**ADDITIONAL OPTIONS TO IMRPOVE TAX COMPLIANCE**

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

August 3, 2006

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# I. IMPROVED INFORMATION REPORTING

## A. Impose Basis Reporting Requirements for Publicly-Traded Securities

### Present Law

**In general**

Gain or loss generally is recognized for Federal income tax purposes upon realization of that gain or loss (e.g., through the sale of property giving rise to the gain or loss). The taxpayer's gain or loss upon a disposition of property is the difference between the amount realized and the adjusted basis.[1]

To compute adjusted basis, a taxpayer must first determine the property's unadjusted or original basis and then make adjustments prescribed by the Code.[2] The original basis of property is its cost, except as otherwise prescribed by the Code (e.g., in the case of property acquired by gift or bequest or in a tax-free exchange). Once determined, the taxpayer's original basis generally is adjusted downward to take account of depreciation or amortization, and generally is adjusted upward to reflect income and gain inclusions or capital outlays with respect to the property.

**Information reporting**

Present law imposes information reporting requirements on participants in certain transactions. These requirements are intended to enable the Internal Revenue Service ("IRS") to determine whether taxpayers' tax returns are correct and complete. For example, every person engaged in a trade or business generally is required to file information returns for each calendar year for payments of $600 or more made in the course of the payor's trade or business.[3]

Section 6045(a) requires brokers to file with the IRS annual information returns showing the gross proceeds realized by customers from various sale transactions. The Secretary is authorized to require brokers to report additional information related to customers.[4] Brokers are required to furnish to every customer information statements with the same gross proceeds information that is included in the returns filed with the IRS for that customer.[5] In a real estate sale the person responsible for closing the sale, the mortgage lender, the seller's broker, or the buyer's broker (in that order) is required to report the gross proceeds from the sale unless, in

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[1] Sec. 1001. All section references are to the Internal Revenue Code of 1986 (the "Code") unless otherwise indicated.

[2] Sec. 1016.

[3] Sec. 6041(a).

[4] Sec. 6045(a).

[5] Sec. 6045(b).

general, the sale is of a principal residence and the gross proceeds are $250,000 or less ($500,000 in the case of a sale by a married seller).[6]

A person who is required to file information returns but who fails to do so by the due date for the returns, includes on the returns incorrect information, or files incomplete returns generally is subject to a penalty of $50 for each return with respect to which such a failure occurs, up to a maximum of $250,000 in any calendar year.[7] Similar penalties, with a $100,000 calendar year maximum, apply to failures to furnish correct information statements to recipients of payments for which information reporting is required.[8]

Present law does not require information reporting with respect to a taxpayer's basis in property but does impose an obligation to keep records, as described below.

**Basis recordkeeping requirements**

Present law imposes an obligation on taxpayers to "keep such records . . . as the Secretary may from time to time prescribe."[9] Treasury regulations impose recordkeeping requirements on any person required to file information returns.[10]

Treasury regulations provide that donors and donees should keep records that are relevant in determining a donee's basis in property.[11] IRS Publication 552 states that taxpayers "should keep" basis records for their homes. The same IRS publication states that basis records should be kept until the period of limitations expires for the year in which the taxpayer disposes of the property.

If a taxpayer does not keep adequate records, the absence of those records may be used as evidence that, if they had been available, the records would have contradicted the taxpayer's assertions.[12]

**Basis computation rules**

If a taxpayer has acquired lots of stock in a corporation on different dates or at different prices and sells or transfers some of the shares of that stock, and the lot from which the stock is

[6] Sec. 6045(e).

[7] Sec. 6721.

[8] Sec. 6722.

[9] Sec. 6001.

[10] Treas. Reg. sec. 1.6001-1(a).

[11] Treas. Reg. sec. 1.1015-1(g).

[12] E.g., *Schooler v. Commissioner*, 68 T.C. 867 (1977) (failure to substantiate alleged gambling losses).

sold or transferred is not adequately identified, the shares deemed sold are the earliest acquired shares (the "first-in-first-out rule").[13] If a taxpayer makes an adequate identification of shares of stock that it sells, the shares of stock treated as sold are the shares that have been identified.[14] A taxpayer who owns shares in a regulated investment company ("RIC") generally is permitted to elect, in lieu of the specific identification or first-in-first-out methods, to determine the basis of RIC shares sold under one of two average cost basis methods described in Treasury regulations.[15]

## Compliance Issue

Studies suggest that the misreporting of tax basis contributes to the tax gap.[16] The lack of a present-law information reporting requirement for tax basis creates the opportunity for inadvertent and intentional overstatement of basis in connection with the reporting of gains and losses on investments.[17] Individual taxpayers in particular might not keep records as extensively as business taxpayers, making it more difficult for them to know the tax basis of assets they sell. Noncompliance relating to the misstatement of basis and the erroneous determination of gain or loss not only results in significant revenue loss, but also undermines the integrity of the tax

[13] Treas. Reg. sec. 1.1012-1(c)(1).

[14] Treas. Reg. sec. 1.1012-1(c).

[15] Treas. Reg. sec. 1.1012-1(e).

[16] The tax gap is the amount of tax that is imposed by law for a given tax year but is not paid voluntarily and timely. The IRS has estimated that the net tax gap for 2001 was $290 billion and that the gross tax gap was $345 billion. Internal Revenue Service, *IRS Updates Tax Gap Estimates,* IR-2006-28, Feb. 14, 2006. Underreporting of individual income tax accounted for $190 billion of the gross tax gap, and $11 billion of that individual underreporting involved capital gain. *Id.* (in a document entitled "Tax Gap Figures"). This $11 billion underreporting of capital gain amounted to a "net misreporting percentage" – the amount of underreported income expressed as a percentage of the total amount that should have been reported – of 12 percent. *Id.* By contrast, the net misreporting percentage for wages, salaries, and tip income was estimated to be one percent, and the estimated net misreporting percentage for interest income and dividend income was four percent. *Id.* Two academics have evaluated various tax gap studies and concluded that the annual revenue loss from basis overstatement and gain omission could be as much as $60 billion. Joseph M. Dodge and Jay A. Soled, *Debunking the Basis Myth Under the Income Tax,* Indiana Law Journal, vol. 81 (Spring 2006) at 579-82.

[17] In a recent study, the Governmental Accountability Office ("GAO") reported that "taxpayers often misreported their capital gains or losses from securities sales because they failed to accurately report the securities' basis." Government Accountability Office, *Capital Gains Tax Gap: Requiring Brokers to Report Securities Cost Basis Would Improve Compliance if Related Challenges Are Addressed,* GAO-06-603, June 2006, at 10 ("GAO report"). Although most taxpayers misreporting capital gains from securities sales underreport their income, some taxpayers overstate their income. The GAO estimated that in 2001, 64 percent of taxpayers who in some way misreported securities sales underreported their income (either by understating gains or overstating losses) and that 33 percent overreported income (by overstating gains or understating losses). (The figures do not add to 100 percent because some taxpayers included in the sample misreported securities sales in a manner that did not affect the amount of income from the sales – for example, by misstating holding periods.) *Id.* at 12.

system. Imposing a basis reporting requirement, where administratively feasible, should ameliorate the problems of inadvertent and intentional basis misreporting. A reporting requirement should increase the accuracy of gain and loss measurement and should reduce the tax gap. Moreover, a basis reporting requirement should benefit taxpayers by eliminating, in many cases, the need for taxpayers to perform complicated tax basis calculations.[18]

Many brokers and dealers already maintain records for the publicly-traded securities of owned by their customers. These records include initial cost basis and adjustments to that basis required by subsequent events such as stock splits and mergers or divisions. In many cases, therefore, substantial improvements to the accuracy of gain measurement might be accomplished without imposing burdensome administrative requirements.

## Description of Proposal

Under the proposal, in every case in which a person (a "broker") is required under present law to report gross proceeds under section 6045(a) and (b), that broker is required to report to the IRS a customer's adjusted basis in publicly-traded securities sold during the preceding taxable year. Every broker also is required to furnish to its customers information statements showing the same basis information that is included for those customers in returns filed with the IRS.

Special rules address the application of the reporting requirements to a sale of securities in which the broker executing the sale did not execute the original purchase. In such a sale, the broker is permitted to rely on basis information provided by other persons, and it is expected that the return filed with the IRS and the information statements filed with customers will indicate this reliance. When securities are transferred from an account with one broker (the "transferring broker") to an account with another broker (the "transferee broker"), the transferring broker is required to furnish the transferee broker with information sufficient to report the bases of the securities upon a subsequent sale of those securities. When a taxpayer initially acquires securities other than through a broker – for example, by gift or by purchasing the securities directly from the issuing company – and later transfers those securities into a brokerage account, the taxpayer is required to furnish basis information to the transferee broker.

Brokers that are required under the proposal to file information returns and to furnish information statements are subject to penalties for failure to comply with the reporting requirements. The penalties to which they are subject are the penalties under present law sections 6721 (failure to file correct information returns) and 6722 (failure to furnish correct payee statements). Taxpayers and transferor brokers are subject to similar penalties for failure to

[18] In part for the reasons described in the accompanying paragraph, recent government reports have suggested basis reporting requirements. GAO report at 33 (stating that Congress "may want to consider requiring brokers to report to both taxpayers and IRS the adjusted basis of securities that taxpayers sell . . ."); National Taxpayer Advocate, *2005 Annual Report to Congress*, Publication 2104 (Rev. 12-2005), at 433-41 (recommending that Congress (1) amend section 6045(a) to authorize the Secretary to prescribe regulations requiring brokers to report to the IRS adjusted basis information in connection with stock and mutual fund sales, and (2) require a broker to provide to a successor broker a customer's basis in mutual fund and stock holdings when those holdings are transferred from the first broker to the second).

furnish correct basis information to transferee brokers. Liability for failure to file correct income tax returns (by, for example, reporting incorrect basis information) is the same as under present law.

"Securities" are defined as any (1) share of stock in a corporation (including a mutual fund); (2) partnership or beneficial ownership interest (including an interest in a limited liability company, real estate investment trust, or similar pass-through entity); (3) note, bond, debenture, or other evidence of indebtedness; (4) evidence of an interest in, or a derivative financial instrument in, any security described in (1) through (3) above, including any option, futures contract, short position, and any similar financial instrument in such a security. A security is "publicly traded" if it is bought and sold on an established securities market.

The proposal modifies the basis computation rules of Treasury Regulations section 1.1012-1 (the first-in-first-out, specific identification, and average cost basis rules). Under the modification, the basis of securities sold from any single brokerage, RIC, or other account held by the taxpayer is determined by reference only to securities held in that account even where the taxpayer owns the same securities in other accounts.

Certain reporting requirements may be provided to ensure that brokers receive information from issuers of securities sufficient to permit accurate basis computations.

Consideration may need to be given to whether the proposal's basis reporting requirements should apply to transactions involving qualified retirement plans, individual retirement arrangements, qualified tuition plans, and similar tax-favored arrangements. To the extent the requirements should apply, coordination with existing reporting rules may be necessary.

Effective date.–The proposal is effective for transactions involving securities first purchased by the taxpayer at least 18 months after date of enactment.

## Discussion

### In general

Although accurate information regarding tax basis is critical to the proper measurement and reporting of gains and losses, present law does not impose tax basis reporting requirements.[19] Intermediaries such as brokers must report the gross proceeds taxpayers receive from the sale of capital gain property, but there is no requirement that basis information with respect to that property be reported to the IRS or taxpayers. Thus, the information the IRS now receives is of limited value for purposes of determining whether gain or loss is properly reported.

Although present law imposes an obligation on taxpayers to keep the records necessary to determine tax liability, there is no explicit duty to keep basis records. Although many taxpayers may make reasonable attempts to maintain records relating to tax basis, many may not do so.

