified credit. The value of a gift is finally determined if (1) the value of the gift is shown on a gift tax return for that gift and that value is not contested by the Treasury Secretary before the expiration of the period of limitations on assessment of gift tax even where the value of the gift as shown on the return does not result in any gift tax being owed (e.g., through use of the unified credit), (2) the value is specified by the Treasury Secretary pursuant to a final notice of redetermination of value (a "final notice") within the period of limitations applicable to the gift for gift tax purposes (generally, three years) and the taxpayer does not timely contest that value, or (3) the value is determined by a court or pursuant of a settlement agreement between the taxpayer and the Treasury Secretary under an administrative appeals process whereby a taxpayer can challenge a redetermination of value by the IRS prior to issuance of a final notice. In the event the taxpayer and the IRS cannot agree on the value of a gift, the 1997 Act provided the U.S. Tax Court with jurisdiction to issue a declaratory judgment on the value of a gift (section 7477). A taxpayer who is mailed a final notice may challenge the redetermined value of the gift (as contained in the final notice) by filing a motion for a declaratory judgment with the U.S. Tax Court. The motion must be filed on or before 90 days from the date that the final notice was mailed. The statute of limitations is tolled during the pendency of the Tax Court proceeding.

*Revaluation of gifts for gift tax purposes.*—Similarly, under a rule applicable to the computation of the gift tax (sec. 2504(c)), the value of gifts made in prior years is its value as finally determined if the period of limitations for assessment of gift tax on the prior gifts has expired.

### *Explanation of Provision*

The Tax and Trade Relief Extension Act of 1998 clarifies the rules relating to revaluations of prior transfers for computation of the estate or gift tax to provide that the value of a prior transfer cannot be redetermined after the period of limitations if the transfer was disclosed in a statement attached to the gift tax return, as well as on a gift tax return, in a manner to adequately apprise the Treasury Secretary of the nature the transfer, even if there was no gift tax imposed on that transfer.

## 4. Coordinate Vaccine Injury Compensation Trust Fund expenditure purposes with list of taxable vaccines (sec. 4003(d) of the Tax and Trade Relief Extension Act of 1998, sec. 904 of the 1997 Act, and sec. 9510(c) of the Code) [128]

### *Present and Prior Law*

A manufacturer's excise tax is imposed on certain vaccines routinely recommended for administration to children (sec. 4131). The tax is imposed at a rate of $0.75 per dose on any listed vaccine component. Taxable vaccine components are vaccines against diphtheria, tetanus, pertussis, measles, mumps, rubella, polio, HIB (haemophilus influenza type B), hepatitis B, and varicella (chicken pox). Tax was imposed on vaccines against diphtheria, tetanus, pertussis, measles, mumps, rubella, and polio by the Omnibus Budget Reconciliation Act of 1987. Tax was imposed on vaccines against HIB, hepatitis B, and varicella by the 1997 Act.

Amounts equal to net revenues from this excise tax are deposited in the Vaccine Injury Compensation Trust Fund ("Vaccine Trust Fund") to finance compensation awards under the Federal Vaccine Injury Compensation Program for individuals who suffer certain injuries following administration of the taxable vaccines. Prior law provided that payments from the Vaccine Trust Fund may be made

[128] Title III of the Tax and Trade Relief Extension Act of 1998 added any vaccine against rotavirus gastroenteritis to the list of taxable vaccines (sec. 3002 of the Act). This technical correction also provides that payments are permitted from the Vaccine Trust Fund for injuries related to the administration of the rotavirus gastroenteritis vaccine. Title XV of Division C of the Omnibus Consolidated and Emergency Supplemental Appropriations Act, 1999, "The Vaccine Injury Compensation Program Modification Act," included a provision that substantially, but incorrectly, duplicates this provision. A technical correction may be needed to clarify that this provision (i.e., as included in Title IV of the Tax and Trade Relief Extension Act of 1998) governs.

only for vaccines eligible under the program as of December 22, 1987 (sec. 9510(c)(1)). Thus, payments could not be made for injuries related to the HIB, hepatitis B or varicella vaccines.

### *Explanation of Provision*

The provision provides that payments are permitted from the Vaccine Trust Fund for injuries related to the administration of the HIB, hepatitis B, and varicella vaccines. The provision also clarifies that expenditures from the Vaccine Trust Fund may occur only as provided in the Code and makes conforming amendments.

## 5. Abatement of interest by reason of Presidentially declared disaster (sec. 4003(e) of the Tax and Trade Relief Extension Act of 1998, sec. 915 of the 1997 Act, and sec. 6404(h) of the Code)

### *Present and Prior Law*

The 1997 Act provided that, if the Secretary of the Treasury extends the filing date of an individual tax return for 1997 for individuals living in an area that has been declared a disaster area by the President during 1997, no interest shall be charged as a result of the failure of an individual taxpayer to file an individual tax return, or pay the taxes shown on such return, during the extension.

The Internal Revenue Service Restructuring and Reform Act of 1998 ("1998 IRS Restructuring Act") contains a similar rule applicable to all taxpayers for tax years beginning after 1997 for disasters declared after 1997. The status of disasters declared in 1998 but that relate to the 1997 tax year is unclear.

### *Explanation of Provision*

The provision amends the 1997 Act rule so that it is available for disasters declared in 1997 or in 1998 with respect to the 1997 tax year.

