

**TAXPAYER PROTECTION AND  
IRS ACCOUNTABILITY ACT OF 2002**

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Before the  
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Prepared by the Staff  
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## INTRODUCTION

This document,<sup>1</sup> prepared by the staff of the Joint Committee on Taxation, provides a description of the “Taxpayer Protection and IRS Accountability Act of 2002.” The House Committee on Ways and Means has scheduled a markup of this bill for March 20, 2002.

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<sup>1</sup> This document may be cited as follows: Joint Committee on Taxation, “*Taxpayer Protection and IRS Accountability Act of 2002*,” (JCX-18-02), March 18, 2002.

## **I. REFORMING PENALTY AND INTEREST PROVISIONS**

### **A. Reduction of Federal Tax Deposit Penalty**

#### **Present Law**

In many instances, taxpayers are required to make deposits of Federal taxes (sec. 6302). Failure to do so is subject to a penalty (sec. 6656). The amount of that penalty depends on the length of time that the deposit was not made. The penalty is 2 percent of the underpayment if the failure to deposit is for not more than 5 days, 5 percent for 6 through 15 days, and 10 percent for more than 15 days.

#### **Description of Proposal**

The proposal would repeal the 5 and 10 percent penalty rates and apply the 2 percent rate in their place.

#### **Effective Date**

The proposal would be effective for deposits required to be made after December 31, 2002.

### **B. Failure to Pay Estimated Tax**

#### **1. Convert estimated tax penalty into an interest provision for individuals, estates, and trusts**

#### **Present Law**

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

#### **Description of Proposal**

The penalty for failure to pay estimated tax would be converted into an interest provision for individuals, estates, and trusts.

### **Effective Date**

The proposal would be effective for estimated tax payments made for taxable years beginning after December 31, 2002.

## **2. Increase and revise estimated tax threshold**

### **Present Law**

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

### **Description of Proposal**

Under the proposal, no interest would be charged for underpayments of estimated tax if the tax shown on the return for the taxable year (or, if no return is filed, the tax), reduced by both withholding and/or equally-paid estimated tax is less than \$2,000.

### **Effective Date**

The proposal would be effective for estimated tax payments made for taxable years beginning after December 31, 2002.

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

### **Present Law**

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

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

### **Description of Proposal**

The interest rates would be aligned so that, for any given estimated tax underpayment period, only one interest rate will apply. The underpayment interest rate in effect on the first day of the quarter in which the pertinent estimated payment due date arises would be the interest rate that will apply during an entire underpayment period.

### **Effective Date**

The proposal would be effective for estimated tax payments made for taxable years beginning after December 31, 2002.

## **4. Provide that underpayment balances are cumulative**

### **Present Law**

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

### **Description of Proposal**

The definition of “underpayment” would be changed to allow existing underpayment balances to be used in underpayment calculations for succeeding estimated payment periods. Taxpayers would now calculate a cumulative underpayment at the end of each underpayment period.

### **Effective Date**

The proposal would be effective for estimated tax payments made for taxable years beginning after December 31, 2002.

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

### **Present Law**

Under current IRS procedures, taxpayers with outstanding underpayment balances that extend from a leap year through a non-leap year are required to make separate calculations solely to account for the different number of days in the two different years. For example, if a taxpayer has an underpayment outstanding from September 15, 2004, through January 15, 2005, then the taxpayer must account for the period from September 15, 2004, through December 31, 2004, by

using a 366-day formula.<sup>2</sup> The taxpayer then must account for the period from January 1, 2005, through January 15, 2005, under a 365-day formula. This calculation is required regardless of whether the interest rate changes on January 1, 2005.

### **Description of Proposal**

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

### **Effective Date**

The proposal would be effective for estimated tax payments made for taxable years beginning after December 31, 2002.

## **C. Exclusion from Gross Income for Interest on Overpayments of Income Tax by Individuals**

### **Present Law**

#### **Overpayment interest**

Interest is included in the list of items that are required to be included in gross income (sec. 61(a)(4)). Interest on overpayments of Federal income tax is required to be included in taxable income in the same manner as any other interest that is received by the taxpayer.<sup>3</sup>

Cash basis taxpayers are required to report overpayment interest as income in the period the interest is received. Accrual basis taxpayers are required to report overpayment interest as income when all events fixing the right to the receipt of the overpayment interest have occurred and the amount can be estimated with reasonable accuracy.<sup>4</sup> Generally, this occurs on the date the appropriate IRS official signs the pertinent schedule of overassessments.<sup>5</sup>

#### **Underpayment interest**

A corporate taxpayer is allowed to currently take into account interest paid on underpayments of Federal income tax as an ordinary and necessary business expense. Typically, this results in a current deduction. However, the deduction may be deferred if the interest is required to be capitalized<sup>6</sup> or may be disallowed if and to the extent it is determined to be a cost of earning tax exempt income under section 265.

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<sup>2</sup> The year 2004 is a leap year, the year 2005 is not.

<sup>3</sup> Treas. Reg. sec. 1.61-7.

<sup>4</sup> Treas. Reg. sec. 1.451-1(a).

<sup>5</sup> Rev. Rul. 62-160, 1962-2 C.B. 451.

<sup>6</sup> Interest may be required to be capitalized under section 263A and similar sections.



Section 163(h) of the Code prohibits the deduction of personal interest by taxpayers other than corporations. Noncorporate taxpayers, including individuals, generally are not allowed to deduct interest on the underpayment of Federal income taxes.

Temporary regulations<sup>7</sup> provide that personal interest includes interest paid on underpayments of individual Federal, State or local income taxes, regardless of the source of the income generating the tax liability. This is consistent with the statement in the General Explanation of the Tax Reform Act of 1986 that “(p)ersonal interest also includes interest on underpayments of individual Federal, State, or local income taxes notwithstanding that all or a portion of the income may have arisen in a trade or business, because such taxes are not considered derived from conduct of a trade or business.”<sup>8</sup> The validity of the temporary regulation has been upheld in those Circuits that have considered the issue, including the Fourth,<sup>9</sup> Sixth,<sup>10</sup> Eighth,<sup>11</sup> and Ninth Circuits.<sup>12</sup>

Personal interest also includes interest that is paid by a trust, S corporation, or other pass-through entity on underpayments of State or local income taxes. Personal interest does not include interest that is paid with respect to sales, excise or similar taxes that are incurred in connection with a trade or business or an investment activity.<sup>13</sup>

### **Description of Proposal**

The proposal would exclude overpayment interest that is paid to individual taxpayers on overpayments of Federal income tax from gross income. Interest excluded under the provision would not be considered disqualified income that could limit the earned income credit. Interest excluded under the provision also would not be considered in determining what portion of a taxpayer’s social security or tier 1 railroad retirement benefits are subject to tax (sec. 86), whether a taxpayer has sufficient taxable income to be required to file a return (sec. 6012(d)), or for any other computation in which interest exempt from tax is otherwise required to be added to adjusted gross income.

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<sup>7</sup> Treas. Reg. sec. 1.163-9T.

<sup>8</sup> Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), p. 266.

<sup>9</sup> *Allen v. U.S.*, 173 F. 3d 533 (1999).

<sup>10</sup> *McDonnell v. U.S.*, 1999 U.S. app. LEXIS 10842 (1999).

<sup>11</sup> *Miller v. U.S.*, 65 F. 3d 687 (1995).

<sup>12</sup> *Redlark v. U.S.*, 141 F. 3d 936 (1998).

<sup>13</sup> Treas. Reg. sec. 1.163-9T(b)(2)(iii)(A).

The exclusion from income of overpayment interest would not apply if the Secretary determines that the taxpayer's principal purpose for overpaying his or her tax is to take advantage of the exclusion.

For example, a taxpayer prepares his return without taking into account significant itemized deductions of which he is, or should be, aware. Before the expiration of the statute of limitations, the taxpayer files an amended return claiming these itemized deductions and requesting a refund with interest. Unless the taxpayer can establish a principle purpose for originally overpaying the tax other than collecting excludible interest, the Secretary may determine that the principal purpose of waiting to claim the deductions on an amended return was to earn interest that would be excluded from income. In that case, the interest on the underpayment could not be excluded from income.