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[19] Bills that impose basis reporting requirements have been introduced in the 109th Congress. See S. 2414 (introduced by Sen. Bayh); H.R. 5367 (introduced by Mr. Emanuel).

The longer a taxpayer's holding period in property, the less likely it is that the records necessary to determine tax basis will have been retained.

Determining the adjusted tax basis of property often requires taxpayers to have knowledge of complex tax rules. For example, in the case of a change in the structure of a corporation (e.g., a spin-off, recapitalization, or merger), taxpayers may end up with stock of one or more corporations other than, or in addition to, the shares of the initial corporation. In these cases, the taxpayer's original basis may need to be reallocated among the resulting shares. Even though a taxpayer may need to make complicated basis adjustments, there often is no taxable event before sale that would require the taxpayer to compute basis. When taxpayers sell property that has been subject to basis adjustments, they may need professional tax advice to calculate accurately gain or loss from the sale.

**Improved compliance and reduced taxpayer burdens**

Applying information reporting systems to a broad range of transactions should improve tax compliance. Research has shown that noncompliance and error rates are lower when reporting systems simultaneously provide taxpayers and the IRS similar information statements about the taxpayers' income.[20] For example, when interest and dividends became subject to information reporting, the noncompliance rate appears to have declined significantly.[21] Imposing a basis reporting requirement for publicly-traded securities could be expected to provide similar benefits in part by allowing the IRS to perform data matches for capital gain from securities subject to the proposal.[22]

The proposal also will lower individual taxpayers' administrative burdens and will not necessarily create equivalent burdens for financial intermediaries subject to the new reporting requirement. It can be expected that these financial intermediaries generally are more sophisticated in financial matters than are individual taxpayers. The intermediaries also might achieve economies of scale by spreading across all their customer accounts the administrative costs of calculating and tracking basis. Individuals who might lack financial sophistication and who are unable to take advantage of economies of scale will face noticeably reduced burdens

[20] See *IRS Updates Tax Gap Estimates, supra* note 16 (finding, among other things, that the net misreporting percentages for individual capital gains and for nonfarm individual proprietor income, two categories for which there is little mandatory third-party reporting, were, respectively, 12 percent and 57 percent in 2001, whereas the net misreporting percentage for wages, salaries, and tips, for which there is reporting by employers, was one percent). See also GAO Testimony before the Subcommittee on Taxation and IRS Oversight, Committee on Finance, *Opportunities Exist to Reduce the Tax Gap Using a Variety of Approaches*, GAO-06-1000T (July 26, 2006).

[21] As described above, in 2001 the net misreporting percentage for interest and dividend income of individuals, which is reported by payors to individuals on IRS Form 1099, was estimated to be four percent. *IRS Updates Tax Gap Estimates, supra* note 16. In contrast, as also described previously, compliance for individuals with income not subject to either withholding or withholding is significantly less.

[22] The extent to which the IRS could perform data matching shortly after the enactment of the proposal is uncertain.

under the proposal because they generally will be able transfer to their tax returns the basis information provided by brokers.[23]

## Taxpayer behavior and broker compliance costs

The proposed basis reporting rules apply only to publicly-traded securities largely because taxpayers typically acquire and hold these securities through intermediaries,[24] and, as described below, many intermediaries already maintain basis information for the securities. Taxpayers may not acquire and hold other assets, such as real estate or equipment, through third parties to the same extent, and when brokers participate in transactions involving these other assets, for example, in the sale of a home, they do not normally keep track of taxpayers' basis over time. A third-party basis reporting requirement for assets other than publicly-traded securities therefore could end up applying to a relatively small percentage of those assets and, when it did apply, it could create larger administrative burdens for intermediaries than does the proposal.

It might be argued that confining the proposal to publicly-traded securities will distort taxpayers' investment behavior. Taxpayers who want to avoid having basis information filed with the IRS may choose to buy assets other than publicly-traded securities.[25] Non-tax considerations might, however, limit distortions of behavior. For example, in some cases there may be no close substitutes for the otherwise desired publicly-traded securities. Possible distortions must be weighed against the benefits of the proposal.

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[23] Individuals will, however, remain subject to the rules under present law applicable to errors on tax returns. Under these rules a taxpayer generally is not subject to an accuracy-related penalty if the taxpayer relied on erroneous information reported on a Form 1099 (or other information return such as a Form W-2) so long as the taxpayer did not know or have reason to know that the information was incorrect. Treas. Reg. sec. 1.6664-4(b)(1).

[24] In a 2005 survey, 22 percent of equity investors owning equities outside employer plans reported having purchased the equities solely from direct sources such as direct stock purchase plans. Forty-one percent reported having purchased equities solely through professional financial advisers, and 36 percent reported having bought equities both through financial advisers and from direct sources. Investment Company Institute and the Securities Industry Association, *Equity Ownership in America, 2005* (2005) at 37. Even when individuals buy stock from direct sources, the purchase often is made through a firm considered to be a broker under section 6045. See note 24, *infra.*

[25] Taxpayers also might choose to buy securities directly from issuers rather than through brokers. Taxpayers could avoid having basis reported on a subsequent sale of those securities only if the sale were not effected through a broker, and it may be difficult (and, in some cases, impossible) to engage in a sale without a broker. For example, many companies offer their stock to the public through direct stock purchase plans that are administered by stock transfer agents such as Computershare (formerly EquiServe). Sales of stock acquired through these plans are made through the transfer agents. These transfer agents generally are brokers subject to the reporting requirements of section 6045. See Treas. Reg. sec. 1.6045-1(b), Example 1(iv). Anecdotal evidence suggests that, as with many brokerage firms, these transfer agents often offer basis reporting as a service to customers.

Opponents also might argue that the proposal will create undue burdens on brokers. In the early 1990s several House of Representatives bills included provisions that would have required mutual funds to report the basis of shares sold by their customers.[26] This reporting requirement never was enacted into law, in part because of objections from the securities industry that it would have been difficult to comply with the requirement. Brokerage firms' technology has improved significantly since the early 1990s. In the early 1990s many brokerage firms reported that they did not keep basis information because of limited computer storage capabilities. Now, many firms provide basis information as a courtesy to their customers -- both in regular account statements and in annual information reports. Many brokerage firms also use a service, Cost-Basis Reporting Service ("CBRS"), offered by the Depository Trust & Clearing Corporation ("DTCC") for transferring basis information between brokers when securities are transferred from one broker to another.[27] In spite of improvements in technology, opponents of the proposal might argue the proposal will create significant burdens. Not all large brokerage firms currently provide cost basis information to customers. Consumer demand, however, is causing those firms to undertake effort to offer basis information. Small brokerage firms and, because of issues (such as the availability of the average cost basis method of reporting shares sold) unique to the industry, mutual funds in particular might encounter administrative and cost difficulties.[28]

To eliminate the administrative burden of determining and reporting basis on sales of property acquired before the effective date and to provide the industry a transition period to implement the necessary systems, the proposal applies only for transactions involving securities first purchased by the taxpayer at least 18 months after the date of enactment.

**Special circumstances**

The Joint Committee staff is aware of various circumstances that can cause the basis amounts reported by brokerage firms and RICs to customers to be inaccurate. These

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[26] H.R. 2735, 102nd Cong., 1st Sess. (1991); H.R. 11, 102nd Cong., 2nd Sess. (1992); H.R. 13, 103rd Cong., 1st Sess. (1993).

[27] DTCC began offering CBRS in early 2003 to firms using its Automated Customer Account Transfer Service ("ACATS"). The majority of brokerage firms use ACATS, and the response to CBRS has been "enthusiastic." Edilyn Meringolo, "Cost-Basis Information: The Bane of the Broker's Existence," *Registered Rep Magazine* (March 1, 2005).

[28] To address concerns about undue burdens on small brokers, an exclusion from the basis reporting requirements for brokers with revenues under a certain threshold could be considered. Any exclusion might not affect a significant portion of financial assets. In 2005, 37 percent of mutual fund assets were held with the five largest fund complexes; 48 percent of assets were held at the 10 largest complexes; and 71 percent of assets were held at the 25 largest complexes. Investment Company Institute, *2006 Investment Company Fact Book* (2006) at 13. While no similar data has been found for individual corporate stock, 47 percent of shareholders owning individual stock in 2002 reported owning it through a full-service brokerage firm. Investment Company Institute and the Securities Industry Association, *Equity Ownership in America* (2002) at 47. A significant portion of this stock can be expected to be held through large, full-service firms. An exclusion for small brokers and mutual funds might, however, encourage taxpayers to shift investments to these small companies.

circumstances include, among numerous others, when (1) a taxpayer sells securities in a transaction determined to be a wash sale under section 1091 and (2) a corporation or RIC makes a distribution that is later determined to constitute, wholly or partially, a return of shareholders' capital. Joint Committee staff is attempting to determine the frequency and magnitude of inaccuracies in basis record-keeping. Based on the extent of basis inaccuracies, special rules for particular circumstances may be warranted. Many of the circumstances that contribute to inaccurate basis recordkeeping, however, might be addressed administratively by the IRS and in Treasury regulations.

The Joint Committee staff also understands that after certain corporate actions including mergers and divisions, especially those involving foreign corporations, brokers may lack information necessary to determine the effect of those actions on the shareholder basis. It may be advisable to provide requirements for reporting of basis information by corporations to brokers after certain corporate actions.

**IRS administration of proposal**

To administer the proposal, the IRS may find it necessary to modify forms used under present law for reporting gross proceeds from securities sales or may determine that new forms are needed. Forms for reporting cost basis may, for example, need to group securities sold into various categories such as securities acquired before the effective date of the proposal and securities acquired after the effective date. Legislative work on the proposal should, to the extent feasible and appropriate, be discussed with the IRS so that modified or new forms may be developed without excessive difficulty.

The GAO report identifies several additional challenges that the IRS would encounter in administering basis reporting requirements.[29] One challenge identified in the report is the difficulty of storing and using the large volume of data that would be filed with the IRS.[30] The GAO report suggests that to reduce the volume of data sent to the IRS, a basis reporting requirement could be implemented in a manner that requires brokers to report basis amounts to the IRS not for each transaction but instead for all of a customer's transactions during a year.[31] Implementing a basis reporting requirement in this way might reduce IRS storage costs, but if reported basis amounts were aggregated, the IRS would not be able to distinguish short-term and long-term gains. As a result, compliance improvement from basis reporting would decrease.

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[29] GAO report, *supra note 17, at 27-32.*

[30] *Id.* at 30.

[31] *Id.* at 30-31.

## B. Reporting Requirements for Real Estate Taxes

### Present Law

The Code allows taxpayers an itemized deduction for real estate taxes imposed by any State or local government or any foreign country.[32] Real estate taxes are deductible only if they are based on the assessed value of the real property and charged uniformly against all property under the jurisdiction of the taxing authority. Taxes are not deductible, however, if they are assessed against local benefits of a kind that tend to increase the value of the property assessed. For example, assessments for streets, sidewalks, water mains, sewer lines, and other like improvements imposed because of, and measured by some benefits inuring directly to the property against which the assessment is levied, are not deductible as taxes. Taxes are considered assessed against local benefits when the property subject to the tax is limited to property benefited.[33] Similarly, separate charges for services (such as trash collection) to specific property or people are not deductible, even if the charge is paid to the taxing authority.[34]

Present law does not require information reporting for the payment of real estate taxes. Local governments generally provide taxpayers with real estate tax statements, but the information provided on such statements varies by jurisdiction. In addition, mortgage lenders generally provide taxpayers with statements reflecting amounts paid from escrow accounts to local governments. However, the information provided on local government statements and mortgage lender statements is not furnished to the IRS.