## 6. Treatment of certain corporate distributions (sec. 4003(f) of the Tax and Trade Relief Extension Act of 1998, sec. 6010(c) of the 1998 IRS Restructuring Act, sec. 1012 of the 1997 Act, and secs. 351(c) and 368(a)(2)(H) of the Code)[129]

### *Present and Prior Law*

The 1997 Act (sec. 1012(a)) requires a distributing corporation to recognize corporate level gain on the distribution of stock of a controlled corporation under section 355 of the Code if, pursuant to a plan or series of related transactions, one or more persons acquire a 50-percent or greater interest (defined as 50 percent or more of the voting power or value of the stock) of either the distributing or controlled corporation (Code sec. 355(e)). Certain transactions are excepted from the definition of acquisition for this purpose. Under the technical corrections included in the Internal Revenue Service Restructuring and Reform Act of 1998, in the case of acquisitions

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[129] Section 6010(c) of the 1998 IRS Restructuring Act is described, as clarified by this provision, in Part Two of this publication.

under section 355(e)(3)(A)(iv), the acquisition of stock in the distributing corporation or any controlled corporation is disregarded to the extent that the percentage of stock owned directly or indirectly in such corporation by each person owning stock in such corporation immediately before the acquisition does not decrease.[130]

In the case of a 50-percent or more acquisition of either the distributing corporation or the controlled corporation, the amount of gain recognized is the amount that the distributing corporation would have recognized had the stock of the controlled corporation been sold for fair market value on the date of the distribution. No adjustment to the basis of the stock or assets of either corporation is allowed by reason of the recognition of the gain.[131]

The 1997 Act (as amended by the technical corrections contained in the Internal Revenue Service Restructuring and Reform Act of 1998) also modified certain rules for determining control immediately after a distribution in the case of certain divisive transactions in which a controlled corporation is distributed and the transaction meets the requirements of section 355. In such cases, under section 351 and modified section 368(a)(2)(H) with respect to reorganizations under section 368(a)(1)(D), the fact that the shareholders of the distributing corporation dispose of part or all of the distributed stock shall not be taken into account.

The effective date (Act section 1012(d)(1)) states that the relevant provisions of the 1997 Act apply to distributions after April 16, 1997, pursuant to a plan (or series of related transactions) which involves an acquisition occurring after such date (unless certain transition provisions apply).

### *Explanation of Provision*

The provision clarifies the "control immediately after" requirement of section 351(c) and section 368(a)(2)(H) in the case of certain divisive transactions in which a corporation contributes assets to a controlled corporation and then distributes the stock of the controlled corporation in a transaction that meets the requirements of section 355 (or so much of section 356 as relates to section 355). In such cases, not only the fact that the shareholders of the distributing corporation dispose of part or all of the distributed stock, but also the fact that the corporation whose stock was distributed issues additional stock, shall not be taken into account.

## 7. Treatment of affiliated group including formerly tax-exempt organization (sec. 4003(g) of the Tax and Trade Relief Extension Act of 1998 and sec. 1042 of the 1997 Act)

### *Present and Prior Law*

An organization described in sections 501(c)(3) or (4) of the Code is exempt from tax only if no substantial part of its activities consists of providing commercial-type insurance. When this rule was

[130] This exception (as certain other exceptions) does not apply if the stock held before the acquisition was acquired pursuant to a plan (or series of related transactions) to acquire a 50-percent or greater interest in the distributing or a controlled corporation.

[131] The 1997 Act does not limit the otherwise applicable Treasury regulatory authority under section 336(e) of the Code. Nor does it limit the otherwise applicable provisions of section 1367 with respect to the effect on shareholder stock basis of gain recognized by an S corporation under this provision.

enacted in 1986, certain treatment applied to Blue Cross and Blue Shield organizations providing health insurance that were subject to this rule and that met certain requirements. Treasury regulations were promulgated providing rules for filing consolidated returns for affiliated groups including such organizations (Treas. Reg. sec. 1.1502–75(d)(5)).

The 1997 Act repealed the grandfather rules provided in 1986 (permitting the retention of tax-exempt status) that were applicable to that portion of the business of the Teachers Insurance Annuity Association and College Retirement Equities Fund which is attributable to pension business and to the portion of the business of Mutual of America which is attributable to pension business. The 1997 Act did not specifically provide rules for filing consolidated returns for affiliated groups including such organizations.

The consolidated return rules provide for an election to treat a life insurance company as an includible corporation, and also provide that a life insurance company may not be treated as an includible corporation for the 5 taxable years immediately preceding the taxable year for which the consolidated return is filed (sec. 1504(c)(2)). A corporation that is exempt from taxation under Code section 501 is not an includible corporation (sec. 1504(b)(1)).

### *Explanation of Provision*

The provision provides rules for filing consolidated returns for affiliated groups including any organization with respect to which the grandfather rule under Code section 501(m) was repealed by section 1042 of the 1997 Act. The provision provides that rules similar to the rules of Treasury Regulation section 1.1502–75(d)(5) apply in the case of such an organization. Thus, an affiliated group including such an organization may make the election described in section 1504(c)(2) (relating to a 5-year period) without regard to whether the organization was previously exempt from tax under Code section 501.

## 8. Treatment of net operating losses arising from certain eligible losses (sec. 4003(h) of the Tax and Trade Relief Extension Act of 1998, sec. 1082 of the 1997 Act, and sec. 172(b)(1)(F) of the Code)

### *Present and Prior Law*

The 1997 Act changed the general net operating loss ("NOL") carryback period of a taxpayer from three years to two years. The three-year carryback period was retained in the case of an NOL attributable to an eligible loss. An eligible loss is defined as (1) a casualty or theft loss of an individual taxpayer, or (2) an NOL attributable to a Presidentially declared disaster area by a taxpayer engaged in a farming business or a small business. Other special rules apply to real estate investment trusts (REITs) (no carrybacks), specified liability losses (10-year carryback), and excess interest losses (no carrybacks).

### *Explanation of Provision*

The provision coordinates the use of eligible losses with the general rule for NOLs in the same manner as a loss arising from a specified liability loss. Thus, an eligible loss for any year is treated as a separate net operating loss and is taken into account after the remaining portion of the net operating loss for the taxable year.

## 9. Determination of unborrowed policy cash value under COLI pro rata interest disallowance rules (sec. 4003(i) of the Tax and Trade Relief Extension Act of 1998, sec. 1084 of the 1997 Act, and sec. 264(f) of the Code)

### *Present and Prior Law*

In the case of a taxpayer other than a natural person, no deduction is allowed for the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash surrender values with respect to any life insurance policy or annuity or endowment contract issued after June 8, 1997. Interest expense is allocable to unborrowed policy cash values based on the ratio of (1) the taxpayer's average unborrowed policy cash values of life insurance policies and annuity and endowment contracts, issued after June 8, 1997, to (2) the sum of (a) in the case of assets that are life insurance policies or annuity or endowment contracts, the average unborrowed policy cash values and (b) in the case of other assets the average adjusted bases for all such other assets of the taxpayer. The unborrowed policy cash values means the cash surrender value of the policy or contract determined without regard to any surrender charge, reduced by the amount of any loan with respect to the policy or contract. The cash surrender value is to be determined without regard to any other contractual or noncontractual arrangement that artificially depresses the unborrowed policy cash value of a contract.