It is expected that the Secretary would indicate whether the interest is eligible to be excluded from income on the Form 1099 it provides that taxpayer for taxable year in which the underpayment interest is paid.

#### **Effective Date**

The proposal would be effective for interest received in calendar years beginning after the date of enactment.

### **D. Abatement of Interest**

#### **Present Law**

##### **In general**

The Secretary of the Treasury can abate or suspend the accrual of interest in a number of situations. In general, the Secretary is authorized to abate interest that is not owed by the taxpayer, either because the interest was erroneously or illegally assessed, or because the interest was assessed after the expiration of the period of limitations. The Secretary also may abate interest that is attributable to certain unreasonable errors and delays by the Internal Revenue Service. The Secretary may abate interest where, in his judgment, the administration and collection costs involved do not warrant the collection of the amount due.

The Secretary is required to abate interest in the case of a declared disaster or certain erroneous refunds attributable solely to errors made by the IRS. The Secretary is required to suspend the accrual of interest if the IRS fails to contact the taxpayer in a timely manner and in the case of taxpayers serving in a combat zone.

Interest that is abated is not owed by the taxpayer and does not accrue additional interest through compounding or result in any additional penalties. If the accrual of interest is suspended for a period, then that period is not taken into account in determining the interest owed on an underpayment.

### **Abatement of interest that is erroneously or illegally assessed**

Most abatements of interest are a result of adjustments to the underlying tax liability. Underpayment interest is assessed any time an underpayment is assessed. If the underlying tax liability is later adjusted, resulting in a reduction in the amount of the underpayment, the portion of the interest attributable to such adjustment must be abated.

### **Abatement of interest on erroneous refunds**

The Secretary is required to abate interest on an erroneous refund for the period from the issuance of the refund until its return is demanded.<sup>14</sup> Since the taxpayer has 21 days from the date of demand to pay without interest,<sup>15</sup> no interest must be paid as the result of an erroneous refund if the taxpayer repays the refund within 21 days of the IRS asking for its return. If the taxpayer does not repay the refund within the 21 day grace period, interest must be paid from the date the return of the refund is demanded. The rule abating interest in the case of erroneous refunds does not apply if the taxpayer (or a related party) has in any way caused the erroneous refund or if the amount of the erroneous refund exceeds \$50,000.

### **Abatement of penalties and additions to tax attributable to erroneous written advice given by the IRS**

The Secretary is required to abate any portion of any penalty or addition to tax attributable to erroneous advice furnished to the taxpayer in writing by an officer or employee of the IRS acting in his or her official capacity. The abatement applies only if (1) the advice is given in response to a specific written request made by the taxpayer, (2) the taxpayer reasonably relied on the advice, and (3) the taxpayer provided adequate and accurate information.<sup>16</sup>

Only penalties and additions to tax that are attributable to erroneous written advice given by the IRS are abated under this rule. Interest is abated only to the extent that it is attributable to abated penalties and additions to tax. Interest attributable to an underpayment of tax, where such underpayment is the result of the taxpayer's proper reliance on written advice of the IRS, is not eligible for abatement.

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<sup>14</sup> Sec. 6404(e)(2).

<sup>15</sup> Sec. 6601(e)(3).

<sup>16</sup> Sec. 6404(f).

## **Procedures for the abatement of interest**

Taxpayers may apply for the abatement of interest by filing a claim on Form 843 with the Internal Revenue Service Center that has assessed the interest the taxpayer seeks to have abated.<sup>17</sup>

Typically, interest is abated when the amount of tax assessed is reduced. Thus, any procedure that may result in the reduction of assessed tax may also result in an abatement of interest.

### **Description of Proposal**

#### **Allow for the abatement of interest in situations where the taxpayer is repaying an excessive refund based on IRS calculations without regard to the size of the refund**

The proposal would eliminate the \$50,000 threshold for abatement of interest on erroneous refunds. Under the proposal, the Secretary would be required to abate interest on any erroneous refund, provided the taxpayer has not in any way caused the erroneous refund to occur.

#### **Allow the abatement of interest to the extent the interest is attributable to taxpayer reliance on written statements of the IRS**

The proposal would require the Secretary to abate interest on an underpayment where the underpayment is attributable to erroneous advice furnished to the taxpayer in writing by an officer or employee of the IRS acting in his or her official capacity. It is anticipated that the abatement would apply to interest attributable to the period of time from the issuance of the erroneous advice through the day that is 21 days (10 days in the case of an underpayment in excess of \$100,000) after the day the IRS gives written notice that its advice was erroneous. The proposal would not eliminate the taxpayer's obligation to satisfy any underpayment of tax attributable to such erroneous advice.

### **Effective Date**

The changes made by these provisions would be effective with respect to interest accruing on or after the date of enactment.

## **E. Deposits to Stop the Running of Interest on Potential Underpayments**

### **Present Law**

Generally, interest on underpayments and overpayments continues to accrue during the period that a taxpayer and the IRS dispute a liability. The accrual of interest on an underpayment is suspended if the IRS fails to notify an individual taxpayer in a timely manner,<sup>18</sup> but interest

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<sup>17</sup> Rev. Proc. 87-43, 1987-2 C.B. 590.

<sup>18</sup> Sec. 6404(g).

will begin to accrue once the taxpayer is properly notified. No similar suspension is available for other taxpayers.

A taxpayer that wants to limit its exposure to underpayment interest has a limited number of options. The taxpayer can continue to dispute the amount owed and risk paying a significant amount of interest. If the taxpayer continues to dispute the amount and ultimately loses, the taxpayer will be required to pay interest on the underpayment from the original due date of the return until the date of payment.

In order to avoid the accrual of underpayment interest, the taxpayer may choose to pay the disputed amount and immediately file a claim for refund. Payment of the disputed amount will prevent further interest from accruing if the taxpayer loses (since there is no longer any underpayment) and the taxpayer will earn interest on the resultant overpayment if the taxpayer wins. However, the taxpayer will generally lose access to the Tax Court if it follows this alternative.<sup>19</sup> Amounts paid generally cannot be recovered by the taxpayer on demand, but must await final determination of the taxpayer's liability. Even if an overpayment is ultimately determined, overpaid amounts may not be refunded if they are eligible to be offset against other liabilities of the taxpayer.<sup>20</sup>

The taxpayer may also make a deposit in the nature of a cash bond. The procedures for making a deposit in the nature of a cash bond are provided in Rev. Proc. 84-58.<sup>21</sup>

A deposit in the nature of a cash bond will stop the running of interest on an amount of underpayment equal to the deposit, but the deposit does not itself earn interest. A deposit in the nature of a cash bond is not a payment of tax and is not subject to a claim for credit or refund. A deposit in the nature of a cash bond may be made for all or part of the disputed liability and generally may be recovered by the taxpayer prior to a final determination. However, a deposit in the nature of a cash bond need not be refunded to the extent the Secretary determines that the assessment or collection of the tax determined would be in jeopardy, or that the deposit should be applied against another liability of the taxpayer in the same manner as an overpayment of tax.<sup>22</sup> If the taxpayer recovers the deposit prior to final determination and a deficiency is later determined, the taxpayer will not receive credit for the period in which the funds were held as a deposit. The taxable year to which the deposit in the nature of a cash bond relates must be

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<sup>19</sup> The taxpayer may, however, sue the IRS for the refund in either the U.S. District Court or the U.S. Court of Federal Claims.

<sup>20</sup> The amount of any overpayment, including interest thereon, may be credited against any other internal revenue tax liability of the taxpayer (sec. 6402(a)). In addition, the overpayment and any overpayment interest may be used to offset past due support payments (sec. 6402(c)), debts owed to other Federal agencies (sec. 6402(d)), and past due, legally enforceable State income tax obligations of residents of the same State (sec. 6402(e)).

<sup>21</sup> 1984-2 C.B. 501.