### Compliance Issue

The most recent published estimate of the size of the deduction for real estate taxes on owner-occupied residences is $19.9 billion for fiscal year 2006.[35] Studies have suggested that overstatements of this deduction result in significant Federal income tax losses.[36] One possible reason for such overstatement is that taxpayers may not receive property tax bills that allow them

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[32] Sec. 164.

[33] Treas. Reg. secs. 1.164-2, 1.164-4.

[34] See, e.g., Rev. Rul. 81-192, 1981-2 CB 63 (The word "taxes" has been defined as an enforced contribution, exacted pursuant to legislative authority in the exercise of the taxing power, and imposed and collected for the purpose of raising revenue to be used for public or governmental purposes and not as a payment for some privilege granted or service rendered.)

[35] Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years, 2006-2010* (JCS-2-06), April 25, 2006.

[36] For example, a 1993 GAO study estimated that overstated real estate tax deductions resulted in a Federal income tax loss of approximately $400 million for the 1992 taxable year. General Accounting Office, *Tax Administration: Overstated Real Estate Tax Deductions Need to be Reduced*, (GAO/GGD-93-43) (February 1993). For purposes of comparison, the estimate of the size of the deduction for fiscal year 1992 was $11 billion. Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years, 1992-1996* (JCS-4-91), March 11, 1991.

to distinguish between deductible taxes, nondeductible taxes, and nondeductible fees for services (i.e., "user fees"). In addition, the absence of a reporting mechanism for real estate taxes may hinder the IRS's ability to identify taxpayers who are overstating the deduction for real estate taxes.

The GAO's 1993 study reported that user fees as a source of local revenue have increased primarily due to reductions in Federal revenue sharing and State or local laws that cap or restrict the growth in real estate taxes. In 1990, the National League of Cities reported that 76 percent of local governments surveyed increased fees for services and 43 percent established new fees.

The GAO study found that many of the local governments that charge user fees provide property tax bills to taxpayers that do not distinguish between user fees and taxes that are based on the assessed value of the real property. Due to this lack of information, taxpayers are likely to claim as a deduction the total amount paid to the taxing jurisdiction, which results in an overstatement of the deduction for taxes equal to the amount of the payment that relates to user fees.

**Issues and Options**

One option for reducing the overstatement of real estate tax deductions is to require State and local taxing jurisdictions to report to the IRS and taxpayers the amount of taxes paid (excluding nondeductible amounts). However, an information reporting requirement would impose administrative burdens on governmental entities that may outweigh the compliance benefits.[37] Thus, before imposing such a requirement, it would be appropriate to obtain updated data not only on the extent to which taxpayers are overstating the deduction for real estate taxes, but also the extent to which governments are currently providing taxpayers with real estate tax bills that clearly distinguish between nondeductible user fees and deductible real estate taxes. To assist with this determination, the Joint Committee staff has asked GAO to analyze a sample of local governments to determine the extent to which localities nationwide are charging use fees for services and whether such localities are providing taxpayers with real estate tax bills that clearly distinguish between deductible taxes and nondeductible amounts. In addition, we have asked GAO to coordinate with the IRS for purposes of initiating a study to determine the extent to which the deduction for real estate taxes is overstated and the extent to which such overstatement is related to taxpayers improperly claiming deductions for user fees.

An alternative option for improving compliance with the deduction is to require mortgage lenders to report to the IRS and taxpayers the amount of real estate taxes paid by taxpayers through escrow accounts. Many taxpayers pay their real estate taxes through a mortgage escrow account. In those cases, each payment from the account would include a prorated amount of the real estate taxes as well as any user fees. The escrow company generally sends taxpayers an annual statement that shows one amount for all payments made to a taxing jurisdiction. If the

[37] Another issue that may affect whether any such proposal would be effective is the extent to which it could be expected that taxing jurisdictions who currently have separately stated fees for certain services, e.g., trash collection, would eliminate such fees and adjust general taxes in response to the proposal.

annual statement does not provide taxpayers with a separate statement of user fees paid, it is difficult for taxpayers to determine the correct amount of the deduction for real estate taxes. Imposing an information reporting requirement on mortgage lenders that require an escrow for taxes could be expected to improve overall compliance with the deduction for taxes, albeit on a smaller scale than a broader proposal that imposes information reporting on governments. However, this alternative also would be less burdensome than imposing reporting requirements on localities because mortgage lenders are already required to file information reports with the IRS with respect to the amount of interest paid by taxpayers. In order to fully evaluate this option, the Joint Committee staff has also asked GAO to determine whether mortgage lenders are providing taxpayers with accurate information regarding real estate taxes paid.

## C. Provide Reporting for Proceeds of Auction Sales

### Present Law

Under present law, a person doing business as a broker is required to file an information return showing the gross proceeds and the name and address of the customer, as provided under Treasury regulations (sec. 6045). For this purpose, a broker includes a dealer, barter exchange, or any other person who (for consideration) regularly acts as a middleman with respect to property or services.

Treasury regulations provide that the term broker means any person who stands ready to effect sales to be made by others. However, the regulations also limit the term "sale" to mean a disposition of securities, commodities, or certain forwards or futures contracts.[38]

### Compliance Issue

Treasury regulations limit the definition of property that is subject to the broker reporting requirements. As a result, there is no third party information reporting with respect to many types of property sold through a middleman, including property sold at auction. Property sold through auctions can include high-dollar-value property that may be likely to have substantial accrued gain, such as appreciated art, wine, antiques, jewelry, vehicles, or other collectibles.

Transactional reporting is necessary, as a general rule, so that the amount received in a sale of property can be matched with the basis of the property to determine gain that is subject to income tax. The absence of a reporting requirement with respect to property sold at auction can give rise to underreporting of gains because there is no record of the sale that is transmitted to the IRS. Any resulting noncompliance would comprise an element of the tax gap.

As part of the National Research Program ("NRP"), the IRS estimated that the amount of the tax gap for the 2001 tax year attributable to unreported capital gains was $11 billion.[39] The component of this estimate attributable to unreported capital gains from property sold at auction was not separately identified in the report. Nevertheless, a portion of this amount may be associated with the lack of a requirement to report proceeds of auction sales, particularly of property other than securities, commodities, and certain forwards or futures contracts.

### Issues and Options

Various approaches could address this compliance issue. For example, underreporting of gain from sales of appreciated property through a broker might be reduced by expanding the categories of property to which gross proceeds reporting under section 6045 applies. One option is to expand broker information reporting to collectibles or similar property. The concept of collectibles is used in the tax law, and is defined in one present-law rule generally to include

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[38] Treas. Reg. sec. 1.6045-1(a)(9).

[39] Internal Revenue Service, *IRS Updates Tax Gap Estimates*, IR-2006-28, Feb. 14, 2006.

works of art, rugs, antiques, metals, gems, stamps, coins, and alcoholic beverages.[40] In defining the expanded scope of the property subject to broker information reporting of gross proceeds, an issue is to identify categories of property that are likely to have substantial accrued gain and on which gain may be underreported, and to distinguish them from other types of property that are not likely to have substantial unreported gain. Consideration could be given to applying the reporting requirement to auction sales of property, the value, gain, or proceeds from which exceeds a dollar threshold.[41]

Another option is to expand broker gross proceeds information reporting generally to auction sales by individuals.[42] In determining how such a rule would work, an issue arises as to how to define an auction sale so as to distinguish it from other sales or exchanges of property, and yet not to exclude from the definition transactions that are economically or functionally equivalent to auction sales. For example, in the case of sales through third parties, such as on-line forums, a question arises as to when such sales are functionally equivalent to auctions, and when they more closely resemble transactions between two parties without a broker.

Defining the types of property, sales of which at auction would be subject to gross proceeds reporting under either of the possible approaches, could be inadvertently underinclusive or overinclusive, and may represent arbitrary line-drawing. A proposal for gross proceeds reporting should not apply to sales by individuals of low-value, low-gain items. For example, no compliance benefit would result from reporting of gross proceeds of second-hand household goods, typically sold for less than the seller paid for the item new. Reporting of gross proceeds in the case of brokered sales of low-value items imposes an undue paperwork burden on taxpayers, as well as on tax administrators, with potentially little benefit in improving compliance or ameliorating the tax gap.

Defining categories of property with substantial accrued gain can involve factual distinctions. For example, if one of the categories of property to which broker gross proceeds reporting were expanded was refurbished vehicles, then used cars sold at auction for parts or

[40] Sec. 408(m)(2). The provision provides that other types of property may be identified in regulations, though the proposed regulations do not identify others. This definition, with associated exceptions for certain coins and metals in section 408(m)(3), applies for purposes of a rule that prohibits an individual retirement arrangement ("IRA") from investing in collectibles. If an IRA invests in a collectible, the acquisition of the collectible is treated as a distribution from the IRA in the amount of the cost to the IRA of the collectible item. This definition is also applied in section 1(h)(3) and (5) for purposes of determining "collectibles gain" that is treated as 28-percent gain under Federal income tax rates.

[41] By contrast, no dollar threshold applies under the present-law broker gross proceeds reporting requirement applicable to securities, commodities, and certain forwards or futures contracts.

[42] The National Taxpayer Advocate has recommended information reporting on gross proceeds from sales conducted on Internet auction sites. Written Statement of Nina E. Olson, National Taxpayer Advocate, before the Subcommittee on Taxation and IRS Oversight, Committee on Finance, Hearing on the Tax Gap (July 26, 2006).

scrap should be distinguished from restored antique cars that are sold for substantial gains at auctions specific to antique cars.

In defining an auction sale, auction sales could be limited to traditional auctions in which property to be sold is consigned by the seller to the auctioneer, potential buyers bid in person at a live auction, and the auctioneer handles delivery of the sold goods as well as the payment of proceeds from the buyer to the seller, subtracting auctioneer's fees from the proceeds paid over to the seller or charging fees directly to the parties. However, increasingly, buying and selling property through telephone bids and through the internet in electronic auctions or auction-like transactions has become an option in addition to traditional auctions. In some cases, the property to be sold is not consigned to a third party, but rather, the seller is responsible for shipping the property to the buyer when it is sold. The party collecting fees for providing the forum for taking bids on property to be sold may not be the same party that transmits payment from the buyer to the seller. In some cases, the buyer may establish procedures for payment directly with the seller, rather than using a payment mechanism established by an auctioneer. The fees charged to the seller to place property at auction and entertain bids may be lower in some types of auction-like arrangements than others, creating disparate transaction costs depending on the forum; the size of fees charged to buyers may differ as well. In the traditional auction, the auctioneer, like a broker of securities, knows the amount of proceeds remitted to the seller and therefore probably is in a position to report it. However, in other situations, there may be another person, such as the person transmitting payment to the seller, that is in a position to report proceeds. The Joint Committee staff is investigating the feasibility of reporting in non-traditional auction and auction-like situations.

If auction-like forums or venues for sales are not included within the definition of auction, imposing a reporting requirement only on limited types of auction sales might provide a distortive and inefficient tax incentive to do business in a manner that eludes the definition of an auction. Imposing too limited a reporting requirement might result in little compliance improvement. If the gross proceeds reporting requirement were to apply only to a narrow range of auction forums with relatively high transaction costs, then taxpayers would be motivated to sell through less expensive forums that have no reporting requirements. For comparison, securities sold through brokers are subject to gross proceeds reporting; the imposition of a reporting requirement on such sales has not added such a large additional transaction cost to brokered securities sales that sellers have opted for a different way of selling securities that does not require reporting. However, the transaction costs may vary more significantly among various types of auction and auction-like sales venues for property other than securities.