### *Explanation of Provision*

The provision clarifies the meaning of "unborrowed policy cash value" under section 264(f)(3), with respect to any life insurance, annuity or endowment contract. The technical correction clarifies that under section 264(f)(3), if the cash surrender value (determined without regard to any surrender charges) with respect to any policy or contract does not reasonably approximate its actual value, then the amount taken into account for this purpose is the greater of: (1) the amount of the insurance company's liability with respect to the policy or contract, as determined for purposes of the company's annual statement, (2) the amount of the insurance company's reserve with respect to the policy or contract for purposes of such annual statement; or such other amount as is determined by the Treasury Secretary. No inference is intended that such amounts may not be taken into account in determining the cash surrender value of a policy or contract in such circumstances for purposes of any other provision of the Code.

### 10. Payment of taxes by commercially acceptable means (sec. 4003(k) of the Tax and Trade Relief Extension Act of 1998, sec. 1205 of the 1997 Act, and sec. 6311(d)(2) of the Code)

*Present and Prior Law*

The Code generally permits the payment of taxes by commercially acceptable means (such as credit cards) (sec. 6311(d)). The Treasury Secretary may not pay any fee or provide any other consideration in connection with this provision. This fee prohibition may have had an unintended impact on Treasury contracts for the provision of services unrelated to the payment of income taxes by commercially acceptable means.

*Explanation of Provision*

The provision clarifies that the prohibition on paying any fees or providing any other consideration applies to the use of credit, debit, or charge cards for the payment of income taxes.

## C. Technical Corrections to the 1984 Act

### 1. Casualty loss deduction (sec. 4004 of the Tax and Trade Relief Extension Act of 1998, sec. 711(c) of the 1984 Act, and secs. 172(d)(4), 67(b)(3), 68(c)(3), and 873(b) of the Code)

*Present and Prior Law*

The Tax Reform Act of 1984 ("1984 Act") deleted casualty and theft losses from property connected with a nonbusiness transaction entered into for profit from the list of losses set forth in section 165(c)(3). This amendment was made in order to provide that these losses were deductible in full and not subject to the $100 per casualty limitation or the 10-percent adjusted gross income floor applicable to personal casualty losses. However, the amendment inadvertently eliminated the deduction for these losses from the computation of the net operating loss. Also, the Tax Reform Act of 1986 provided that casualty losses described in section 165(c)(3) are not miscellaneous itemized deductions subject to the 2-percent adjusted gross income floor, and the Revenue Reconciliation Act of 1990 provided that these losses are not treated as itemized deductions in computing the overall limitation on itemized deductions. The losses of nonresident aliens are limited to deductions described in section 165(c)(3). Because of the change made by the 1984 Act, the reference to section 165(c)(3) does not include casualty and theft losses from nonbusiness transactions entered into for profit.

*Explanation of Provision*

The provision provides that all deductions for nonbusiness casualty and theft losses are taken into account in computing the net operating loss. Also, these deductions are not treated as miscellaneous itemized deductions subject to the 2-percent adjusted gross income floor, or as itemized deductions subject to the overall limitation on itemized deductions, and are allowed to nonresident aliens.

### *Effective Dates*

The provision relating to the net operating loss and the deduction for nonresident aliens applies to taxable years beginning after December 31, 1983.

The provision relating to miscellaneous itemized deductions applies to taxable years beginning after December 31, 1986.

The provision relating to the overall limitation on itemized deductions applies to taxable years beginning after December 31, 1990.

## D. Perfecting Amendments Related to Withholding From Social Security Benefits and Other Federal Payments (sec. 4005 of the Act and secs. 201 and 207 of the Social Security Act)

### *Present and Prior Law*

The Uruguay Round Agreements Act (P.L. 103–465) contained a provisions requiring that U.S. taxpayers who receive specified Federal payments (including Social Security benefits) be given the option of requiesting that the Federal agency making the payments withhold Federal income taxes from the payments.

### *Explanation of Provision*

Due to a drafting oversight, the Uruguay Round Agreements Act included only the necessary changes to the Internal Revenue Code and failed to make certain conforming changes to the Social Security Act (specifically a section that prohibits assignments of benefits). The provision amends the Social Security Act anti-assignment section to allow the Internal Revenue Code provisions to be implemented. The provision also allocates funding for the Social Security Administration to administer the tax-withholding provisions.

### *Effective Date*

The provision applies to benefits paid on or after the first day of the second month beginning after the month of enactment.

## E. Disclosure of Tax Return Information to the Department of Agriculture (sec. 4006(a) of the Tax and Trade Relief Extension Act of 1998 and sec. 6103 (j) of the Code)

### *Present and Prior Law*

Tax return information generally may not be disclosed, except as specifically provided by statute. Disclosure is permitted to the Bureau of the Census for specified purposes, which included the responsibility of structuring, conducting, and preparing the census of agriculture (sec. 6103(j)(1)). The Census of Agriculture Act of 1997 (P.L. 105–113) transferred this responsibility from the Bureau of the Census to the Department of Agriculture.

### *Explanation of Provision*

The provision permits the continuation of disclosure of tax return information for the purpose of structuring, conducting, and preparing the census of agriculture by authorizing the Department of Agriculture to receive this information.

### *Effective Date*

The provision is effective on the date of enactment of this technical correction.

## F. Technical Corrections to the Transportation Equity Act for the 21st Century (sec. 4006(b) of the Tax and Trade Relief Extension Act of 1998, sec. 9004 of the Transportation Equity Act for the 21st Century, and sec. 9503(f) of the Code)

### *Present and Prior Law*

The Transportation Equity Act for the 21st Century ("Transportation Equity Act") (P.L. 105–178) extended the Highway Trust Fund and accompanying highway excise taxes. The Transportation Equity Act also changed the budgetary treatment of Highway Trust Fund expenditures, including repeal of a provision that balances maintained in the Highway Trust Fund pending expenditure earn interest from the General Fund of the Treasury.