<sup>22</sup> Rev. Proc. 84-58, sec. 4.02(1).

designated, but the taxpayer may request that the deposit be applied to a different year under certain circumstances.<sup>23</sup>

## **Description of Proposal**

### **In general**

The proposal would allow a taxpayer to deposit funds with the IRS that the taxpayer may subsequently use to offset an underpayment of income, gift, estate, generation-skipping, or certain excise taxes. Interest would not be charged on the portion of the underpayment that is offset by the deposited amount for the period the amount is on deposit. Generally, funds deposited in a qualified dispute reserve account may be withdrawn at any time. The funds will earn interest at the applicable Federal rate if they are not used to offset underpayments of tax to the extent they were attributable to a disputable tax.

### **Use of a deposit to offset underpayments of tax**

The taxpayer may designate any amounts of deposit to offset an underpayment of tax that is ultimately determined for the taxable year to which the deposit relates. If an underpayment is offset in this manner, the taxpayer would not be charged underpayment interest on the portion of the underpayment that is offset for the period the funds were on deposit.

For example, a calendar year individual taxpayer deposits \$20,000 on May 15, 2001. On April 15, 2003, an examination of the taxpayer's year 2000 return is completed, the taxpayer and the IRS agree that the taxable year 2000 taxes were underpaid by \$25,000, the taxpayer designates the amount deposited as an offset to the underpayment, and the taxpayer pays the balance. In this case, the taxpayer will owe underpayment interest from April 15, 2001 (the original due date of the return) to the date of payment (April 15, 2003) only with respect to the \$5,000 of the underpayment that is not offset by the deposit. The taxpayer would owe underpayment interest on the remaining \$20,000 of the underpayment only from April 15, 2001 to May 15, 2001, the date the \$20,000 was deposited.

### **Withdrawal of amounts**

A taxpayer may request the withdrawal of any amount of deposit at any time. The Secretary must comply with the withdrawal request unless the amount has already been designated to offset an underpayment of tax or the Secretary properly determines that assessment and collection of tax is in jeopardy. Interest would be paid on amounts that are withdrawn from a dispute reserve account at a rate equal to the short-term applicable Federal rate for the period from the date of deposit to a date not more than 30 days preceding the date of the check paying the withdrawal.<sup>24</sup> Interest is not payable to the extent not attributable to a disputable tax.

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<sup>23</sup> Id. sec. 4.02(4).

<sup>24</sup> This 30-day period is consistent with other determinations of interest owed to a taxpayer.

For example, a calendar year individual taxpayer receives a 30-day letter showing a deficiency of \$20,000 for taxable year 2000 and deposits \$20,000 on May 15, 2002. On April 15, 2003, an administrative appeal is completed, the taxpayer and the IRS agree that the 2000 taxes were underpaid by \$15,000, and the taxpayer designates \$15,000 of the deposit as an offset to the underpayment. In this case, the taxpayer will owe underpayment interest from April 15, 2001 (the original due date of the return) to May 15, 2002, the date the \$20,000 was deposited. Simultaneously with the designation of the \$15,000 to offset the deficiency, the taxpayer requests the return of the remaining \$5,000 of the deposit. This amount must be returned to the taxpayer with interest determined at the short-term applicable Federal rate from the May 15, 2002 to a date not more than 30 days preceding the date of the check repaying the \$5,000 to the taxpayer.

### **Limitation on amounts for which interest may be allowed**

Interest on a deposit which is returned to a taxpayer shall be allowed for any period only to the extent attributable to a disputable item for that period. A disputable item is any item for which the taxpayer 1) has a reasonable basis for the treatment used on its return and 2) reasonably believes that the Secretary also has a reasonable basis for disallowing the taxpayer's treatment of such item.

All items included in a 30-day letter to a taxpayer are deemed disputable for this purpose. Thus, once a 30-day letter has been issued, the disputable amount cannot be less than the amount of the deficiency shown in the 30-day letter. A 30-day letter is the first letter of proposed deficiency that allows the taxpayer an opportunity for administrative review in the Internal Revenue Service Office of Appeals.

### **Deposits are not payments of tax**

An amount deposited is not a payment of tax prior to the time it is designated to offset an underpayment. Thus, the interest earned on withdrawn amounts would not be eligible for the proposed exclusion from income of an individual. Similarly, withdrawal of a deposit will not establish a period for which interest was allowable at the short-term applicable Federal rate for the purpose of establishing a net zero rate interest rate on a similar amount of underpayment for the same period.

### **Effective Date**

The proposal would apply to deposits made after the date of enactment. Amounts already on deposit as of the date of enactment would be treated as deposited (for purposes of applying this provision) on the date the taxpayer identifies the amount as a deposit made pursuant to this provision.

## **F. Expansion of Interest Netting for Individuals**

### **Present Law**

A special net interest rate of zero applies to the extent that, for any period, interest is payable under subchapter A and allowable under subchapter B on equivalent underpayments and

overpayments by the same taxpayer.<sup>25</sup> If both the underpayment and overpayment are unsatisfied, the interest rate applied to both will be zero. If either the underpayment or overpayment has previously been satisfied, the interest rate applicable to the unsatisfied amount will be equal to the interest rate applicable to the satisfied amount to the extent that interest was allowable or payable on both the underpayment and the overpayment for the same period.

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

For example, on July 1, 2003, a deficiency of \$1,500 is determined with respect to an individual taxpayer's 2000 Federal income tax return, which the taxpayer pays within 21 days. In the meantime, the taxpayer has filed returns for 2001 and 2002, showing a refund due to overwithholding each year of \$1,000. The IRS issues the appropriate refund checks on May 15 of each year, within 45 days of the due date of the return. Thus, interest is not allowable to the taxpayer with respect to either 2001 or 2002.<sup>26</sup> In this case, the taxpayer owes interest on the \$1500 year 2000 underpayment from the original due date of the return (April 15, 2001) until the underpayment is satisfied.<sup>27</sup> Although, there are offsetting periods of overpayment (April 15, 2002 to May 15, 2002 and April 15, 2003 to May 15, 2003), there is no offsetting period for which interest is allowable on an overpayment.

### **Description of Proposal**

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

In the example discussed as part of present law, above, a net interest rate of zero would be applied to \$1,000 of the taxpayer's year 2000 underpayment for the periods between the due date of the 2002 and 2003 returns and the dates on which the refunds are made. The taxpayer in the example would owe interest at the underpayment rate for the periods from April 16, 2001 to April 16, 2002; May 16, 2002 to April 16, 2003; and from May 16, 2003 to July 1, 2003. For the periods April 16 to May 15, 2002 and April 16, 2003 to May 15, 2003, a zero net interest rate will apply.

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<sup>25</sup> This provision was enacted in section 3301 of the IRS Reform Act.

<sup>26</sup> Sec. 6611(e)(1) provides that no interest will be allowable if any overpayment of tax is refunded within 45 days after the return is filed.

<sup>27</sup> If the underpayment is satisfied within 21 days of the determination on July 1, 2003, the taxpayer does not owe interest for any portion of time after that date (sec. 6601(e)(3)).



### **Effective Date**

The proposal would be effective for interest accrued after December 31, 2002.

## **G. Waiver of Certain Penalties for First-Time Unintentional Minor Errors**

### **Present Law**

Taxpayers who fail to file tax returns or pay taxes as required by the Code are subject to penalty (sec. 6651). The Code authorizes the IRS to waive these penalties for reasonable cause. There is no explicit statutory provision providing for a waiver for first-time unintentional minor errors.

### **Description of Proposal**

The proposal would explicitly permit the IRS to waive these penalties for unintentional minor errors that are committed by a taxpayer with a good history of tax compliance and the penalty for which would be disproportionate to the amount involved. Waiving these penalties under these circumstances must also promote tax compliance and effective tax administration. This waiver is applicable once to a taxpayer.

### **Effective Date**

The proposal would be effective after December 31, 2002.