In an effort to formulate a proposal that would produce the most efficient effect on compliance, the Joint Committee staff has requested input from both IRS and Treasury, and is seeking to obtain additional information with respect to the amount of underreporting of income that is attributable to the lack of a present-law reporting requirement.

## D. Improved Third-Party Information Reporting Relating to the Mortgage Interest Deduction

### Present Law

**In general**

Qualified residence interest is deductible notwithstanding the general rule that personal interest is nondeductible. Qualified residence interest generally is interest on: (1) debt to acquire, construct, or substantially improve a principal or second residence ("acquisition debt") (up to total debt of $1 million), plus (2) home equity debt (up to $100,000). Both acquisition debt and home equity debt must be secured by a principal or second residence. Home equity debt may not exceed the fair market value of the residence at the time the debt is incurred, reduced by the amount of the acquisition debt on the residence. Qualified residence interest also includes interest on a refinancing of such debt only to the extent that the amount of debt resulting from the refinancing does not exceed the amount of refinanced debt immediately before the refinancing.

**Prepaid interest**

Points are one type of interest payment that can qualify as deductible qualified residence interest. The term "points" is used to describe certain charges paid, or treated as paid, by a borrower to obtain a home mortgage. A borrower is treated as paying any points that a home seller pays for the borrower's mortgage. Points also may be called loan origination fees, maximum loan charges, loan discount, or discount points. All such amounts are, in essence, prepaid interest.

Generally, prepaid interest (including points) is not deductible in the year paid by a cash basis taxpayer (sec. 461(g)). Under an exception from this general rule, points are deductible in the year paid by a cash basis taxpayer if certain requirements set out by regulation are satisfied. The five principal requirements are that: (1) the loan must be secured by the residence; (2) the amount of the points must be clearly stated on the settlement statement; (3) the points must be computed as a percentage of the stated principal amount of the loan; (4) the amount of points must conform to the established business practice for points on personal residences in the area where the residence is located; and (5) the points must be paid directly by the taxpayer from funds that have not been borrowed for this purpose as part of the overall transaction. Failure to meet these requirements generally means that the deduction for the points must be claimed on a prorated basis over the life of the loan.

Points paid on a refinancing, however, generally must be claimed on a prorated basis over the life of the loan, not in the year paid. The Court of Appeals for the Eighth Circuit[43] has held that points on a refinancing are deductible in the year paid, if the refinancing is an integrated step in obtaining new financing. Other circuits do not follow this decision and the IRS does not follow the decision outside of the Eighth Circuit.

**Individual alternative minimum tax**

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[43] *Huntsman v. Commissioner*, 905 F. 2D 1182 (8th Cir. 1990).

Similar to the regular tax treatment, personal interest generally is not allowed as a deduction in computing the individual alternative minimum tax. The individual alternative minimum tax does allow a deduction for qualified housing interest. Qualified housing interest is interest on indebt to acquire, construct, or substantially improve a principal residence or other qualified dwelling used by the taxpayer. For these purposes qualified dwelling means any house, apartment, condominium, or mobile home not used on a transient basis. Qualified housing interest also includes interest on a refinancing of such debt only to the extent that the amount of debt resulting from the refinancing does not exceed the amount of refinanced debt immediately before the refinancing.

**Information reporting**

An annual statement to the taxpayer from the mortgage holder is required if $600 or more of interest is paid to a financial institution or a cooperative housing association in the course of that mortgage holder's trade or business. A governmental unit which is a mortgage holder is also required to furnish such a statement. This statement (the "Form 1098" or similar mortgage interest statement) must be sent to the taxpayer by January 31 of the year following the taxable year. A copy of this form is also sent to the IRS. The form will show the total interest paid during the year. In the case of a purchase of a principal residence, the form will also show deductible points paid during the year, including seller-paid points. Certain deductible points are not shown on the form (e.g., certain seller-paid points).

## Compliance Issue

The present law rules require taxpayers to make difficult factual determinations in order to correctly calculate the amount and timing of their qualified interest deduction for each taxable year. Similarly, the IRS needs several pieces of information to effectively audit a taxpayer's qualified interest deduction.[44] To illustrate how factual changes result in different tax treatment of interest, consider the following examples.

Example 1

Assume A incurs a mortgage of $600,000 secured by the taxpayer's principal residence with a fair market value of $750,000 at the time of the refinancing. Assume further than A has no other debt secured by A's principal residence and A has no second residence. A uses the proceeds of the refinancing to retire the existing $500,000 mortgage (which had also been secured by the taxpayer's principal residence) to take advantage of lower interest rates and to

[44] It has been argued that the present-law rule allowing a deduction for home-equity debt encroaches on the general rule of non-deductibility of personal interest, creating a confusing array of conflicting policies, causing complexity in the tax law, and yielding disparate treatment of taxpayers. Further, particular requirements of home equity debt rules have been criticized as arbitrary and subject to manipulation, creating further complexity. As a result of examining these concerns, however, the Joint Committee staff previously reported an option to repeal the deduction for home equity indebtedness. Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05) January 27, 2005. The current discussion is more limited in nature and assumes the continued application of the present-law home equity debt rules.

increase the total debt secured by the residence by $100,000. Under these facts, A and the IRS will not need to know the use to which the additional $100,000 in debt will be put to determine the correct tax treatment of interest paid on the $600,000 of debt. All the interest is deductible ($500,000 of acquisition debt and $100,000 of home equity debt).

Example 2

Assume the same facts at example 1, above, but A incurs a mortgage of $700,000 rather than $600,000. Under these facts, A and the IRS need to know the use to which the additional $200,000 in debt will be put to determine the correct tax treatment of interest paid on such debt. If $100,000 or more of the additional $200,000 is used to substantially improve the residence, then the interest on the entire $700,000 of debt will be deductible--$600,000 or more of acquisition debt and up to $100,000 of home equity debt). If less than $100,000 of the refinancing proceeds is used to substantially improve A's principal residence then a portion of the interest generally is nondeductible.[45]

Example 3

Assume that B pays prepaid interest (points) on debt to acquire a principal residence. B may deduct the prepaid interest in the year paid if the five present-law requirements, described above, are satisfied.

Example 4

Assume the same facts as example 3, above, but that the prepaid interest (points) is incurred in a refinancing. In this case, the IRS will require B to claim the prepaid interest on a prorated basis over the life of the loan.

The first two examples illustrate how the use of debt proceeds can determine the correct tax treatment of the interest paid on that debt and what information is relevant to this determination (e.g., acquisition debt subject to the $1 million debt limit and $100,000 of home equity debt). The second two examples illustrate the correct treatment of prepaid interest under present law. In the case of prepaid interest, the taxpayer and the IRS need to know whether the interest relates to a financing or a refinancing to determine the appropriate tax treatment (i.e., a deduction in the year paid for a cash basis taxpayer or prorated over the life of the loan). While there are no current estimates of noncompliance in the area of home mortgage interest, the complexity of the rules combined with the size of the deduction leads to concern about such noncompliance. The most recent published estimate of the size of the deduction for mortgage interest on owner-occupied residences is $69.4 billion for fiscal year 2006.[46] Due to the size of the deduction, even low levels of noncompliance would involve significant dollar amounts of noncompliance.

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[45] If the proceeds are used to acquire an investment asset then the interest may be deductible as investment interest.

[46] Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years, 2006-2010* (JCS-2-06), April 25, 2006.

## Issues and Options

One way to improve compliance in this area may be to expand present-law information reporting. One possible modification to present-law reporting would be to require additional information on the annual interest statement to taxpayers. The additional information could include some indication (e.g., a check-the-box system) whether the loan which produced the interest payment by the taxpayer was a refinancing. Further, if the loan was a refinancing, the annual interest statement could indicate the amount by which the refinanced loan exceeded the outstanding balance of the loan being refinanced.

The addition of a check-the-box system to identify the type of loan (financing or refinancing) will help highlight to both taxpayers and the IRS the correct treatment of any prepaid interest (see examples 3 and 4, above). While further factual determinations will still be necessary to determine the correct tax treatment of any prepaid interest, this additional information, at a minimum, should indicate to taxpayers that there is disparate tax treatment for financing and refinancing. It will also serve as notice to taxpayers that the IRS has third-party reporting as to the nature of the loan. Therefore, the check-the-box system would serve as a reminder to the taxpayer that investigation is necessary to determine the extent of deductibility. Also, it may serve as an indicia for the IRS to use on audit.

In conjunction with a check-the-box system, some indication on the annual interest statement of the amount by which the refinancing loan amount exceeds the balance of the loan being refinanced will help the IRS allocate audit resources to returns where the proceeds of the new debt may not satisfy the definition of acquisition indebtedness and where the $100,000 limit on home-equity loans may be exceeded. This is potentially important to determine the regular tax treatment where the deduction for home equity debt is limited to $100,000 of debt. It is also important to the individual alternative minimum tax treatment. Similar to the check-the-box modification, above, further factual determinations are necessary by the taxpayer and the IRS to determine the correct tax treatment of these loans. However, this additional information will highlight to taxpayers that the IRS has third-party information on refinancings that may involve amounts in excess of the $100,000 home equity loan limit. The fact that this information is readily available to the IRS may encourage better taxpayer compliance absent any additional IRS action.

The Joint Committee staff has requested that the GAO investigate current and past IRS compliance efforts (including audit measures) relating to the mortgage interest deduction. The GAO has also been requested as part of this study to determine why Treasury regulations have not been revised since the enactment of the current mortgage interest deduction rules in 1987. Study of these issues is intended to ascertain whether additional steps may be taken by the IRS to improve compliance in this area. The GAO has also been requested to investigate whether compliance can be improved by better information reporting such as along the lines of possible modifications outlined above. In particular, the GAO has been requested to contact representatives of financial intermediaries (e.g., real estate closing agents) and financial institutions (e.g., mortgage banks) to discuss the feasibility of expanded third-party information reporting.

## E. Reporting Requirements for Individuals with an Interest in Offshore Bank Accounts and Offshore Trusts

### Present Law

#### In general

Congress has enacted provisions in the tax Code and title 31 of the United States Code (the "Bank Secrecy Act") addressing issues of U.S. persons transferring and holding assets in foreign bank accounts and foreign trusts. In 1996, Congress substantially expanded the information reporting requirements with respect to U.S. persons transferring assets and receiving distributions from a foreign trust.[47] The IRS has indicated that it will revise the reporting requirements with respect to U.S. persons holding an interest in a foreign bank account.[48]

#### Foreign bank accounts

A citizen, resident, or person doing business in the United States is required to keep records and file reports, as specified by the Secretary of the Treasury, when that person enters into a transaction or maintains an account with a foreign financial entity.[49] In general, individuals must fulfill this requirement by answering a question regarding foreign bank accounts that is contained in Part III of Schedule B of IRS Form 1040. An individual who answers "yes" in response to the question asking whether the individual has an interest in or signature authority over a foreign account(s) exceeding $10,000[50] must then file Treasury Department Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts ("FBAR").[51] This form must be filed by June 30 of the year following the year when the $10,000 threshold is

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[47] The Small Business Job Protection Act of 1996 (Pub. L. No. 104-188) made substantial changes to the tax law governing foreign trusts in response to concerns of taxpayer abuse. The Act expanded information reporting requirements for U.S. persons making transfers to foreign trusts (and for U.S. owners of foreign trusts), added new reporting requirements for U.S. beneficiaries of foreign trusts, revised the civil penalties for failure to file information with respect to foreign trusts, and added civil penalties for failure to report certain transfers to foreign entities.

[48] Treasury Department Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts, was last revised in July 2000. On March 16, 2006, the Department of the Treasury and the IRS issued a request for comments on proposed changes to the form and instructions. 71 Fed. Reg. 13674. The proposed changes include additional information regarding joint accounts, the elimination of certain duplicate information, and a clarification of the term "United States person."