### *Explanation of Provision*

The provision clarifies that the Secretary of the Treasury is not required to invest Highway Trust Fund balances in interest-bearing obligations (because any interest paid to the Trust Fund by the General Fund would be immediately returned to the General Fund).

## PART FOUR: RICKY RAY HEMOPHILIA RELIEF FUND ACT OF 1998 (Sec. 103(h) of H.R. 1023) [132]

### *Present and Prior Law*

Under present and prior law, gross income does not include any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of a personal physical injury or physical sickness (Code sec. 104(a)(2)). If an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom are treated as payments received on account of physical injury or physical sickness whether or not the recipient of the damages is the injured party. The term "damages received whether by suit or agreement" is defined under Treasury regulations to mean an amount received (other an workmen's compensation) through prosecutions of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution. Under prior law, payments not meeting the requirements of section 104 were not excludable from income under that section.

### *Reasons for Change*

The Congress clarified the tax treatment of certain "compassionate" payments made to individuals with blood-clotting disorders who contracted the human immunodeficiency virus ("HIV") because the Congress believed that, in the absence of such clarification, such payments generally would not be excluded from gross income under the prior-law exclusion for damage payments. Whether such amounts might be excluded from income under some other provision of the Internal Revenue Code or regulations is unclear. The Congress found the payments under the Act to be sufficiently unusual and sympathetic to justify clarifying that such payments are not included in gross income. However, the Congress emphasized that it was taking action because of the extraordinary nature of the problem that is addressed by the Act.

### *Explanation of Provision*

The Act provides that payments pursuant to the provisions of the Act to certain individuals with blood-clotting disorders who contracted HIV due to contaminated blood products are treated for purposes of the Internal Revenue Code as damages received on account of personal physical injury or physical sickness described in

[132] P.L. 105–369. H.R. 1023 was reported by the House Committee on Judiciary on March 25, 1998 (H. Rept. 105–465, Part I). The bill was reported by the House Committee on Ways and Means on May 7, 1998 (H. Rept. 105–465, Part II). The bill was passed by the House on May 19, 1998. The Senate Committee on Labor and Human Resources reported the bill on October 7, 1998. The Senate passed the bill on October 21, 1998. H.R. 1023 was signed by the President on November 12, 1998.

section 104(a)(2). Thus, such payments made to individuals are excluded from gross income.

### *Effective Date*

The provision is effective on the date of enactment (November 12, 1998).

# APPENDIX:

# ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN 1998

# APPENDIX:
# ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN 1998

## Fiscal Years 1998–2007

[Millions of dollars]

| Provision | Effective | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 1998–07 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **PART ONE: SURFACE TRANSPORTATION REVENUE ACT OF 1998 (TITLE IX OF H.R. 2400)** (1) | | | | | | | | | | | | |
| A. Extend Highway Trust Fund motor fuels taxes, retail truck tax, highway use tax, heavy truck tire tax and certain exemptions through 9/30/05; extend renewable source alcohol excise tax exemptions through 9/30/07 and renewable source alcohol income tax credits through 12/31/07, and reduce ethanol tax benefits from 54 cents/gallon to 53 cents/gallon in 2001–2002, 52 cents/gallon in 2003–2004, and 51 cents/gallon thereafter (2) | 10/1/99 | | | | 9 | 12 | 23 | 27 | 39 | 44 | 44 | 198 |
| B. Extend and modify Highway Trust Fund and Aquatic Resources Trust Fund expenditure authority, through 9/30/03 | 10/1/98 | No Revenue Effect | | | | | | | | | | |
| C. Repeal 1.25 cents/gallon tax on railroad diesel fuel | 11/1/98 | | −24 | (3) | | | | | | | | −25 |
| D. Modify purposes for which non-Amtrak States may spend their share of Amtrak net operating loss income tax refunds | aiii TRA'97 | No Revenue or Outlay Effect | | | | | | | | | | |
| E. Delay for 2 years the requirement that terminals offer dyed diesel fuel and kerosene | DOE | Negligible Revenue Effect | | | | | | | | | | |
| F. Simplify motor fuels tax refund procedures | 10/1/98 | | −5 | (3) | (3) | (3) | (3) | (3) | (3) | (3) | (3) | −5 |

| | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| G. Delay indexing for all qualified transportation benefits in 1999, allow employees to elect cash in lieu of qualified transportation benefits (effective for taxable years beginning after 12/31/97), allow employers to offer up to $100 each month in qualified fringe benefits for transit and vanpooling (effective 1/1/02), with indexing for inflation (starting in taxable years beginning after 12/31/02) | | | 3 | 3 | 4 | −1 | −3 | −10 | −7 | −12 | −8 | −31 |
| H. Repeal National Recreational Trails Trust Fund | DOE | No Revenue or Outlay Effect | | | | | | | | | | |
| **Subtotal: Title IX of H.R. 2400** | | | **−26** | **3** | **13** | **11** | **20** | **17** | **32** | **32** | **36** | **137** |
| **PART TWO: INTERNAL REVENUE SERVICE RESTRUCTURING AND REFORM ACT OF 1998 (H.R. 2676)** | | | | | | | | | | | | |
| **Title I. Reorganization of Structure and Management of the Internal Revenue Service** | | **No Revenue Effect** | | | | | | | | | | |
| **Title II. Electronic Filing** | | **No Refenue Effect** | | | | | | | | | | |
| **Title III. Taxpayer Protections and Rights** | | | | | | | | | | | | |
| A. Burden of Proof—apply to only income, estate and gift taxes (permanent) | eca DOE | (4) | −231 | −256 | −269 | −278 | −297 | −311 | −327 | −344 | −360 | −2,674 |
| B. Proceedings by Taxpayers | | | | | | | | | | | | |
| 1. Expansion of authority to award costs and certain fees at prevailing rate and rule 68 provision with net worth limitation (includes outlays effects); with modified hourly cap | 180da DOE | | −11 | −12 | −13 | −14 | −16 | −18 | −19 | −20 | −22 | −145 |
| 2. Civil damages with respect to unauthoriazed collection actions (includes outlay effects) | aoa DOE | −2 | −15 | −25 | −50 | −30 | −25 | −25 | −25 | −25 | −25 | −247 |