## **H. Frivolous Tax Returns and Submissions**

### **Present Law**

The Code provides that an individual who files a frivolous income tax return is subject to a penalty of \$500 imposed by the IRS (sec. 6702). The Code also permits the Tax Court<sup>28</sup> to impose a penalty of up to \$25,000 if a taxpayer has instituted or maintained proceedings primarily for delay or if the taxpayer's position in the proceeding is frivolous or groundless (sec. 6673(a)).

### **Description of Proposal**

The proposal would modify this IRS-imposed penalty by increasing the amount of the penalty to up to \$5,000 and by applying it to all taxpayers and to all types of Federal taxes.

The proposal would also modify present law with respect to certain submissions that raise frivolous arguments or that are intended to delay or impede tax administration. The submissions to which this provision would apply would be requests for a collection due process hearing,

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<sup>28</sup> Because in general the Tax Court is the only pre-payment forum available to taxpayers, it deals with most of the frivolous, groundless, or dilatory arguments raised in tax cases.

installment agreements, offers-in-compromise, and taxpayer assistance orders. First, the proposal would permit the IRS to dismiss such requests. Second, the proposal would permit the IRS to impose a penalty of up to \$5,000 for such requests, unless the taxpayer withdraws the request after being given an opportunity to do so.

The proposal would require the IRS to publish a list of positions, arguments, requests, and proposals determined to be frivolous for purposes of these provisions.

#### **Effective Date**

The proposal would be effective for submissions made and issues raised after the date on which the Secretary first prescribes the required list.

## **II. IMPROVING THE FAIRNESS OF IRS COLLECTION PROCEDURES**

### **A. Authorize IRS to Enter into Installment Agreements that Provide for Partial Payment**

#### **Present Law**

The Code authorizes the IRS to enter into written agreements with any taxpayer under which the taxpayer is allowed to pay taxes owed, as well as interest and penalties, in installment payments if the IRS determines that doing so will facilitate collection of the amounts owed (sec. 6159). An installment agreement does not reduce the amount of taxes, interest, or penalties owed. Generally, during the period installment payments are being made, other IRS enforcement actions (such as levies or seizures) with respect to the taxes included in that agreement are held in abeyance.<sup>29</sup>

Prior to 1998, the IRS administratively entered into installment agreements that provided for partial payment (rather than full payment) of the total amount owed over the period of the agreement. In that year, the IRS Chief Counsel issued a memorandum concluding that partial payment installment agreements were not permitted.

#### **Description of Proposal**

The proposal would clarify that the IRS is authorized to enter into installment agreements with taxpayers who do not provide for full payment of the taxpayer's liability over the life of the agreement. The proposal would also require the IRS to review partial payment installment agreements every two years.

#### **Effective Date**

The proposal would be effective for installment agreements entered into on or after the date of enactment.

### **B. Additional Considerations to be Taken into Account as Bases for Accepting an Offer in Compromise**

#### **Present Law**

The Code permits the IRS to compromise a taxpayer's tax liability (sec. 7122). 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. The IRS is required to prescribe guidelines to determine whether an offer in compromise is adequate and should be accepted. These guidelines must provide allowances for basic living expenses.

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<sup>29</sup> Sec. 6331(k).

### **Description of Proposal**

The proposal would specify additional considerations that must be taken into account in evaluating an offer in compromise. Consideration must, in all cases, be given to whether the taxpayer has a history of complying with the Code, whether there is evidence of an error by the IRS with respect to the underlying tax, and whether the taxpayer has made a good faith effort to resolve and pay the liability. A reasonable allowance would be made for voluntary payments for support of dependents. A reasonable allowance would be made for payments for certain unsecured debt. Consideration must also be given to the level of the taxpayer's education and financial and business experience relative to the complexity of the transaction giving rise to the liability. Time and dollar limitations on these additional allowances and considerations would be imposed.

### **Effective Date**

The proposal would be effective for offers in compromise submitted after the date of enactment.

## **C. Extend Time Limit for Contesting IRS Levy**

### **Present Law**

The IRS is authorized to return property that has been wrongfully levied upon (sec. 6343). In general, monetary proceeds may be returned within 9 months of the date of the levy.

### **Description of Proposal**

The proposal would extend this 9 month period to 2 years.

### **Effective Date**

The proposal would be effective on the date of enactment.

## **D. Place Threshold on Tolling of Statute of Limitations During Review by Taxpayer Advocate Service**

### **Present Law**

Taxpayers suffering significant hardship may request that the Office of the Taxpayer Advocate issue a Taxpayer Assistance Order, which requires the IRS to take (or refrain from taking) specified actions (sec. 7811). The statute of limitations is suspended for the period beginning on the date of the taxpayer's application and ending on the date of the decision by the National Taxpayer Advocate.

### **Description of Proposal**

The proposal would modify this suspension of statute of limitations by applying it only if the date of the decision by the National Taxpayer Advocate is at least 7 days after the date of the taxpayer's application.

### **Effective Date**

The proposal would be effective on the date of enactment.

## **E. Study of Liens and Levies**

### **Present Law**

To aid in the collection of tax liabilities, the IRS may impose liens and levies against property of the taxpayer.

### **Description of Proposal**

The proposal would require the Treasury to conduct a study of the practices of the IRS concerning liens and levies. The study would examine the declining use of liens and levies by the IRS and the practicality of recording liens and levies against property in cases where the cost of such actions exceeds the amount to be realized from the property.

### **Effective Date**

The study would be required to be submitted to the Congress not later than one year after the date of enactment.

### **III. IMPROVING THE EFFICIENCY OF TAX ADMINISTRATION**

#### **A. Modify Section 1203 of the IRS Restructuring and Reform Act of 1998**

##### **Present Law**

Section 1203 of the IRS Restructuring and Reform Act of 1998 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.

Section 1203 also provides non-delegable authority to the Commissioner to determine that mitigating factors exist, that, in the Commissioner's sole discretion, mitigate against terminating the employee. 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.

##### **Description of Proposal**

The proposal would remove from the list of violations requiring termination (1) the late filing of refund returns and (2) employee versus employees acts. The proposal would also add to the list of violations (1) willful unauthorized inspection of returns and return information and (2) the requirement that other violations in general be willful. The proposal would also provide that, notwithstanding any other provision of law, any determination by the Commissioner may not be reviewed.

##### **Effective Date**

The proposal would be effective on the date of enactment.

## **B. Confirmation of Tax Court Authority to Apply Equitable Recoupment**

### **Present Law**

Equitable recoupment is a common-law equitable principle that permits the defensive use of an otherwise time-barred claim to reduce or defeat an opponent's claim if both claims arise from the same transaction. U.S. District Courts and the U.S. Court of Federal Claims, the two Federal tax refund forums, may apply equitable recoupment in deciding tax refund cases.<sup>30</sup> In *Estate of Mueller v. Commissioner*,<sup>31</sup> the Court of Appeals for the Sixth Circuit held that the Tax Court may not apply the doctrine of equitable recoupment. More recently, the Court of Appeals for the Ninth Circuit, in *Branson v. Commissioner*,<sup>32</sup> held that the Tax Court may apply the doctrine of equitable recoupment.

### **Description of Proposal**

The proposal would amend section 6214(b) to confirm that the Tax Court may apply the principle of equitable recoupment to the same extent that it may be applied in Federal civil tax cases by the U.S. District Courts or the U.S. Court of Claims. No implication is intended as to whether the Tax Court has the authority to continue to apply other equitable principles in deciding matters over which it has jurisdiction.

### **Effective Date**

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

## **C. Consolidate Review of Collection Due Process Cases in the Tax Court**

### **Present Law**

In general, the IRS is required to notify taxpayers that they have a right to a fair and impartial hearing before levy may be made on any property or right to property (sec. 6330(a)). Similar rules apply with respect to liens (sec. 6320). The hearing is held by an impartial officer from the IRS Office of Appeals, who is required to issue a determination with respect to the issues raised by the taxpayer at the hearing. The taxpayer is entitled to appeal that determination to a court. That appeal must be brought to the United States Tax Court, unless the Tax Court does not have jurisdiction over the underlying tax liability. If that is the case, then the appeal must be brought in the district court of the United States (sec. 6330(d)). Special rules apply if the taxpayer files the appeal in the incorrect court.