[49] 31 U.S.C. sec. 5314.

[50] The exact wording of the question on the 2005 Form 1040, Schedule B is: "At any time during 2005, did you have an interest in or a signature or other authority over a financial account in a foreign country, such as a bank account, securities account, or other financial account?"

[51] 31 C.F.R. sec. 103.24.

met.[52] The form is mailed to the Department of the Treasury in Detroit and is received and processed by the IRS. The form is not part of the tax return that is filed with the IRS.

Penalties may apply if the FBAR is not timely filed or the information supplied is inaccurate or incomplete. These penalties are imposed under title 31 of the United States Code, rather than the Internal Revenue Code. In April 2003, the Financial Crimes and Enforcement Network ("FinCEN") delegated civil enforcement authority over these penalties to the IRS.[53] An individual who willfully fails to file an FBAR may be subject to civil penalties equal to the greater of $100,000 or 50 percent of the amount in the account at the time of the violation.[54] An individual who fails to file, but is not willful, may be subject to civil penalties equal to $10,000 for each negligent violation.[55] In addition, criminal violations are subject to both monetary penalties and imprisonment.

**Foreign trusts**

Taxpayers also must answer a question regarding distributions from, and transfers to, foreign trusts on Part III of Schedule B of the IRS Form 1040. Taxpayers who answer "yes" to the question regarding receiving distributions from, or making transfers to, foreign trusts[56] must file Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts. Generally, this form is required if the taxpayer received a distribution from a foreign trust or the taxpayer was the grantor or transferor to a foreign trust.[57] This form must be filed with the IRS Center in Philadelphia by the due date of the income tax return.

Penalties may apply if the Form 3520 is not timely filed or the information supplied is inaccurate or incomplete.[58] The penalties are imposed by the IRS under the Code. Generally, the penalty is 35 percent of the gross value of the property transferred to the foreign trust for failure by the U.S. transferor to report the transfer, 35 percent of the gross value of the property distributed by the foreign trust to the U.S. beneficiary for failure to report receipt of the

[52] 31 C.F.R. sec. 103.27(c).

[53] 31 C.F.R. sec. 103.56(g). Memorandum of Agreement and Delegation of Authority for Enforcement of FBAR Requirements (April 2, 2003). Consequently, the IRS now processes the FBARs.

[54] 31 U.S.C. sec. 5321(a)(5)(C).

[55] 31 U.S.C. sec. 5321(a)(5)(B)(i). The penalty may be waived if there is a reasonable cause for the failure to report and if any income from the transaction was properly reported. 31 U.S.C. sec. 5321(a)(5)(B)(ii).

[56] The exact wording of the question on 2005 Form 1040, Schedule B is: "During 2005, did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust?"

[57] Sec. 6048.

[58] Secs. 6677 and 6039F.

distribution, or five percent of the amount of certain foreign gifts for each month for which the failure to report continues (not to exceed a total of 25 percent).[59]

**Due diligence**

In 1997, Congress enacted section 6695(g), which imposes a due diligence requirement on the income tax return preparer with respect to the earned income credit. Under that section, the preparer is subject to a $100 penalty for each failure if the preparer fails to comply with the due diligence requirements imposed by the Secretary of the Treasury by regulations with respect to determining the eligibility and the amount of the earned income credit.

## Compliance Issue

On April 26, 2002, the Secretary of the Treasury submitted "A Report to Congress in Accordance with § 361(b) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (USA Patriot Act)." In its report, the Secretary noted that FBAR filings have increased by almost 52 percent from 1991 to 2001 (116,600 FBAR filings in 1991 and 177,151 FBAR filings in 2001). However, the Secretary estimated that there may be as many as one million U.S. taxpayers who have signature authority or control over a foreign bank account and may be required to file FBARs. As a result, the Secretary estimated that the compliance rate with respect to FBAR filing requirements may be less than 20 percent based on the available information.[60] The Secretary has noted that compliance as to FBAR filing requirements appears to have somewhat increased as a result of offshore initiatives undertaken by the IRS in 2003.[61]

## Description of Proposal

**In general**

There are two parts to the proposal. The first part of the proposal is a legislative change relating to the income tax return preparer. The second part of the proposal involves recommendations for administrative changes relating to the FBAR. The Secretary appears to

[59] The penalties may be waived if due to reasonable cause and not willful neglect. Secs. 6677(d) and 6039F(c)(2).

[60] The Secretary of the Treasury acknowledges that this is only a rough approximation of the compliance rate because of the difficulty in determining whether the amounts held in the offshore accounts exceed the $10,000 threshold. In the most recent 2005 report on FBAR filings, the Secretary notes that, in 2003, FBAR filings have increased to 204,689 from 174,528 filings in 2000. Secretary of the Treasury, "A Report to Congress in Accordance with sec. 361(b) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (USA Patriot Act)" (April 8, 2005).

[61] For example, the IRS's Offshore Voluntary Compliance Initiative ("OVCI") secured 2,099 delinquents FBARs. The OVCI was set forth in Rev Proc. 2003-11, 2003-1 C.B. 311. It was followed by the IRS's Last Chance Compliance Initiative. The IRS also implemented the Abusive Tax Avoidance Transactions Offshore Transactions Initiative (including the Offshore Credit Card Program).

have the power currently to implement these administrative changes. The proposal directs the Secretary to implement them as promptly as possible.

**Legislative changes**

Under the proposal, the income tax return preparer is subject to a statutory due diligence requirement in determining whether the preparer's client is required to file an FBAR or Form 3520. As a result, the return preparer is required to explain to the client the reporting requirements pursuant to the FBAR and Form 3520, the meaning of the various terms (such as "financial interest" and "signature authority") that are used in determining whether the forms are required to be filed, and the applicable penalties, civil and criminal, if the client negligently or willfully fails to file the forms when required to do so. In addition, the return preparer is required to document the client's responses and retain the documentation for possible use in any audit with respect to the client's income tax return for the year.

The proposal imposes a due diligence requirement, similar to that in section 6695(g), on the income tax return preparer in determining whether the FBAR or Form 3520 is required to be filed by the taxpayer. The detailed due diligence requirements will be specified in Treasury regulations. It might be appropriate to consider a minimum income threshold, so that the preparer due diligence requirements would not be applicable with respect to taxpayers who have adjusted gross income below a certain threshold or, perhaps, with respect to those taxpayers eligible to file Form 1040EZ (or Form 1040A). The amount of the preparer's penalty for failure to follow the due diligence rules will be specified in the statute, but should be substantially greater than the $100 penalty for failures with respect to the earned income credit.

**Recommended administrative changes**

The proposal requires the FBAR form and its accompanying instructions to be updated so that the form itself is not an obstacle to compliance. Specifically, the form must use updated terminology and clarify how the filing requirement applies to new types of financial transactions. In addition, the form must be revised in a manner to encompass transactions that should be reported but may arguably fall outside the literal language of the instructions. For example, under the instructions, the term "financial interest" includes an account held by an entity where the owner of record or holder of legal title is (1) a corporation in which the U.S. person owns directly or indirectly more than 50 percent of the total value of shares of stock, (2) a partnership in which the U.S. person owns an interest in more than 50 percent of the profits, or (3) a trust in which the U.S. person either has a present beneficial interest in more than 50 percent of the assets or receives more than 50 percent of the current income.[62] Under the proposal, the

[62] According to the instructions to the FBAR, a "financial interest" in a bank, securities, or other financial account in a foreign country means "an interest described in either of the following two paragraphs: (1) A United States person has a financial interest in each account for which such person is the owner of record or has legal title, whether the account is maintained for his or her own benefit or for the benefit of others including non-United States persons. If an account is maintained in the name of two persons jointly, or if several persons each own a partial interest in an account, each of those United States persons has a financial interest in that account. (2) A United States person has a financial interest in each bank, securities, or other financial account in a foreign country for which the owner of record or holder of legal title is: (a) a person acting as an agent, nominee, attorney, or in some other capacity on behalf of the

definition of "financial interest" in the instructions is expanded to include an account held by a corporation in which a U.S. person owned, directly or indirectly, more than 50 percent of the value "or the voting power" of the corporation. A financial interest also includes a partnership in which the U.S. person owns an interest, "either directly or indirectly," in more than 50 percent of the profits "or capital of the partnership." The revised instructions also should address the situation in which a partnership that permits special allocations could be used to allocate more than 50 percent of the income from the account to a partner who has a 50 percent or less interest in the partnership (by profits or capital). In addition, the definition of "financial interest" is to be expanded to include an account held by the trustee (for the benefit of the trust) or by a U.S. person who has a beneficial interest, "either directly or indirectly," in more than 50 percent of the trust's assets.

In addition, the instructions should be expanded to cover foreign trusts established by U.S. persons for which a trust protector, usually a foreign person, is appointed. A trust protector is a third party who is responsible for monitoring the trustee's activities and can replace the trustee under certain specified conditions. A trust protector sometimes is used to prevent the U.S. person from having (or appearing to have) signature or other authority as defined for FBAR reporting purposes.[63] Under the proposal, the duties and powers of the trust protector are to be attributed to the U.S. person for FBAR reporting purposes.

## Discussion

According to the Secretary of the Treasury, in 2002, the number of U.S. persons holding funds in foreign bank accounts may be as many as one million. Also, according to IRS statistics, 429 Form 3520 returns were filed in 2002 by U.S. persons showing transfers totaling nearly $2.19 billion to foreign trusts.[64] As a result, the number of U.S. persons with an interest in foreign bank accounts or foreign trusts, and the amount of assets being transferred to foreign bank accounts and foreign trusts, is not insignificant and appears to have grown significantly in recent years.[65] The IRS currently is providing education outreach as a result of the April 2003,

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U.S. person; (b) a corporation in which the United States person owns directly or indirectly more than 50 percent of the total value of shares of stock; (c) a partnership in which the United States person owns an interest in more than 50 percent of the profits (distributive share of income); or (d) a trust in which the United States person either has a present beneficial interest in more than 50 percent of the assets or from which such person receives more than 50 percent of the current income."

[63] According to the instructions to the FBAR, a person has "signature authority" over an account "if such person can control the disposition of money or other property in it by delivery of a document containing his or her signature (or his or her signature and that of one or more other persons) to the bank or other person with whom the account is maintained."

"Other authority" exists in a person "who can exercise comparable power over an account by direct communication to the bank or other person with whom the account is maintained, either orally or by some other means."

[64] Daniel S. Holik, "Foreign Trusts, 2002," *SOI Bulletin*, 134 (Summer 2005).

[65] Staff of the Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress* (JCS-5-05), May 2005 at 378. See also Statement of Eileen J. O'Connor, Assistant

delegation of authority for civil enforcement from FinCEN. In addition, the IRS has issued Publication 4261, entitled "Do You Have a Foreign Bank Account?" in order to remind foreign account holders of the reporting requirements. The publication is available on the IRS website and is provided to tax practitioners, brokers and banks. However, there are some persons who claim not to understand the applicable filing rules. There appear to be three categories of U.S. individuals who are currently not filing the FBAR and Form 3520s as required by law. The first category consists of those taxpayers who fail to file because of lack of knowledge or confusion about the filing requirements. Imposing a due diligence requirement on the return preparer will help alleviate much of the lack of knowledge and confusion.

The second category of taxpayers who fail to file consists of those who are concealing income or possibly engaged in some kind of criminal activity. For these taxpayers, no amount of changes to the instructions of the FBAR (or Form 3520) will increase compliance. In addition, imposing a due diligence requirement on the return preparer will probably have little to no effect on increasing the compliance rate as to FBAR filings and Form 3520 filings. The Secretary of the Treasury has noted that, for this category of non-compliant taxpayers, "achiev[ing] deterrence . . . will require a series of highly publicized criminal actions against intentional violators in order to raise the cost of being an FBAR scofflaw." Recently, Congress, as part of the American Jobs Creation Act of 2004,[66] enacted an additional penalty regime with respect to FBAR filings in an attempt to increase compliance. The new regime applies a monetary penalty without regard to willfulness. It is too soon to determine whether compliance has increased as a result of the new penalty regime.