## APPENDIX:—Continued

## ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN 1998

### Fiscal Years 1998–2007

[Millions of dollars]

| Provision | Effective | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 1998–07 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 3. Increase size of cases permitted on small case calendar to $50,000 | pca DOE | | | | | | No Revenue Effect | | | | | |
| 4. Actions for refund with respect to certain estates which have elected the installment method of payment | rfa DOE | | | | | | Negligible Revenue Effect | | | | | |
| 5. Extend IRS administrative appeals right to issuers of tax-exempt bonds | DOE | (4) | −5 | −2 | −2 | −2 | −2 | −2 | −2 | −2 | −2 | −21 |
| 6. Civil action for release of erroneous lien | DOE | | | | | | Negligible Revenue Effect | | | | | |
| C. Relief for Innocent Spouses and for Taxpayers Unable to Manage Their Financial Affairs Due to Disabilities | | | | | | | | | | | | |
| 1. Relief for innocent spouses | laa & ulb DOE | −10 | −131 | −92 | −74 | −86 | −121 | −157 | −204 | −243 | −288 | −1,406 |
| 2. Suspension of statute of limitations on filing refund claims during periods of disability | tyoo/a DOE | −10 | −70 | −35 | −15 | −16 | −17 | −18 | −19 | −20 | −21 | −241 |
| D. Provisions Relating to Interest and Penalties | | | | | | | | | | | | |
| 1. Elimination of interest rate differential on overlapping periods of interest on income tax overpayments and underpayments | tyoo/a DOE | −26 | −68 | −58 | −61 | −56 | −59 | −62 | −65 | −68 | −72 | −593 |
| 2. Increase refund interest rate to Applicable Federal Rate ("AFR") + 3 for individual taxpayers (5) | 2nd & scqa DOE | | −36 | −54 | −56 | −59 | −62 | −65 | −69 | −72 | −76 | −549 |

| | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 3. Reduced penalty on individual's failure to pay during installment agreements ... | iapma 12/31/99 | ............ | ............ | −108 | −136 | −143 | −152 | −159 | −167 | −175 | −185 | −1,225 |
| 4. Mitigation of failure to deposit penalty | drma 180da DOE | ............ | −47 | −64 | −64 | −65 | −66 | −66 | −67 | −68 | −68 | −575 |
| 5. Suspend accrual of interest and penalties if IRS fails to contact taxpayer within 12 months after a timely-filed return (except for fraud and criminal penalties): (1) for first 5 years, time period is 18 months (instead of 12 months); and (2) provide that termination with respect to specific additional tax liability occurs on earliest notice of such liability ............ | tyea DOE | ............ | ............ | −146 | −174 | −196 | −209 | −248 | −431 | −435 | −439 | −2,278 |
| 6. Procedural requirements for imposition of penalties and additions to tax ............ | nia & paa 12/31/00 | Negligible Revenue Effect | | | | | | | | | | |
| 7. Permit personal delivery of section 6672 notices ............ | DOE | No Revenue Effect | | | | | | | | | | |
| 8. Notice of interest charges ............ | nia 12/31/00 | No Revenue Effect | | | | | | | | | | |
| E. Protections for Taxpayers Subject to Audit or Collection Activities | | | | | | | | | | | | |
| 1. Due process for IRS collection actions .. | caia 180da DOE | ............ | −11 | −7 | −7 | −7 | −7 | −7 | −8 | −8 | −8 | −70 |
| 2. Examination activities | | | | | | | | | | | | |
| a. Extend the attorney client privilege to accountants and other tax practitioners, with exception from both attorney/client privilege and tax practitioner/client privilege for communications relating to corporate tax shelters ............ | cmo/a DOE | [6] | [6] | [6] | [6] | [6] | [6] | [6] | [6] | [6] | [6] | [7] |
| b. Limitation on financial status audits ............ | DOE | No Revenue Effect | | | | | | | | | | |

## APPENDIX:—Continued
## ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN 1998
### Fiscal Years 1998–2007

[Millions of dollars]

| Provision | Effective | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 1998–07 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| c. Limitation on IRS authority to require production of computer source code and protections against improper disclosure | sia & saa DOE | ............ | −13 | −16 | −20 | −22 | −26 | −30 | −33 | −36 | −37 | −233 |
| d. Prohibition on improper threat of audit activity for tip reporting | DOE | | | | | No Revenue Effect | | | | | | |
| e. Allow taxpayers to quash all third-party summonses | ssa DOE | | | | | Negligible Revenue Effect | | | | | | |
| f. Permit service of summonses by mail or in person | ssa DOE | | | | | No Revenue Effect | | | | | | |
| g. IRS must provide general notice and periodic reports to taxpayers before contacting third parties regarding IRS examination or collection activities with respect to the taxpayer | 180da DOE | ............ | (6) | (6) | (6) | (6) | (6) | (6) | (6) | (6) | (6) | (7) |
| 3. Collection activities | | | | | | | | | | | | |
| a. Approval process—IRS to implement approval process for liens, levies, or seizures; clarification of "appropriate" | (8) | | | | | Negligible Revenue Effect | | | | | | |
| b. Increase the amount exempt from levy to $6,250 for personal property and $3,125 for books and tools of trade, indexed for inflation | Lia DOE | (4) | −1 | −1 | −1 | −1 | −2 | −2 | −2 | −2 | −2 | −13 |
| c. Require the IRS to release a levy upon agreement that the amount is not collectible | lia 12/31/99 | | | | | Negligible Revenue Effect | | | | | | |

| | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| d. Suspend collection by levy during refund suit | tyba 12/31/98 | Negligible Revenue Effect | | | | | | | | | | |
| e. Require District Counsel review of jeopardy and termination assessments and jeopardy levies | taa & lma DOE | Negligible Revenue Effect | | | | | | | | | | |
| f. Increase in amount of certain property on which lien not valid | DOE | Negligible Revenue Effect | | | | | | | | | | |
| g. Waive the 10% early withdrawal tax when IRA or qualified plan is levied | wa 12/31/99 | | | −1 | −3 | −4 | −4 | −5 | −5 | −5 | −5 | −33 |
| h. Prohibit the IRS from selling taxpayer's property for less than the minimum bid | Soa DOE | No Revenue Effect | | | | | | | | | | |
| i. Require the IRS to provide an accounting and receipt to the taxpayer (including the amount credited to the taxpayer's account) for property seized and sold | soa DOE | Negligible Revenue Effect | | | | | | | | | | |
| j. Require the IRS to study and implement a uniform asset disposal mechanism for sales of seized property to prevent revenue officers from conducting sales | DOE & 2 years | No Revenue Effect | | | | | | | | | | |
| k. Codify IRS administrative procedures for seizure of taxpayer's property | DOE | No Revenue Effect | | | | | | | | | | |
| l. Procedures for seizure of residences and businesses | DOE | (4) | −3 | −3 | −3 | −3 | −3 | −3 | −3 | −3 | −3 | −27 |
| 4. Provisions relating to examination and collection activities | | | | | | | | | | | | |
| a. Prohibition on extension of statute of limitations for collection beyond 10 years with installment payment exception | (9) | | | −9 | −13 | −16 | −18 | −19 | −19 | −21 | −24 | −139 |
| b. Offers-in-compromise | generally DOE | −1 | | 9 | 4 | 4 | 4 | 4 | 4 | 4 | 4 | 38 |

## APPENDIX:—Continued

## ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN 1998

### Fiscal Years 1998–2007

[Millions of dollars]

| Provision | Effective | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 1998–07 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| c. Notice of deficiency to specify deadlines for filing Tax Court petition ... | nma 12/31/98 | | | | | | Negligible Revenue Effect | | | | | |
| d. Refund or credit of overpayments before final determination ... | DOE | | | | | | Negligible Revenue Effect | | | | | |
| e. IRS procedures relating to appeal of examinations and collections ... | DOE | | | | | | No Revenue Effect | | | | | |
| f. Codify certain fair debt collection procedures ... | DOE | | | | | | No Revenue Effect | | | | | |
| g. Ensure availability of installment agreements ... | DOE | | | | | | No Revenue Effect | | | | | |
| h. Prohibit Federal Government officers and employees from requesting taxpayers to give up their rights to sue ... | DOE | | | | | | No Revenue Effect | | | | | |
| F. Disclosure to Taxpayers | | | | | | | | | | | | |
| 1. Explanation of joint and several liability ... | 180da DOE | | | | | | No Revenue Effect | | | | | |
| 2. Explanation of taxpayers' rights in interveiws with IRS ... | 180da DOE | ... | −13 | [4] | [4] | [4] | [4] | [4] | [4] | [4] | [4] | [10] |
| 3. Disclosure of criteria for examination selection ... | 180da DOE | | | | | | No Revenue Effect | | | | | |
| 4. Explanations of appeals and collection process ... | 180da DOE | | | | | | No Revenue Effect | | | | | |

| | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 5. Require IRS to explain reason for denial for refund | 180da DOE | | | | | | No Revenue Effect | | | | | |
| 6. Statement to taxpayers with installment agreements | 7/1/00 | | | | | | No Revenue Effect | | | | | |
| 7. Require IRS to notify all partners of any resignation of the tax matters partner that is required by the IRS, and of the identity of any successor tax matters partner who was appointed to fill the vacancy created by such resignation | sotmpa DPE | (3) | (3) | (3) | (3) | (3) | (3) | (3) | (3) | (3) | (3) | −2 |
| 8. Require information to taxpayers concerning disclosure of their income tax return information to parties outside the IRS | DOE | | | | | | No Revenue Effect | | | | | |
| 9. Disclosure of Chief Counsel advice | ai 90da DOE | | | | | | No Revenue Effect | | | | | |
| G. Low-Income Taxpayer Clinics | DOE | | | | | | No Revenue Effect | | | | | |
| H. Other Provisions | | | | | | | | | | | | |
| 1. Cataloging complaints of IRS employee misconduct | 1/1/00 | | | | | | No Revenue Effect | | | | | |
| 2. Archive of records of Internal Revenue Service | DOE | | | | | | No Revenue Effect | | | | | |
| 3. Payment of taxes to the Treasury (5) | DOE | | | | | | No Revenue Effect | | | | | |
| 4. Clarification of authority of Secretary relating to the making of elections | DOE | | | | | | No Revenue Effect | | | | | |
| 5. IRS employee contacts | 6ma DOE | | | | | | No Revenue Effect | | | | | |
| 6. Require approval of use of pseudonyms by IRS employees | DOE | | | | | | No Revenue Effect | | | | | |
| 7. Require the IRS to end the use of the illegal tax protestor label | DOE & rdnrb 1/1/99 | | | | | | No Revenue Effect | | | | | |
| 8. Modify section 6103 to allow the tax-writing committees to obtain data from IRS employees regarding employee and taxpayer abuse | DOE | | | | | | No Revenue Effect | | | | | |