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<sup>30</sup> See *Stone v. White*, 301 U.S. 532 (1937); *Bull v. United States*, 295 U.S. 247 (1935).

<sup>31</sup> 153 F.3d 302 (6<sup>th</sup> Cir.), cert. den. 525 U.S. 1140 (1999).

<sup>32</sup> 264 F.3d 904 (9<sup>th</sup> Cir.), pet. for cert. filed January 2, 2002.

The United States Tax Court is established under Article I of the United States Constitution<sup>33</sup> and is a court of limited jurisdiction.<sup>34</sup>

### **Description of Proposal**

The proposal would consolidate all judicial review of these collection due process determinations in the United States Tax Court.

### **Effective Date**

The proposal would apply to appeals filed after the date of enactment.

## **D. Office of Chief Counsel Review of Offers-in-Compromise**

### **Present Law**

The IRS has the authority to settle a tax debt pursuant to an offer-in-compromise. IRS regulations provide that such offers can be accepted if the taxpayer is unable to pay the full amount of the tax liability and it is doubtful that the tax, interest, and penalties can be collected or there is doubt as to the validity of the actual tax liability. Amounts of \$50,000 or more can only be accepted if the reasons for the acceptance are documented in detail and supported by a written opinion from the IRS Chief Counsel (sec. 7122).

### **Description of Proposal**

The proposal would repeal the requirement that an offer-in-compromise of \$50,000 or more must be supported by a written opinion from the Office of Chief Counsel. Written opinions would only be provided if the Secretary determines that an opinion is required with respect to a compromise.

### **Effective Date**

The proposal would apply to offers-in-compromise submitted or pending on or after the date of enactment.

## **E. Study of Taxpayer Notification Alternatives**

### **Present Law**

The Code requires the IRS to mail a variety of notices to taxpayers. Some of these notices are statutorily required to be sent via certified or registered mail.<sup>35</sup>

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<sup>33</sup> Sec. 7441.

<sup>34</sup> Sec. 7442.

<sup>35</sup> The following provisions of the Code require that IRS send notices by certified or registered mail: 534(b), 982(c)(1), 2011(c)(3), 2058(b)(2)(C)(i), 6015(e)(1)(A)(i)(I),



The IRS is required by statute to send any notice relating to a joint return separately to each individual filing the joint return, wherever practicable.<sup>36</sup>

### **Description of Proposal**

The proposal would require the Treasury to conduct a study of alternatives to the current methods of notifying taxpayers of determinations and other actions of the IRS. The study would examine the advantages and disadvantages of the use of certificates of mailing, of modifications to certified or registered mail requirements that eliminate the use of a return receipt, and of modifications with respect to dual notices to taxpayers filing joint returns residing at the same address.

### **Effective Date**

The study would be required to be submitted to the Congress not later than one year after the date of enactment.

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6038A(e)(2)(C), 6038C(d)(2)(C), 6110(f)(3)(B) and (f)(4)(B), 6164(d)(2), 6212 (a) and (b)(2), 6234(a), 6245(b)(1), 6320(a)(2)(C), 6330(a)(2)(C), 6331(d)(2)(C), 6532 (a)(1) and (a)(4) and (c)(2), 7428(b)(3), 7430(f)(2), 7436(b)(2), 7476(b)(5), 7477(b)(3), 7478(b)(3), and 7479(b)(3). The following provision of the Code require that States send notices by certified or registered mail: 6402(e)(4)(A). The following provisions of the Code require that taxpayers send information to the IRS by certified or registered mail: 527(j)(2)(A)(II) and 7425(c)(1) and (3).

<sup>36</sup> Section 3201(d) of the IRS Restructuring and Reform Act of 1998 (Pub. L. No. 105-206; July 22, 1998).

## **IV. TAXPAYER INFORMATION CONFIDENTIALITY**

### **A. Collection Activities with Respect to a Joint Return Disclosable Based on Oral Request**

#### **Present Law**

Section 6103(e) concerns disclosures to persons with a material interest. Section 6103(e)(7) permits the IRS to disclose return information to the same persons who may have access to a return under the other provisions of section 6103(e). Pursuant to this section 6103(e)(7) and section 6103(e)(1)(B), either spouse may obtain return information regarding a joint return. This includes collection information. Requests for information pursuant to this section do not have to be in writing.

In response to concerns that former spouses were not able to obtain information regarding collection activities relating to a joint return, the Taxpayer Bill of Rights 2 added section 6103(e)(8).<sup>37</sup> When a deficiency is assessed with respect to a joint return, upon written request, section 6103(e)(8) permits the IRS to disclose: (1) whether the IRS has attempted to collect such deficiency from the other individual; (2) the general nature of such collection activities; and (3) the amount collected.<sup>38</sup> This provision applies if individuals who filed the joint return are no longer married or no longer reside in the same household. Requests under this section must be in writing.

#### **Description of Proposal**

The proposal would eliminate the requirement for former spouses to make a written request for disclosure of collection activities with respect to a joint return.

#### **Effective Date**

The proposal would apply to requests made after the date of enactment.

### **B. Taxpayer Representatives Not Subject to Examination Without Supervisor Approval**

#### **Present Law**

Under section 6103(h)(1), returns and return information are, without written request, open to inspection by or disclosure to officers and employees of the Department of the Treasury, including IRS employees, whose official duties require such inspection or disclosure for tax

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<sup>37</sup> “The IRS does not routinely disclose collection information to a former spouse that relates to tax liabilities attributable to a joint return that was filed when married.” Joint Committee on Taxation, *General Explanation of Taxation Legislation Enacted in the 104<sup>th</sup> Congress* (JCS-12-96), December 18, 1996 at 29.

<sup>38</sup> Sec. 6103(e)(8).

administration purposes. The Office of Chief Counsel issued an opinion stating that it was appropriate for a local IRS employee to examine tax records to determine whether taxpayer representatives who submit Form 2848 (Power of Attorney) are current in their tax obligations.<sup>39</sup> The opinion concluded that section 6103(h)(1) permits local IRS employees to access the Integrated Data Retrieval System<sup>40</sup> to determine whether a taxpayer's representative is current in his or her tax obligations.

### **Description of Proposal**

The proposal would clarify that an IRS employee conducting an examination of a taxpayer is not authorized to inspect a taxpayer representative's return or return information solely on the basis of the representative relationship to the taxpayer. Under the proposal, the supervisor of the IRS employee would be required to approve such inspection after making a determination that other grounds justified such an inspection. The proposal would not affect the ability of employees of the IRS Director of Practice, or other employees whose assigned duties concern the regulation of practice before the IRS, to access returns and return information of a representative.

### **Effective Date**

The proposal would be effective on the date of enactment.

## **C. Disclosure in Judicial or Administrative Tax Proceedings of Return and Return Information of Persons Who Are Not Party to Such Proceedings**

### **Present Law**

Under section 6103(h)(4), a return or return information may be disclosed in a Federal or State judicial or administrative proceeding pertaining to tax administration under certain circumstances. Under section 6103(h)(4)(A), such information may be disclosed if the taxpayer is a party to the proceeding or if the proceeding arose out of, or in connection with, determining the taxpayer's liability with respect to any tax. Under section 6103(h)(4)(B), such information may be disclosed if the treatment of an item reflected on a return is directly related to the resolution of an issue in the proceeding. Under section 6103(h)(4)(C), such information may be disclosed if the return or return information directly relates to a transactional relationship between a person who is a party to the proceeding and the taxpayer which directly affects the resolution of an issue in the proceeding. Thus, the returns and return information of a nonparty taxpayer may be disclosed if one of these requirements are met. The statute does not require that the nonparty taxpayer be given notice or be consulted prior to disclosure.

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<sup>39</sup> Internal Revenue Service, IRS Legal Memorandum ILM 199

<sup>40</sup> The Integrated Data Retrieval System (commonly referred to as "IDRS") is the IRS' primary computer database for return information.