The third category of taxpayers who fail to file consists of those who structure transactions, usually with counsel from lawyers or accountants, in a manner that avoids the filing requirements. Generally, these transactions violate the intent of the filing requirements while arguably falling outside the literal filing requirements. The proposals to expand the number of transactions subject to the filing requirements by adding accounts and interests in accounts held "directly or indirectly" by taxpayers should include a greater number of transactions within the filing requirements that should be reported to the Treasury Department or IRS.

As stated above, one of the most significant recent developments in increasing compliance for FBAR filings is the April 2, 2003, delegation of civil enforcement authority from FinCEN to the IRS. Prior to that delegation, the Secretary of the Treasury had delegated examination authority for FBAR compliance to the IRS but had delegated to FinCEN the authority to assess civil penalties for violation of the FBAR filing requirements. As a result, if a taxpayer refused to pay the penalty, FinCEN referred the matter to the Department of Justice, which instituted an action against the taxpayer in which the liability and the amount of the penalty were litigated. In a memorandum dated April 2, 2003, FinCEN delegated all of its civil enforcement authority with respect to FBAR filings to the IRS.[67] As a result, the IRS can "create

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Attorney General, Tax Division, Before the Committee on Finance, United States Senate, Concerning "Corporate and Partnership Enforcement Issues" (June 13, 2006).

[66] Pub. L. No. 108-357 (2004).

[67] Memorandum of Agreement and Delegation of Authority for Enforcement of FBAR Requirements (April 2, 2003).

interpretive education outreach materials for the FBAR, revise the form and instructions, examine individuals and other entities, and assess civil penalties for violations."[68] While it is too soon to determine whether the delegation of authority from FinCEN to the IRS with respect to civil enforcement authority has increased compliance with FBAR filing requirements, adoption of the proposals should only further increase compliance with the filing requirements. The next step in developing this proposal should be a discussion with the IRS and the Treasury Department regarding the language of the forms and related issues.

Other committees and offices of Congress also have an interest in this area. The Permanent Subcommittee on Investigations of the Senate Committee on Homeland Security and Governmental Affairs recently held a hearing and issued a report, both entitled "Tax Haven Abuses: the Enablers, the Tools and Secrecy."[69] The report contains eight recommendations, some of which are relevant to this proposal. The Joint Committee staff will study the hearing testimony and the report (including the recommendations), and will consider broader changes to the present-law reporting and substantive trust rules. The GAO is also currently working on two reports involving offshore bank accounts and offshore trusts.

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[68] Secretary of the Treasury, "A Report to Congress in Accordance with sec. 361(b) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (USA Patriot Act)" (April 8, 2005).

[69] The Subcommittee hearing was held on August 1, 2006.

## II. ENHANCED TAX ADMINISTRATION

### A. Modify the Determination of Amounts Subject to Self-Employment Tax for Partners and S Corporation Shareholders in Personal Service Businesses

#### Present Law

As part of the financing for Social Security and Medicare benefits, a tax is imposed on the wages of an individual received with respect to his or her employment under the Federal Insurance Contributions Act (the FICA tax).[70] A similar tax is imposed on the net earnings from self-employment of an individual under the Self-Employment Contributions Act (the SECA or self-employment tax).[71]

Under the present-law self-employment tax rules (sec. 1402), the net earnings from self-employment of an individual who is a general partner in a partnership generally include the partner's distributive share (whether or not distributed) of income or loss from any trade or business carried on by the partnership. Specified types of income or loss are excluded from net earnings from self-employment of a general partner, such as rentals from real estate in certain circumstances, dividends and interest, gains or loss from the sale or exchange of a capital asset or from timber, certain minerals or other property that is neither inventory nor held primarily for sale to customers, and retirement payments from the partnership if the partner rendered no services for the partnership and certain other requirements are met.

A special rule applies for limited partners of a partnership.[72] In determining a limited partner's net earnings from self-employment, an exclusion is provided for his or her distributive share of partnership income or loss. The exclusion does not apply to guaranteed payments to the limited partner as remuneration for services.

A shareholder of an S corporation who performs services as an employee of the S corporation is subject to FICA tax on his or her wages, but generally is not subject to FICA tax on amounts that are not wages (such as distributions to shareholders).[73] Nevertheless, an S corporation employee is subject to FICA tax on the amount of his or her reasonable compensation, even though the amount may have been characterized as other than wages. A significant body of case law has addressed the issue of whether amounts paid to shareholder-employees of S corporations constitute reasonable compensation and therefore are wages subject

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[70] See Chapter 21 of the Code.

[71] Sec. 1401.

[72] Sec. 1402(a)(13). For this purpose, limited partner status is determined under State law.

[73] Though unrelated to the FICA tax, present law provides that an S corporation is treated as a partnership and a two-percent shareholder is treated as a partner, for purposes of applying rules relating to employee fringe benefits. Sec. 1372.

to the FICA tax, or rather, are properly characterized as another type of income that is not subject to FICA tax.[74]

## **Compliance Issue**

The employment tax treatment of partners who are neither limited nor general partners is uncertain. In particular, owners of a limited liability company may view themselves as comparable to limited partners, even though they are not limited partners under applicable State law. This uncertainty makes compliance with the law difficult for taxpayers and administration of the law difficult for the IRS. The uncertainty in treatment creates an opportunity for abuse by taxpayers willing to make the argument that they are not subject to any employment tax (FICA or self-employment), even though this argument is contrary to the spirit and intent of the employment tax rules. In addition, the increasing ability of individuals who are limited partners under State law to perform services for the partnership suggests that the limited partner rule is out of date and should be changed.

It has become increasingly common for individuals who perform services in businesses that they own to choose the S corporation form to seek to reduce their FICA taxes. S corporation shareholders may pay themselves wages below the wage cap, while treating the rest of their compensation as a distribution by the S corporation in their capacity as shareholders.[75] They may take the position that no part of the S corporation distribution to them as shareholders is subject to FICA tax. While present law provides that the entire amount of an S corporation shareholder's reasonable compensation is subject to FICA tax in this situation, enforcement of this rule by the government may be difficult because it involves factual determinations on a case-by-case basis. A 2005 study stated that "the S corporation form of ownership has become a multibillion dollar employment tax shelter for single-owner businesses."[76]

More broadly, there are significant differences in the employment tax treatment of individuals who are owners of interests in passthrough entities and who perform services in the business. S corporation shareholder-employees are treated like other employees (i.e., subject to FICA), whereas a broader category of income of some partners (other than limited partners) is subject to self-employment tax. These discontinuities cause taxpayers' choice-of-business form decisions to be motivated by a desire to avoid or reduce employment tax, rather than by nontax considerations. The NRP updated estimate of the gross tax gap for 2001 included an estimated

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[74] See, e.g., *Renewed Focus on S Corp. Officer Compensation*, AICPA Tax Division's S Corporation Taxation Technical Resource Panel, Tax Advisor, May 2004, at 280.

[75] Because the HI tax has no wage cap, this approach may be viewed as a tax planning opportunity with respect to HI tax even at higher wage levels.

[76] Treasury Inspector General for Tax Administration, *Actions are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations*, May 2005, Reference No. 2005-30,080, at 2. The report discusses options for addressing the compliance problem, including an option to apply employment tax generally to the operating income of an S corporation in which any one individual (including his or her family members) owns more than 50 percent of the stock. *Id.* at 18-19.

$39 billion of the tax gap attributable to self-employment tax and an estimated $15 billion of the tax gap attributable to FICA and unemployment taxes.[77]

## Description of Proposal

Several approaches could be effective in addressing these compliance problems. One approach would be to provide a uniform rule for owners receiving compensation from passthrough entities (i.e., partnerships and S corporations). That approach provides that the present-law rule for general partners generally applies to any partner of a partnership, or shareholder of an S corporation, for determining the individual's net earnings from self-employment.[78]

A more targeted approach, more narrowly focussing on income from labor, might concentrate on income from service businesses conducted through passthrough entities (i.e., partnerships and S corporations). This approach, limited to service businesses, might provide that the present-law rule for general partners applies to any partner for determining net earnings from self-employment, provided the partnership is a service partnership. For this purpose, a service partnership is a partnership (including an LLC or other entity that is treated as a partnership for Federal income tax purposes), substantially all of whose activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting (similar to sec. 448(d)(2)). Similarly, for purposes of employment tax, an S corporation that is a service business is treated as a partnership and shareholders of the S corporation are treated as general partners. Wages paid to a shareholder employee of an S corporation would not be treated as deductible by the S corporation for employment tax purposes. Regulatory authority is provided under the proposal to prevent avoidance of the provision through the aggregation of business activities within

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[77] Internal Revenue Service, *IRS Updates Tax Gap Estimates,* IR-2006-28, Feb. 14, 2006.

[78] Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures,* JCS-02-05 (January 27, 2005), 95. Under that proposal, all partners and S corporation shareholders are subject to self-employment tax on their distributive share (whether or not distributed) of income or loss of the partnership or S corporation. As under present law, specified types of income or loss are excluded from net earnings from self-employment, such as certain rental income, dividends and interest, certain gains, and other items. However, under the proposal, in the case of a service partnership or S corporation, all of the partner’s or S corporation shareholder's net income from the partnership or S corporation is treated as net earnings from self-employment. A service partnership or S corporation is one, substantially all of whose activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting (similar to sec. 448(d)(2)). Wages paid to a shareholder employee of an S corporation would not be treated as deductible by the S corporation for employment tax purposes. If, however, any partner (regardless of whether he or she is a general partner, limited partner, or neither a general nor limited partner, such as a limited liability company member) or S corporation shareholder does not materially participate in the trade or business of the partnership, a special rule provides that only the partner’s reasonable compensation from the partnership is treated as net earnings from self-employment. Thus, some general partners who would be subject to self-employment tax on their distributive share of partnership income under present law will be subject to tax only on reasonable compensation from the partnership under this approach.

entities or the recharacterization of income as other than service income (e.g., as rent, interest, or gain).

## **Discussion**

The conceptual premise of the proposal relating to service businesses is that the base for the employment and self-employment tax should be labor income. Historically, the employment tax has applied to labor income, relating very roughly to the rules for accruing benefits under the Social Security system, which require the individual to perform quarters of labor.[79] The proposal applies this notion more uniformly than does present law to individuals who perform services for or on behalf of a service business conducted by a passthrough entity in which they own an interest (i.e., a partnership, limited liability company, or S corporation). The proposal treats such individuals similarly to sole proprietors in service businesses, as well as similarly to each other. Not only does this more uniform treatment improve the fairness of the tax law and increase the internal theoretical consistency of the tax rules, it also tends to improve tax neutrality by reducing the importance of FICA and self-employment tax differences in taxpayers' choice of business entity.