## APPENDIX:—Continued

## ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN 1998

### Fiscal Years 1998–2007

[Millions of dollars]

| Provision | Effective | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 1998–07 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 9. Publish telephone numbers for local IRS offices | DOE | | | | | | No Revenue Effect | | | | | |
| 10. Alternative to Social Security numbers for tax return preparers | DOE | | | | | | No Revenue Effect | | | | | |
| 11. Authorize the Federal Government to offset a Federal income tax refund to satisfy a past-due, legally owing State income tax debt | rpa 12/31/99 | | | 2 | 3 | 3 | 3 | 3 | 4 | 4 | 4 | 26 |
| 12. Modify section 6050S to require educational institutions to report grant amounts processed through and refunds made be the institution; with clarifications regarding the definition of "qualified tuition and related expenses" and certain other educational institution reporting requirements | tyba 12/31/98 | | | | | | Negligible Revenue Effect | | | | | |
| I. Studies | | | | | | | | | | | | |
| 1. Administration of penalties and interest | 1ya DOE | | | | | | No Revenue Effect | | | | | |
| 2. Confidentiality of tax return information | 18ma DOE | | | | | | No Revenue Effect | | | | | |
| 3. Noncompliance with internal revenue laws by taxpayers | 1ya DOE | | | | | | No Revenue Effect | | | | | |
| 4. Payments for informants | 1ya DOE | | | | | | No Revenue Effect | | | | | |
| **Title IV. Congressional Accountability for the Internal Revenue Service** | | | | | | | No Revenue Effect | | | | | |

| | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Title V. Additional Provisions** | | | | | | | | | | | | |
| A. Change the Holding Period for Long-Term Capital Gains to 12 months | aptiao/a 1/1/98 | 35 | 611 | −312 | −335 | −335 | −337 | −341 | −347 | −354 | −362 | −2,077 |
| B. Deductibility of Meals Provided for the Convenience of Employer on Employer's Premises | tybbo/a DOE | ............... | −20 | −33 | −34 | −35 | −36 | −38 | −39 | −40 | −41 | −316 |
| **Title VI. Tax Technical Corrections** | | No Revenue Effect | | | | | | | | | | |
| **Title VII. Revenue Offsets** | | | | | | | | | | | | |
| A. Overrule *Schmidt Baking* with Respect to Vacation Pay, Severance Pay and Other Types of Compensation With 3-Year Spread | tyea DOE | 593s | 839 | 997 | 456 | 308 | 156 | 163 | 172 | 180 | 189 | 4,053 |
| B. Freeze Grandfathered Status of Stapled or Paired-Share REITs | tyea 3/26/98 | (11) | 1 | 3 | 6 | 10 | 14 | 19 | 26 | 35 | 45 | 159 |
| C. Make Certain Trade Receivables Ineligible for Mark-to-Market Treatment | tyea DOE | 33 | 317 | 500 | 333 | 117 | 70 | 73 | 77 | 81 | 85 | 1,686 |
| D. Disregard Minimum Distributions in Determining AGI for IRA Conversions to a Roth IRA | tyba 12/31/04 | | | | | | | | 2,362 | 2,854 | 2,812 | 8,028 |
| **Subtotal: H.R. 2676** | | **608** | **1.087** | **270** | **−535** | **−933** | **−1,218** | **−1,320** | **788** | **1,211** | **1,093** | **1,050** |
| **Other Item in H.R. 2676**. | | | | | | | | | | | | |
| **Abate Interest on Underpayments by Taxpayers in Presidentially Declared Disaster Areas** | **dda 12/31/97** | ............... | **−8** | **−25** | **−25** | **−25** | **−25** | **−25** | **−25** | **−25** | **−25** | **−234** |

## APPENDIX:—Continued

## ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN 1998

### Fiscal Years 1998–2007

[Millions of dollars]

| Provision | Effective | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 1998–07 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **PART THREE: TAX AND TRADE RELIEF ACT OF 1998 (DIVISION J OF H.R. 4328, THE OMNIBUS CONSOLIDATED AND EMERGENCY SUPPLEMENTAL APPROPRIATIONS ACT, 1999)** | | | | | | | | | | | | |
| **Title I. Extension of Expiring Tax Provisions** | | | | | | | | | | | | |
| A. Extend the Research Tax Credit (through 6/30/99) | 7/1/98 | ............... | −1,126 | −505 | −258 | −184 | −94 | −20 | | | | −2,187 |
| B. Extend Work Opportunity Tax Credit (through 6/30/99) | wpoifibwa 6/30/98 | ............... | −191 | −140 | −73 | −29 | −10 | −2 | | | | −445 |
| C. Extend Welfare-to-Work Tax Credit (through 6/30/99) | wpoifibwa 4/30/99 | ............... | −4 | −10 | −7 | −3 | −1 | | | | | −25 |
| D. Permanently Extend Contributions of Appreciated Stock to Private Foundations; Public Inspection of Private Foundation Annual Returns | 7/1/98 (12) | ............... | ............... | −23 | −56 | −71 | −83 | −91 | −95 | −100 | −109 | −732 |
| E. 1-Year Modified Extension of Exemption from Subpart F for Active Financing Income | tybi 1999 | ............... | −117 | −378 | | | | | | | | −495 |
| F. Extension of Tax Information Reporting for Income Contingent Student Loan Program (through 9/30/03) (5) | 10/1/98 | Negligible Budget Effect | | | | | | | | | | |

| | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Title II. Other Tax Provisions** | | | | | | | | | | | | |
| Subtitle A. Provisions Relating to Individuals | | | | | | | | | | | | |
| A. Treatment of Nonrefundable Personal Credits (child credit, adoption credit, HOPE and Lifetime Learning credits, etc.) Under the Alternative Individual Minimum Tax (for 1998 only) | tyba 12/31/97 | | −474 | | | | | | | | | −474 |
| B. Accelerate Self-Employed Health Insurance Deduction—60% in 1999 through 2001, 70% in 2002, and 100% in 2003 and thereafter (13) | tyba 12/31/98 | | −105 | −289 | −235 | −251 | −384 | −637 | −680 | −602 | −257 | −3,439 |
| C. Prior Year Estimated Tax Safe Harbor for Individuals With AGI over $150,000 (106% in 2000 and 2001) | tyba 12/31/99 | | | 525 | | −525 | | | | | | |
| Subtitle B. Provisions Relating to Farmers | | | | | | | | | | | | |
| A. Permanent Extension of Income Averaging for Farmers | tyba 12/31/00 | | | | −2 | −21 | −22 | −22 | −23 | −24 | −24 | −138 |
| B. Production Flexibility Contract Payments to Farmer Not Included in Income Prior to Receipt | tyea 12/31/95 | | | | | | Negligible Budget Effect | | | | | |
| C. Extend the Net Operating Loss Carryback Period for Farm Losses | NOLgi tyba 12/31/97 | | −73 | −66 | −60 | −55 | −50 | −46 | −42 | −39 | −36 | −468 |
| Subtitle C. Miscellaneous Provisions | | | | | | | | | | | | |
| A. Increase Private Activity Bond Volume Cap to the Greater of $55 Per Capita or $165 Million Staring in 2003; Phased In Ratably to the Greater of $75 Per Capita or $225 Million in 2007 | 1/1/03 | | | | | | −11 | −44 | −111 | −177 | −252 | −595 |
| B. Treasury Study on Depreciation (due 3/31/00) | | | | | | | | | | | | |
| C. State Election to Except Student Employees From Social Security (5) | ea 6/30/00 | | | −5 | −47 | −49 | −51 | −52 | −54 | −56 | −58 | −372 |