### **Description of Proposal**

The proposal would require that only the portions of a nonparty return or return information that directly relate to the resolution of an issue in the proceeding would be disclosed in such proceeding. When nonparty returns and return information are to be disclosed under section 6103(h)(4)(B) and (C)<sup>41</sup>, the proposal would require that an effort be made to give notice to the taxpayer prior to the disclosure. The notice would include a statement of the issue or issues for which such return or return information affects resolution. Finally, the nonparty taxpayer would be given an opportunity to request the deletion of certain matters from the return or return information that would be disclosed. For purposes of S corporations, partnerships, estates, and trusts, the notice is to be made at the entity level.

The proposal would not afford a right to intervene or for judicial review of the requested redactions. The notification requirements are not intended to apply to ex parte proceedings for securing a search warrant, orders for entry on premises or safe deposit boxes, or similar ex parte proceedings. The notification requirements would not apply to the disclosure of third party return information by indictment or criminal information. The notice provision is also not intended to apply if it would seriously impair a criminal tax investigation.

### **Effective Date**

The proposal would apply to proceedings commenced after the date of enactment.

### **D. Prohibition of Disclosure of Taxpayer Identification Information with Respect to Disclosure of Accepted Offers-in-Compromise**

#### **Present Law**

Section 6103 permits the IRS to disclose return information to members of the general public to permit inspection of accepted offers in compromise.<sup>42</sup> The IRS makes summaries of the accepted offers in compromise, Form 7249 - Offer Acceptance Report, available for public inspection in the IRS district offices. Currently, this form contains the taxpayer identification number of the taxpayer, e.g., the social security number in the case of an individual taxpayer, along with the taxpayer's name and full address.

### **Description of Proposal**

The proposal would prohibit the disclosure of the taxpayer's address and taxpayer identification number as part of the publicly available summaries of accepted offers in compromise.

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<sup>41</sup> Under the proposal these provisions would be redesignated as clauses ii, and iii of section 6103(h)(4)(A).

<sup>42</sup> Sec. 6103(k)(1).

### Effective Date

The proposal would apply to disclosures made after the date of enactment.

### **E. Compliance By Contractors with Confidentiality Safeguards**

#### Present Law

Section 6103 permits the disclosure of returns and return information to State agencies, as well as to other Federal agencies for specified purposes. Section 6103(p)(4) requires, as conditions of receiving returns and return information, that State agencies (and others) provide safeguards as prescribed the Secretary of the Treasury by regulation to be necessary or appropriate to protect the confidentiality of returns or return information.<sup>43</sup> It also requires that a report be furnished to the Secretary at such time and containing such information as prescribed by the Secretary regarding the procedures established and utilized for ensuring the confidentiality of returns and return information.<sup>44</sup> After an administrative review, the Secretary may take such actions as are necessary to ensure these requirements are met, including the refusal to disclose returns and return information.<sup>45</sup>

Under present law, employees of a State tax agency may disclose returns and return information to contractors for tax administration purposes.<sup>46</sup> These disclosures can be made only to the extent necessary to procure contractually equipment, other property, or the providing of services, related to tax administration.<sup>47</sup>

The contractors can make redisclosures of returns and return information to their employees as necessary to accomplish the tax administration purposes of the contract, but only to contractor personnel whose duties require disclosure.<sup>48</sup> Treasury regulations prohibit redisclosure to anyone other than contractor personnel without the written approval of the IRS.<sup>49</sup>

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<sup>43</sup> Sec. 6103(p)(4)(D).

<sup>44</sup> Sec. 6103(p)(4)(E).

<sup>45</sup> Sec. 6103(p)(4) (flush language) and (7); Treas. Reg. sec. 301.6103(p)(7)-1.

<sup>46</sup> Sec. 6103(n) and Treas. Reg. sec. 301.6103(n)-1(a). “Tax administration” includes “the administration, management, conduct, direction, and supervision of the execution and application of internal revenue laws or related statutes (or equivalent laws and statutes of a State)...” Sec. 6103(b)(4).

<sup>47</sup> Treas. Reg. sec. 301.6013(n)-1(a). Such services include the processing, storage, transmission or reproduction of such returns or return information, the programming, maintenance, repair, or testing of equipment or other property, or the providing of other services for purposes of tax administration.

<sup>48</sup> Treas. Reg. sec. 301.6103(n)-1(a) and (b). A disclosure is necessary if such procurement or the performance of such services cannot otherwise be reasonably, properly, or

By regulation, all contracts must provide that the contractor will comply with all applicable restrictions and conditions for protecting confidentiality prescribed by regulation, published rules or procedures, or written communication to the contractor.<sup>50</sup> Failure to comply with such restrictions or conditions may cause the IRS to terminate or suspend the duties under the contract or the disclosures of returns and return information to the contractor.<sup>51</sup> In addition, the IRS can suspend disclosures to the State tax agency until the IRS determines that the conditions are or will be satisfied.<sup>52</sup> The IRS may take such other actions as deemed necessary to ensure that such conditions or requirements are or will be satisfied.<sup>53</sup>

### **Description of Proposal**

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

This proposal would not alter or affect in any way the right of the IRS to conduct safeguard reviews of State or Federal agency contractors. It also would not affect the right of the IRS to initially approve the safeguard language in the contract and the safeguards in place prior to any disclosures made in connection with such contracts.

### **Effective Date**

The proposal would be effective for disclosures made after December 31, 2002. The first certification is required to be made with respect to calendar year 2003.

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economically accomplished without such disclosure. Treas. Reg. sec. 301.6103(n)-1(b). The regulations limit the quantity of information to that needed to perform the contract.

<sup>49</sup> Treas. Reg. sec. 301.6103(n)-1(a).

<sup>50</sup> Treas. Reg. sec. 301.6103(n)-1(d).

<sup>51</sup> Treas. Reg. sec. 301.6103(n)-1(d)(1).

<sup>52</sup> Treas. Reg. sec. 301.6103(n)-1(d)(2).

<sup>53</sup> Treas. Reg. sec. 301.6103(n)-1(d).

## F. Higher Standards for Requests for and Consents to Disclosure

### Present Law

Under section 6103(c), a taxpayer may designate in a request or consent to the disclosure by the IRS of his or her return or return information to a third party. Treasury regulations set forth the requirements for such consent.<sup>54</sup> The Treasury regulations require that the taxpayer sign and date the consent. The taxpayer must also indicate in the written document (1) the taxpayer's taxpayer identity information; (2) the identity of the person to whom disclosure is to be made; (3) the type of return (or specified portion of the return) or return information (and the particular data) that is to be disclosed; and (4) the taxable year covered by the return or return information. The regulations also require that the consent be submitted within 60 days of the date signed and dated, however, at the time of submission, the IRS generally is unaware of whether a consent form was completed or dated after the taxpayer signs it. Present law does not require that a recipient receiving returns or return information by consent maintain the confidentiality of the information received. Under present law, the recipient is also free to use the information for purposes other than for which the information was solicited from the taxpayer.

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

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

Ostensibly to avoid confusion over why the taxpayer would be authorizing a party other than the originator to receive his tax return, the taxpayer may be asked to sign a blank Form 4506 at closing. In some cases, mortgage originators ask taxpayers not to date the Form 4506. This allows the form to be submitted to the IRS at a later date, often months or years later, for purposes of mortgage resale.

Under section 7206, it is a felony to willfully make and subscribe any document that contains or is verified by a written declaration that it is made under penalties of perjury and which such person does not believe to be true and correct as to every material matter.<sup>55</sup> Upon

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<sup>54</sup> Treas. Reg. sec. 301.6103(c)-1.

<sup>55</sup> Sec. 7206(1).

conviction, such person may be fined up to \$100,000 (\$500,000 in the case of a corporation) or imprisoned up to 3 years, or both, together with the costs of prosecution.