The self-employment tax (and the earlier-instituted FICA tax) were originally designed both to measure Social Security benefit accruals by determining whether individuals earned income from working, and to collect revenues to fund such benefit accruals.[80] However, taxpayers' incentives have changed as the wage base and the resulting tax cost to individual taxpayers of accruing benefits has risen, and the value of Social Security benefits to high-income taxpayers has become relatively lower as a percentage of income. A portion of Social Security benefits became taxable to higher-income individuals in 1984.[81] The motivation of higher-income taxpayers to avoid the employment tax was further increased by the elimination of the cap on the HI component of the tax by the Revenue Reconciliation Act of 1993.[82] Benefits under the HI component that may be paid to the taxpayer in the future generally do not increase as the tax cost of the HI component to the taxpayer increases. Rather than having an incentive to accrue benefits, taxpayers now have the opposite incentive: to avoid or reduce the tax cost,

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[79] *See* Patricia E. Dilley, *Breaking the Glass Slipper - Reflections on the Self-Employment Tax*, 54 Tax Law. 65 (Fall 2000) at note 18. Benefit accruals have historically been tied to performance of labor (quarters of service), but the amount of FICA taxes collected does not necessarily relate to the individual's Social Security benefits.

[80] *See* Dilley, *supra*, at notes 23-30.

[81] Social Security Amendments of 1983, Pub. L. No. 98-21, sec. 121(a) (1983). Both the FICA and the SECA tax bases have two components, OASDI and HI. Under the OASDI component, the rate of tax is 12.40 percent. Under the HI component, the rate is 2.90 percent. The amount subject to employment tax under the OASDI component is capped at $94,200 of wages (under FICA) or self-employment income (under SECA) (for 2006). However, the amount subject to the HI component is not capped.

[82] Because eligibility for hospital insurance under Medicare is based on an individual's quarters of coverage, not the amount of the individual's wages, paying HI tax on higher wages does not increase the individual's Medicare benefits.

which may exceed the value to them of the social insurance benefit. The tax rules are not currently designed to prevent avoidance, and indeed, may facilitate it because the rules apply unevenly depending on whether the taxpayer chooses to do business through an S corporation, partnership, or sole proprietorship. Eliminating this unevenness, at least with respect to service businesses, not only increases the fairness of the tax as between similarly situated taxpayers, but also is consistent with a purpose to raise revenue from labor income among all workers comparably.

In particular as it relates to S corporation shareholders, the proposal relating to service businesses aims to reduce the use of S corporations to avoid the employment tax by recharacterizing wages from service businesses as some other type of S corporation distribution. Disparate treatment of wages and other distributions under present law creates an undesirable incentive for individuals performing services to avoid FICA tax on labor income, including on the uncapped HI component, by setting up business as an S corporation and characterizing as wages a small amount of service income below the wage cap, while the rest is passed through the S corporation to the shareholder-employee free of FICA tax.

Under the proposal, taxpayers' choice of entity for service businesses is not skewed by differing FICA and self-employment tax results. By treating S corporation shareholders who perform services for or on behalf of the S corporation's service business in the same manner as partners who perform services for or on behalf of the partnership's service business, the proposal improves the neutrality of the tax law.

The proposal has the effect of applying the self-employment tax collection system to S corporation shareholder-employees, rather than the withholding regime that applies to them (along with other employees) under the present-law FICA tax rules. There are both drawbacks and advantages to this approach. One drawback is that withholding may be a more effective and faster collection mechanism than self-assessment as under the self-employment rules. Another is that the income tax deduction for wages or compensation paid by an S corporation would have to be added back or disallowed for employment tax purposes calculating self-employment tax of the S corporation shareholder.

Other disadvantages would arise from retaining the FICA withholding system from some compensation while imposing the self-effecting SECA rules on other compensation of the same individual. For example, preserving a withholding regime on S corporation shareholder wages, and imposing self-employment tax only on the portion of the shareholder’s distributive share that exceeds previously taxed wages, would require a mechanism to prevent double-counting from one taxable year to the next, which could impose additional administrative and recordkeeping burdens on the S corporation. Imposing two separate employment tax regimes on S corporation compensation payments to one individual could be criticized as unecessarily complex. Therefore, the proposal applies the self-employment tax rules to S corporation shareholder-employees of service businesses in the same manner that those rules apply to partners in service partnerships.

Focussing on service businesses could be viewed as an incomplete capture of labor income earned through passthrough entities, as labor income is also earned by employee-owners of passthrough entities conducting capital-intensive businesses. Nevertheless, targeting the proposal to service businesses has the advantage that it is not very likely to affect non-labor income, and is at the same time likely to address FICA or SECA tax avoidance opportunities in which taxpayers now may attempt to engage.

Limiting the proposal to service businesses provides several simplification benefits. Focussing on service businesses may eliminate any need for a bifurcated approach to income from labor and from capital. In the case of a service business, it is assumed that the income is generally from personal services. Previous proposals have suggested that the self-employment tax not apply to income from a business that is from capital rather than from labor. For example, one way to attempt to limit employment tax to labor income would be to provide a special rule to exclude from the employment tax base some measure of the return on capital, in the case in which a business pays a worker-owner a return that represents income both from his or her labor, and from his or her capital invested in the business.[83] This type of approach raises administrability concerns, as rates of return (including return on capital) can vary significantly among different types of businesses, at different times in the life of a business activity, and with different management of the business, among other factors.[84] By way of comparison, no such special rule is provided under present law for sole proprietors subject to the self-employment tax.

Another simplification benefit of limiting the proposal to service businesses is to eliminate the need for the present-law inquiry into whether the individual's compensation from the service business is reasonable, for employment tax purposes.[85] This inquiry is inherently factual and can cause uncertainty in some cases, encourage taxpayer noncompliance, and give rise to disputes and litigation. The question of whether an individual's compensation is reasonable is one that has been repeatedly addressed in case law. The addition of the independent investor test used in the Seventh Circuit and partially adopted in some other Circuits has changed the previously predictable analysis under the multi-factor test applied in many judicial decisions to determine reasonable compensation.

[83] The AICPA has proposed this type of approach to modernize the self-employment tax reference to limited partners in section 1402(a)(13). See Letter of David A. Lifson, Chair, Tax Executive Committee of AICPA, to the Honorable William V. Roth, Chairman, Senate Committee on Finance, dated June 22, 2000, enclosing such a recommendation originally made by letter dated July 6, 1999. The AICPA proposal would provide that if the partner works less than a minimum number of hours in the partnership's business, none of his income would be treated as subject to the self-employment tax. The AICPA proposal would provide that a limited liability company owner's income would be treated as subject to the self-employment tax, except for a defined rate of return on his capital in the partnership.

[84] Alternatively, this approach might specify a definition for a reasonable rate of return on capital. It could be based, for example, on a percentage or multiple of the applicable Federal rate, as defined under present law. While this approach may conceptually take account of a partner's return on capital, it may not represent the simplest and most direct approach, nor would it be accurate in most cases.

[85] Reasonable compensation has also been suggested as a standard for determining the net earnings from self-employment of all limited partners and LLC members, but the administrative concerns with the standard could make this approach less attractive than the more mechanical approach taken under the proposal.

## B. Denial of Deductions and Credits with Respect to Untimely Returns of Nonresident Aliens and Foreign Corporations

### Present Law

#### In general

In general, nonresident aliens and foreign corporations (collectively, "foreign persons") are subject to tax by means of withholding on certain types of U.S. source gross income, for example, dividends, rents, royalties, and other fixed or determinable annual or periodical gains, profits and income.[86] However, foreign persons engaged in the conduct of a trade or business in the United States are taxed on a net basis with respect to income that is effectively connected[87] (or deemed to be effectively connected[88]) with the conduct of such trade or business ("effectively connected income"). In the case of such income, the tax base is calculated, in general, by allowing deductions only if and to the extent that they are connected with effectively connected income.[89]

Tax returns of foreign corporations with an office or place of business in the United States are due on or before the 15th day of the third month following the close of their taxable year.[90] Tax returns of foreign corporations that do not have an office or place of business in the United States and nonresident aliens (other than those whose wages are subject to withholding under the provisions generally applicable to U.S. persons[91]) are generally due on or before the 15th day of the sixth month following the close of their taxable year.[92] Penalties similar to those applicable to U.S. persons apply in the case of the failure of a foreign person to timely file its returns.[93]

In addition, the Code provides that foreign persons may receive the benefit of most otherwise allowable deductions and credits only by filing a true and accurate tax return, in the

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[86] Secs. 871(a) and 881. Tax is withheld at a rate of 30 percent. Secs. 1441 and 1442.

[87] Secs. 871(b) and 882(a).

[88] For example, gain or loss from the disposition by a foreign person of a United States real property interest is deemed to be effectively connected income. Sec. 897. For another example, a foreign person may elect to treat non-effectively connected income from real estate as effectively connected income. Secs. 871(d), 882(d).

[89] Secs. 873(a) and 882(c)(1)(A).

[90] Sec. 6072(b).

[91] Such persons are required to file on or before the 15th day of the fourth month following the close of their taxable year. Treas. Reg. sec. 1.6072-1(c).

[92] Sec. 6072(c).

[93] Sec. 6651(a)(1).

manner prescribed by subtitle F of the Code, including on the return all the information which the Secretary deems necessary for the calculation of such deductions and credits.[94]

## Historic case law

The IRS may seek to deny the deductions or credits of a foreign person with effectively connected income that does not file a tax return, or that files a return later than permitted by the IRS. In the latter case, the IRS typically has argued to the courts that the statute provides that such foreign persons may take deductions and credits only if a return is filed in the "manner" prescribed by subtitle F (or by the prior procedural and administrative provisions of the revenue acts), and that the term "manner" incorporates the timely filing requirements under the Code. The courts, however, have generally held that the term "manner" as used in this provision does not include the general timely filing requirements. Consequently, the courts have concluded that a foreign person's filing of returns after the IRS has prepared and filed returns for the foreign person, but before the IRS delivered a notice of deficiency to the taxpayer, does not preclude the foreign person from taking otherwise lawful deductions, even though the taxpayer may be subject to penalties for late filing.[95]

On the other hand, the courts have recognized that the interests of proper administration require that a foreign person should not be permitted to wait indefinitely (presumably with the hope of not being detected) before filing returns, while avoiding the sanction of loss of deductions in the event that the taxpayer is detected. Thus, cases have held that it is generally too late for the foreign person to obtain deductions by filing returns after the IRS issues a notice of deficiency.[96] It is also too late for the foreign person to file in cases in which the foreign person receives a notice from the IRS requesting that the person file a return, the person does not comply with the IRS request within a reasonable time, and the IRS then files a return on behalf of the foreign person, allowing no deductions.[97]

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[94] Secs. 874(a) and 882(c)(2). The provision is substantially the same for nonresident aliens and foreign corporations. Subtitle F of the Code, relating to procedure and administration, consists of sections 6001 through 7874. The provision does not apply to the tax imposed on personal holding companies under section 541. Nor does it apply to deny credits for taxes withheld at the source on the income of foreign persons under section 33 and for certain uses of gasoline under section 34.

The Treasury Department Technical Explanation to the United States Model Income and Capital Tax Convention of 1996, Art. 24, Para. 2, states that it does not violate the nondiscrimination article of the model treaty to require foreigners to provide information in a reasonable manner that may be different than the information requirements imposed on a resident enterprise, referencing Code sections 874(a) and 882(c)(2).

[95] See, e.g., *Ardbern Co. v. Commissioner*, 41 B.T.A. 910 (1940); *Anglo-Am. Direct Tea Trading Co. v. Commissioner*, 38 B.T.A. 711 (1938), *nonacq*. 1939-1 C.B. 39; *Mills, Spence & Co. v. Commissioner*, B.T.A. Memo 1938-342.

[96] See, e.g., *Taylor Sec., Inc. v. Commissioner*, 40 B.T.A. 696 (1939).

[97] See, e.g., *Espinosa v. Commissioner*, 107 T.C. 146 (1996); *Blenheim Co. v. Commissioner*, 42 B.T.A. 1248 (1940).