## APPENDIX:—Continued

## ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN 1998

### Fiscal Years 1998–2007

[Millions of dollars]

| Provision | Effective | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 1998–07 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Title III. Revenue Offset Provisions** | | | | | | | | | | | | |
| A. Change the Treatment of Certain Deductible Liquidating Distributions of RICs and REITs | dma 5/21/98 | ............... | 2,425 | 1,109 | 723 | 640 | 672 | 705 | 741 | 778 | 817 | 8,610 |
| B Add Vaccines Against Rotavirus Gastroenteritis to the List of Taxable Vaccines ($0.75 per dose) | vpa DOE | ............... | 1 | 2 | 3 | 4 | 5 | 6 | 6 | 6 | 7 | 42 |
| C. Claify and Expand Math Error Procedures | tyea DOE | ............... | 12 | 25 | 26 | 27 | 28 | 29 | 30 | 31 | 32 | 240 |
| D. Restrict Special Net Operating Loss Carryback Rules for Specified Liability Losses | NOLgi tyea DOE | ............... | 14 | 21 | 29 | 39 | 42 | 40 | 40 | 40 | 42 | 308 |
| E. Medicare Offset: Tax Treatment of Prizes and Awards | (14) | ............... | 170 | 1,618 | −99 | −348 | −397 | −384 | −367 | −346 | −321 | −474 |
| **Title IV. Tax Technical Corrections Provisions** | | No Revenue Effect | | | | | | | | | | |
| **Subtotal: H.R. 4328** | | ............... | **509** | **1,851** | **−71** | **−838** | **−364** | **−522** | **−560** | **−493** | **−159** | **−644** |

Joint Committee on Taxation.

NOTE: Details may not add to totals due to rounding.

**Legend for "Effective" column:**

ai = advice issued
aiii TRA'97 = as if included in the Taxpayer Relief Act of 1997
aoa = actions occurring after
aptiao/a = amounts properly taken into account on or after
caia = collection actions initiated after
cmo/a = communications made on or after
dda = disasters declared after
dma = distributions made after
DOE = date of enactment
drma = deposits required to be made after
ea = earnings after
eca = examinations commencing after
iapma = installment agreement payments made after
laa = liability arising after
lia = levies imposed after
Lia = levies issued after
lma = levies made after
nia = notices issued after
nma = notice mailed after
NOLgi = net operating losses generated in
paa = penalties assessed after
pca = proceedings commencing after
rdnrb = removal designation not required before
rfa = refunds filed after
rpa = refunds payable after
saa = software acquired after
scqa = succeeding calendar quarters beginning after
sia = summonses issued after
soa = seizures occurring after
Soa = sales occurring after
sotmpa = selections of tax matters partners after
ssa = summonses served after
taa = taxes assessed after
tyba = taxable years beginning after
tybbo/a = taxable years beginning before, on, or after
tyea = taxable years ending after
tybi = taxable years beginning in
tyoo/a = taxable years open on or after
ulb = unpaid liability before
vpa = vaccines purchased after
wa = withdrawals after
wpoifibwa = wages paid or incurred for individuals beginning work after
1ya = 1 year after
6ma = 6 months after
18ma = 18 months after
90da = 90 days after
180da = 180 days after

**Footnotes for Appendix:**

[1] This table provides estimates of the provisions of Title IX of H.R. 2400 ("Transportation Equity Act for the 21st Century") only. The Transportation Infrastructure Finance and Innovation Act program contained in another title of the bill results in revenue losses from increased issuance of tax-exempt debt with offsetting receipts from the imposition of a credit enhancement fee. The magnitude of these effects cannot be determined until the Congressional Budget Office determines outlay levels for the program, as included in the conference agreement.

[2] The Congressional Budget Office revenue baseline assumes that the Highway Trust Fund excise taxes and exemptions to the taxes will remain in effect throughout the budget window. Thus, the extension of the excise taxes and certain exemptions is scored as having no revenue effect. The table shows the revenue effect of reducing the renewable source alcohol fuels income tax credit and excise tax exemption from 54 cents/gallon to 53 cents/gallon in 2001–2002, 52 cents/gallon in 2003–2004, and 51 cents/gallon thereafter.

[3] Loss of less than $500,000.

[4] Loss of less than $1 million.

[5] Estimate provided by the Congressional Budget Office.

[6] Loss of less than $5 million.

[7] Loss of less than $50 million.

[8] Generally effective for collection actions commencing after the date of enactment; collections at ACS sites effective for levies imposed after 12/31/00.

[9] Effective for requests to extend the statute of limitations made after 12/31/99 and to all extensions of the statute of limitations on collections that are open after 12/31/99.

[10] Loss of less than $25 million.

[11] Gain of less than $500,000.

[12] Effective for requests made after the later of the date which is 60 days after the date on which the Treasury Department publishes regulations or 12/31/98.

[13] Under prior law, the self-employed health insurance deduction percentages were 45% in 1998 and 1999, 50% in 2000 and 2001, 60% in 2002, 80% in 2003 through 2005, 90% in 2006, and 100% in 2007 and thereafter.

[14] The provision applies with respect to any qualified prize to which a person first becomes entitled after the date of enactment. In addition, the provision also applies to any qualified prize to which a person became entitled on or before the date of enactment if the person has an option to receive a lump-sum payment only during some portion of the 18-month period beginning on 7/1/99.