### **Description of Proposal**

The proposal would render invalid a consent that does not designate a recipient or is not dated at the time of execution. The person submitting the consent to the IRS would be required to verify under penalties of perjury that the form was complete and dated at the time it was signed by the taxpayer. Inspection or disclosure of a return or return information pursuant to an invalid consent would be unauthorized under section 6103. Thus, a person making such unauthorized disclosure or inspection could be liable for civil damages under section 7431, and criminal penalties under section 7213 or 7213A for willful unauthorized disclosure or inspection. It is not intended to validate consents that do not otherwise comply with the Treasury regulations. For example, a consent that does not contain tax years or type of tax at the time of execution is not valid, and this proposal would not authorize disclosures pursuant to such consents.

The proposal would require the consent form prescribed by the IRS to contain a warning, prominently displayed, informing the taxpayer that he or she should not sign the form unless it is complete. The proposal would require the consent form to state that if the taxpayer believes there is an attempt to coerce him to sign and incomplete or blank form, the taxpayer should report the matter to the Treasury Inspector General for Tax Administration. The telephone number and address for the Treasury Inspector General for Tax Administration would be included on the form. Under the proposal, all third parties receiving returns and return information by consent would be required to: (1) ensure that the information received will be kept confidential; (2) use the information only for the purpose for which it was requested; and (3) not further disclose the information except to accomplish that purpose, unless a separate consent from the taxpayer is obtained.

The Treasury Inspector General for Tax Administration would be required to submit a report to Congress on compliance with the designation and certification requirements no later than 18 months after the date of enactment. Such report would evaluate (on the basis of random sampling) whether the proposal is achieving its purpose, whether requesters and submitters are continuing to evade the purpose of the proposal, whether the sanctions are adequate, and such recommendations as considered necessary or appropriate to better achieve the purposes of the proposal.

### **Effective Date**

The provision applies to requests and consents made after 3 months after the date of enactment.



## **G. Notice to Taxpayer Concerning Administrative Determination of Browsing; Annual Report**

### **Present Law**

Present law requires the IRS to notify a taxpayer that an unlawful disclosure or inspection of the taxpayer's return or return information has occurred when the offender has been charged by criminal indictment or information.<sup>56</sup> If the offender is not so charged, present law does not require the IRS to give notice to the taxpayer, even though the Treasury Inspector General for Tax Administration has concluded that an inspection or disclosure in violation of section 6103 has occurred.

The IRS is required under present law to provide, for disclosure to the public, an annual report to the Joint Committee on Taxation regarding authorized disclosures of returns and return information.<sup>57</sup> The IRS is not required to submit a report to Congress on unauthorized disclosures or inspections of returns and return information.

### **Description of Proposal**

Under the proposal, the IRS would be required to notify a taxpayer at the point the Treasury Inspector General for Tax Administration determines that a taxpayer's return or return information has been disclosed or inspected without authorization. The proposal further requires the IRS to provide information on unauthorized disclosures or inspections of return and return information in its public annual report to the Joint Committee on Taxation.

### **Effective Date**

The proposal would be effective upon date of enactment as it relates to notifying the taxpayer of determinations of an unlawful disclosure or inspection. As to the annual report requirement, the provision would be effective for calendar years ending after the date of enactment.

## **H. Disclosure Regarding Suicide Threats**

### **Present Law**

The Code permits the IRS to disclose return information to the extent necessary to apprise Federal or State law enforcement officials of circumstances involving an imminent danger of death or physical injury.

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<sup>56</sup> Sec. 7431(e).

<sup>57</sup> See sec. 6103(p)(3)(C).

### **Description of Proposal**

The proposal would expand this provision to permit disclosure to local law enforcement authorities.

### **Effective Date**

The proposal would be effective on the date of enactment.

## **I. Disclosure of Taxpayer Identity for Tax Refund Purposes**

### **Present Law**

When the IRS is unable to find a taxpayer due a refund, present law provides that the IRS may use “the press or other media” to notify the taxpayer of the refund.<sup>58</sup> Section 6103(m) allows the IRS to give the press taxpayer identity information for this purpose.<sup>59</sup>

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

### **Description of Proposal**

The proposal would allow the IRS to use any means of “mass communication,” including the Internet, to notify the taxpayer of an undelivered refund.

### **Effective Date**

The proposal would be effective upon date of enactment.

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<sup>58</sup> Sec. 6103(m)(1). This section provides:

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

<sup>59</sup> Sec. 6103(m)(1), and (b)(6) (definition of “taxpayer identity”).

## V. MISCELLANEOUS PROVISIONS

### A. Clarification of Definition of Church Tax Inquiry

#### Present Law

Under present law, the IRS may begin a church tax inquiry only if the IRS regional commissioner (or a higher official) reasonably believes, on the basis of facts and circumstances recorded in writing, that an organization (1) may not qualify for tax exemption as a church, (2) may be carrying on an unrelated trade or business, or (3) otherwise may be engaged in taxable activities.<sup>60</sup> A church tax inquiry is defined as any inquiry to a church (other than an examination) that serves as a basis for determining whether the organization qualified for tax exemption as a church or whether it is carrying on an unrelated trade or business or otherwise is engaged in taxable activities. An inquiry is considered to commence when the IRS request information or materials from a church or a type contained in church records, other than routine requests for information or inquiries regarding matters that do not primarily concern the tax status or liability of the church itself.

#### Description of Proposal

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

#### Effective Date

The proposal would be effective on the date of enactment.

### **B. Extension of Declaratory Judgment Procedures to Non-501(c)(3) Tax-Exempt Organizations and Failure of IRS to Act on Determinations Treated as Exhaustion of Remedies**

#### Present Law

In order for an organization to be granted tax exemption as a charitable entity described in section 501(c)(3), it generally must file an application for recognition of exemption with the IRS and receive a favorable determination of its status. Similarly, for most organizations, a charitable organization's eligibility to receive tax-deductible contributions is dependent upon its receipt of a favorable determination from the IRS. In general, a section 501(c)(3) organization can rely on a determination letter or ruling from the IRS regarding its tax-exempt status, unless there is a material change in its character, purposes, or methods of operation. In cases in which an organization violates one or more of the requirements for tax exemption under section

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<sup>60</sup> Sec. 7611.

501(c)(3), the IRS is authorized to revoke an organization's tax exemption, notwithstanding an earlier favorable determination.

In situations in which the IRS denies an organization's application for recognition of exemption under section 501(c)(3) or fails to act on such application, or in which the IRS informs a section 501(c)(3) organization that it is considering revoking or adversely modifying its tax-exempt status, present law authorizes the organization to seek a declaratory judgment regarding its tax status (sec. 7428). Section 7428 provides a remedy in the case of a dispute involving a determination by the IRS with respect to: (1) the initial qualification or continuing qualification of an organization as a charitable organization for tax exemption purposes or for charitable contribution deduction purposes; (2) the initial classification or continuing classification of an organization as a private foundation; (3) the initial classification or continuing classification of an organization as a private operating foundation; or (4) the failure of the IRS to make a determination with respect to (1), (2), or (3). A "determination" in this context generally means a final decision by the IRS affecting the tax qualification of a charitable organization, although it also can include a proposed revocation of an organization's tax-exempt status or public charity classification. Section 7428 vests jurisdiction over controversies involving such a determination in the U.S. District Court for the District of Columbia, the U.S. Court of Federal Claims, and the U.S. Tax Court.

Prior to utilizing the declaratory judgment procedure, an organization must have exhausted all administrative remedies available to it within the IRS. An organization is deemed to have exhausted its administrative remedies at the expiration of 270 days after the date on which the request for a determination was made if the organization has taken, in a timely manner, all reasonable steps to secure such determination.

If an organization (other than a section 501(c)(3) organization) files an application for recognition of exemption and receives a favorable determination from the IRS, the determination of tax-exempt status is usually effective as of the date of formation of the organization if its purposes and activities during the period prior to the date of the determination letter were consistent with the requirements for exemption. However, if the organization files an application for recognition of exemption and later receives an adverse determination from the IRS, the IRS may assert that the organization is subject to tax on some or all of its income for open taxable years. In addition, as with charitable organizations, the IRS may revoke or modify an earlier favorable determination regarding an organization's tax-exempt status.

Under present law, a non-charity (i.e., an organization not described in section 501(c)(3)) may not seek a declaratory judgment with respect to an IRS determination regarding its tax-exempt status. The only remedies available to such an organization are to petition the U.S. Tax Court for relief following the issuance of a notice of deficiency or to pay any tax owed and sue for refund in federal district court or the U.S. Court of Federal Claims.

### **Description of Proposal**

The proposal would extend declaratory judgment procedures similar to those currently available only to charities under section 7428 to other section 501(c) determinations. The

proposal would limit jurisdiction over controversies involving such determinations to the United States Tax Court.<sup>61</sup>

In addition, the proposal would modify the present-law declaratory judgment procedures to provide that an organization is deemed to have exhausted its administrative remedies under the declaratory judgment procedures at the expiration of (1) 270 days after the date on which the request for a determination was made, or (2) in the case of a failure by any office of the IRS to make a determination (other than the office responsible for initial determinations with respect to the issue), 450 days after the date on which the request for a determination was made. The proposal would also require the organization to take, in a timely manner, all reasonable steps to secure such determination.

### **Effective Date**

The extension of the declaratory judgment procedures to organizations other than section 501(c)(3) organizations would be effective for pleadings with respect to determinations made after the date of enactment. The proposal modifying the time that an organization is deemed to have exhausted its administrative remedies would be effective on the date of enactment.

## **C. Employee Misconduct Report to Include Summary of Complaints by Category**

### **Present Law**

The Treasury Inspector General for Tax Administration is subject to the semi-annual reporting requirements set forth in section 5 of the Inspector General Act of 1978. Under present law, reports are made to the Committees on Government Reform and Oversight and Ways and Means in the House of Representatives and the Committees on Governmental Affairs and Finance in the Senate. Each semi-annual report is required to include 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 Inspector General for Tax Administration.

### **Description of Proposal**

The proposal would modify the semi-annual reporting requirement for the Treasury Inspector General for Tax Administration to require that the reporting with respect to allegations of serious IRS employee misconduct include a summary (by category) of the 10 most common complaints made and the number of such common complaints (by category).

### **Effective Date**

The proposal would be effective for reporting periods ending after the date of enactment.

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<sup>61</sup> This limitation currently applies to declaratory judgments relating to tax qualification for certain employee retirement plans (sec. 7476).

## **D. Annual Report on Awards of Costs and Certain Fees in Administrative and Court Proceedings**

### **Present Law**

The Code requires that the IRS pay a taxpayer's reasonable administrative and litigation expenses under specified circumstances.<sup>62</sup> Among other requirements, the IRS is not required to pay these amounts if the IRS can demonstrate that its position was substantially justified.

### **Description of Proposal**

The proposal would require TIGTA to publish annually statistics on the number of payments (whether as a result of a settlement or judicial decision) made pursuant to section 7430 and the amount of each such payment. TIGTA would also be required to publish an analysis of the administrative issues that gave rise to the necessity of making these payments and the changes (if any) that will be implemented by the IRS as a result of TIGTA's analysis, as well as any other changes that TIGTA recommends on the basis of its analysis. This would permit the Congress to assess the extent to which the IRS may be inappropriately pursuing an issue and to pursue potential remedies to alleviate this problem.

### **Effective Date**

The first annual report would be required for fiscal year 2002. The reports must be published no later than three months following the close of the fiscal year.

## **E. Annual Report on Abatements of Penalties**

### **Present Law**

Some penalties in the Code are imposed automatically (such as for failure to file or failure to pay), while others are imposed in response to the specific factual situation presented on a tax return (such as negligence). In addition, some penalties can be abated automatically, while others are abated in response to a specific factual presentation made by the taxpayer. In general, most penalties can be abated for reasonable cause, but the details of what constitutes reasonable cause can vary somewhat from penalty to penalty as a reflection of the differences in the types of behaviors that the different penalties are designed to deter.

### **Description of Proposal**

The proposal would require TIGTA to report to the Congress annually on penalty abatements and the reasons and criteria for abatements. Better statistical information will enable more rigorous analysis of the systems to occur, which will provide the opportunity for problems to surface and be dealt with in a systematic manner.

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<sup>62</sup> Sec. 7430.

### **Effective Date**

The first annual report would be required for fiscal year 2002. The reports must be provided to the Congress no later than six months following the close of the fiscal year.

## **F. Better Means of Communicating with Taxpayers**

### **Present Law**

The IRS generally communicates with taxpayers (or their designated representatives) in one of three methods: by mail, by telephone, or in person. Many telephone or in person contacts are initiated by the taxpayer, whereas many mail contacts are initiated by the IRS.

### **Description of Proposal**

The proposal would require TIGTA to issue a report to the Congress evaluating whether technological advances, such as e-mail and the fax, permit the utilization of alternate means of communicating with taxpayers to eliminate some of the difficulties with the present system.

### **Effective Date**

The report must be issued no later than 18 months after the date of enactment.

## **G. Information Regarding Statute of Limitations**

### **Present Law**

In general, a taxpayer must file a refund claim within three years of the filing of the return or within two years of the payment of the tax, whichever period expires later (if no return is filed, the two-year limit applies).<sup>63</sup> A refund claim that is not filed within these time periods is rejected as untimely.

A special rule applies during periods of disability. Equitable tolling of the statute of limitations for refund claims of an individual taxpayer applies during any period in which an individual 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. Equitable 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.

There is no requirement that IRS publications contain information that both describes this statute of limitations provision and explains the consequences of failing to file within the time period prescribed by the statute of limitations.

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<sup>63</sup> Sec. 6511(a).

### **Description of Proposal**

The proposal would require the IRS to revise Publication 1 (“Your Rights as a Taxpayer”) by adding an explanation of the consequences of failing to file within the time period prescribed by the statute of limitations to the section on refunds that describes the statute of limitations. The proposal also would require the IRS to revise the instructions that accompany all of the Form 1040 packages (including 1040A and 1040EZ) in a similar manner to add a description of this statute of limitations and an explanation of the consequences of failing to file within the time period prescribed by the statute of limitations.

### **Effective Date**

The revisions to Publication 1 would be required to be made as soon as practicable, but not later than 180 days after the date of enactment. The revisions to the Form 1040 instructional packages would be required to be made for instructions for taxable years beginning after December 31, 2001.

## **H. Amendment to Treasury Auction Reforms**

### **Present Law**

Member of the Treasury Borrowing Advisory Committee are prohibited from disclosing anything relating to the securities to be auctioned in a midquarter refunding by the Secretary until the Secretary makes a public announcement of the refunding.<sup>64</sup>

### **Description of Proposal**

The proposal would permit earlier disclosure upon the release by the Secretary of the minutes of the meeting.

### **Effective Date**

The proposal would apply to meetings held after the date of enactment.

## **I. Enrolled Agents**

### **Present Law**

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

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<sup>64</sup> Sec. 202(c)(4)(B) of the Government Securities Act Amendments of 1993.



### **Description of Proposal**

The proposal would add a new section to the Code permitting the Secretary to prescribe regulations to regulate the conduct of enrolled agents in regard to their practice before the IRS and to permit enrolled agents meeting the Secretary's qualifications to use the credentials or designation "enrolled agent", "EA", or "E.A."

### **Effective Date**

The proposal would be effective on the date of enactment.

## **VI. AUTHORIZATION OF APPROPRIATION**

### **A. Low-Income Taxpayer Clinics**

#### **Present Law**

The Code provides that the Secretary is authorized to provide up to \$6 million per year in matching grants to certain low-income taxpayer clinics.

#### **Description of Proposal**

The proposal would increase this authorization to \$9 million for 2002, to \$12 million for 2003, and to \$15 million for 2004 and thereafter. The proposal would specify that grants may not be used for any purpose other than those specified in the Code (this restriction would be inapplicable to funds from other sources). The proposal would also authorize the IRS to promote the benefits and encourage the use of low-income taxpayer clinics.

#### **Effective Date**

The proposal would be effective on the date of enactment.