## **Regulations**

In 1990, regulations (the "regulations") were issued[98] that provide that a foreign person may receive the benefit of deductions and credits only if the foreign person timely files, in the manner prescribed in subtitle F, a true and accurate return of the person's taxable income.[99] The regulations provide that whether a return for the current taxable year has been filed on a timely basis is dependent upon whether the foreign person filed a return for the taxable year immediately preceding the current taxable year. If a return was filed for that immediately preceding taxable year, or if the current taxable year is the first taxable year of the foreign person for which a return is required to be filed, the required return for the current taxable year must be filed within 18 months of the due date (as set forth in section 6072) for a foreign corporation return and within 16 months of the due date for a nonresident alien return, as the case may be.[100] If no return for the taxable year immediately preceding the current taxable year has been filed, the required return for the current taxable year (other than the first taxable year of the foreign corporation for which a return is required to be filed) must be filed no later than the earlier of the following two dates: (1) the date which is 18 months after the due date (as set forth in section 6072) in the case of a foreign corporation and 16 months after the due date in the case of a nonresident alien, and (2) the date the IRS mails a notice to the foreign person advising the person that the current year tax return has not been filed and that, generally, no deductions or credits may be claimed by the taxpayer.[101]

The regulations further provide that the IRS may waive the filing deadlines if the foreign person establishes that the person, based on the facts and circumstances, acted reasonably and in good faith in failing to file a U.S. income tax return (including a protective return as described below). For this purpose, a foreign person shall not be considered to have acted reasonably and in good faith if the foreign person knew that a return was required to be filed and the person chose not to do so. In addition, a foreign person may not be granted a waiver unless the person cooperates in the process of determining its income tax liability for the taxable year for which the return was not filed.[102]

In addition, under the regulations, a foreign person may file a "protective return" under certain circumstances. If a foreign person conducts limited activities in the United States in a

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[98] T.D. 8322, later amended by T.D. 8981 and T.D. 9043.

[99] Treas. Reg. sec. 1.874-1(a) (relating to nonresident aliens), Treas. Reg. sec. 1.882-4(a)(2) (relating to foreign corporations).

[100] Those regular due dates are the 15th day of the third month following the close of their taxable year for foreign corporations with an office or place of business in the United States, and the 15th day of the sixth month following the close of the taxable year for foreign corporations that do not have an office or place of business in the United States and (in general) nonresident aliens.

[101] Treas. Reg. sec. 1.874-1(b)(1) (relating to nonresident aliens), Treas. Reg. sec. 1.882-4(a)(3)(i) (relating to foreign corporations).

[102] Treas. Reg. sec. 1.874-1(b)(2) (relating to nonresident aliens), Treas. Reg. sec. 1.882-4(a)(3)(ii) (relating to foreign corporations).

taxable year which the foreign person determines does not give rise to gross income which is effectively connected with the conduct of a trade or business within the United States, the foreign person may nonetheless file a return for that taxable year on a timely basis and thereby protect the right to receive the benefit of the deductions and credits attributable to that gross income if it is later determined that the original determination was incorrect. On that timely filed return, the foreign person is not required to report any gross income as effectively connected with a United States trade or business or any deductions or credits but instead attaches a statement indicating that the return is being filed for the reasons set forth above.[103]

***Swallows Holding, Ltd. v. Commissioner*[104]**

In *Swallows Holding, Ltd. v. Commissioner*, the taxpayer, a foreign corporation, had filed a timely income tax return (under the statutory timely filing rules) for its first year, effectively making the net real estate election under section 882(c)(1)(A), but its returns for the following three years were untimely under the regulations. The Tax Court, in a decision filed January 26, 2006, and reviewed by the full court, determined the regulations to be invalid to the extent that they adopt a timely filing requirement. The court held the timely filing requirement and the attempt to overrule the contrary judicial precedent and settled law through the issuance of interpretative regulations to be unreasonable under the authority of *National Muffler Dealers Association v. United States*.[105] Consequently, the taxpayer was permitted to deduct its expenses. The IRS filed a notice of appeal to the Third Circuit on July 5, 2006.

**Compliance Issue**

If the decision in *Swallows Holding, Ltd.* is upheld on appeal, a taxpayer that is a foreign person will have no definite deadline to file a return in order to be permitted to take deductions. Such a taxpayer may, therefore, play the "audit lottery," awaiting detection with little risk of consequences. If the IRS does learn of the taxpayer's activities, the taxpayer may still have sufficient time to file a return that includes deductions and credits, prior to the occurrence of events that (under the historic case law) preclude the allowance of such deductions and credits, such as (1) the issuance of a notice of deficiency, or (2) the receipt of notice from the IRS followed by its filing of returns on behalf of the taxpayer (without benefit of deductions and credits).

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[103] Treas. Reg. sec. 1.874-1(b)(6) (relating to nonresident aliens), Treas. Reg. sec. 1.882-4(a)(3)(vi) (relating to foreign corporations).

[104] 126 T.C. 96 (2006), *appeal filed*, (3d Cir. July 5, 2006).

[105] 440 U.S. 472 (1979). Under the Tax Court's *National Muffler* analysis, the earlier cases had determined that Congress acted unambiguously in omitting a "timeliness" requirement. Since the requirement that the return must be filed "in the manner prescribed by subtitle F of the Code" unambiguously omitted any reference to timely filing, the regulation was invalid. Three dissenting opinions held, in summary, that the regulations are reasonable administrative rules that address an ambiguity in the statute that had previously been addressed by the courts. The ambiguity lies in the determination of the appropriate amount of time that should be allowed to a foreign person to file a return before deductions and credits are foreclosed.

## Description of Proposal

The proposal has two variations:

1. Specify by statute the filing dates or events after which a foreign person's deductions and credits are denied. Such dates could be fixed by reference to the filing requirements of section 6072, by events such as notice, or otherwise.

2. Specify by statute that deductions and credits are denied with respect to foreign persons' returns that are not timely filed, and delegate to Treasury the authority to define what is meant by "timely" in this context.

## Discussion

As some courts have noted, the present-law statute implicitly provides a timely filing requirement for foreign persons and could not be properly administered in the absence of some such requirement. Even if the statute is construed not to include such an implication, it would be necessary to have some special rules to ensure compliance with the statute. Since the days of the earlier cases, cross-border commerce has increased, and the increased volume of U.S. activities of foreign persons may make it more difficult for the IRS to track such activities. In addition, information relating to tax obligations is generally more readily available to taxpayers, including taxpayers operating cross-border. These factors suggest that there are special considerations in enforcing the requirement that foreign persons engaged in the conduct of a trade or business in the United States file their U.S. tax returns and, therefore, that special rules, such as the denial of deductions and credits for nonfilers or late filers, can help to secure such taxpayers' compliance. The existence of bright line rules can assist in these compliance efforts.

On the other hand, due to lack of familiarity with U.S. tax rules and lack of proximity to the United States, it is reasonable to expect that it could take more time for foreign persons than for U.S. persons to determine their tax return filing obligations. Consequently, it may be appropriate to permit foreign taxpayers some leeway beyond their present-law timely filing obligation (which itself provides additional time when compared with that of U.S. persons), before applying the somewhat drastic sanction of denying their deductions and credits. Therefore, it may be reasonable to strike a balance by delaying the application of these sanctions until a date after the "regular" filing date for foreign persons provided by section 6072.

Awaiting the appellate decision in *Swallows Holding, Ltd.* would resolve the issue if the appellate court rules in favor of the IRS. However, it is also possible that the appellate court will affirm the Tax Court and rule in favor of the taxpayer. It is also possible that the IRS could dismiss the appeal, or that if the IRS wins the appeal, another taxpayer similarly situated could pay a gross basis assessment, make a claim for refund, and file a refund suit in a district court or the Court of Federal Claims. Thus, the issue might not be judicially settled on a definitive basis for several years. Any judicial resolution would also be subject to future court cases affecting administrative law generally (i.e., non-tax cases). A legislative solution would resolve uncertainty concerning the application of the timely filing rule.

Under the first variation of the proposal, Congress specifies the parameters of the "timely" filing rule, while under the second variation Congress delegates to Treasury the regulatory authority to define “timely.” Treasury and the IRS have a long history of addressing this issue generally, and 16 years of experience in addressing the issue through regulations. Thus, the experience of Treasury and the IRS in this matter weighs heavily in favor of the delegation of authority. If, upon further investigation, there is reason to believe that the substance of the regulations should be changed, for example, if the regulations are not effective in inducing foreign persons to file required returns or if the regulations operate in an unfair manner, then a purely legislative solution might make more sense. Unless the application of the regulations gives rise to such specific issues (besides the question of validity), however, the second variation appears to provide a quicker and clearer resolution to the issues raised by *Swallows Holding, Ltd.*

Further steps in this matter should include discussions with the IRS and the Treasury Department concerning the application and effectiveness of the regulations and the effects of *Swallows Holding, Ltd.* on the administration of sections 874(a) and 882(c)(2).

## C. Compliance with Earnings Stripping Provision

### Present Law

Present law limits the ability of U.S. corporations (among other taxpayers) to reduce the U.S. tax on their U.S.-source income through earnings stripping transactions. Section 163(j) specifically addresses earnings stripping involving interest payments, by limiting the deductibility of interest paid to certain related parties or interest on debt guaranteed by certain related parties ("disqualified interest"), if the payor's debt-equity ratio exceeds 1.5 to 1 and the payor's net interest expense exceeds 50 percent of its "adjusted taxable income" (generally taxable income computed without regard to deductions for net interest expense, net operating losses, domestic manufacturing income, and depreciation, amortization, and depletion). The debt-equity ratio is defined as the ratio that total indebtedness of the corporation bears to the sum of its cash and the tax basis of all of its other assets. Disallowed interest amounts can be carried forward indefinitely. In addition, excess limitation (i.e., any excess of the 50-percent limit over a company's net interest expense for a given year) can be carried forward three years.

### Compliance Issue

As indicated above, the Code requires that the tax basis of assets be used in computing the debt-equity ratio under the earnings stripping provision. However, information showing the tax basis of assets is not provided on the corporate income tax return. In addition, the corporation's tax return does not require disclosure of information necessary to compute the amount of disqualified interest for the year. For example, interest paid by a U.S. corporation to a U.S. bank is disqualified interest if the debt was guaranteed by a foreign parent but there is no requirement that the corporation disclose whether any debt was guaranteed by another. As a result, it is difficult to determine whether a corporation is subject to the earnings stripping provision based on the information provided on the corporate income tax return.[106]

### Description of Proposal

Under the proposal, a corporate taxpayer must report to the IRS whether any portion of its interest deduction is disallowed for the taxable year under section 163(j) (the earnings stripping provision). If part of the corporation's interest deduction is disallowed for the year under the earnings stripping provision, the corporation is required to report to the IRS the computation of how much disqualified interest was paid or accrued during the year, the payees of the disqualified interest, the amount disallowed for the year, and the amount carried forward to the following year.

[106] Code section 6038A requires certain information be provided to the IRS on transactions between a 25 percent foreign-owned domestic corporation and its 25 percent foreign shareholder (and related parties), including interest paid to any such shareholder (and related parties). This information is provided on Form 5472. However, the aggregate information provided on Form 5472 does not convey any details regarding disqualified interest (including whether any interest is disqualified) and its calculation.

If the corporation had no interest disallowed for the year under the earnings stripping provision, it would disclose under the proposal how much disqualified interest was paid or accrued during the year, and if relied on to avoid disallowance, the corporation's debt-equity ratio for the year (and the supporting calculation) and the tax basis in its assets.

## Discussion

Congress enacted the earnings stripping provision in 1989 targeting several types of transactions, all of which involved stripping income from the U.S. income tax base through the use of interest deductions paid or accrued to a related tax-exempt party. Four years later, in 1993, Congress expanded the earnings stripping provision to include interest paid or accrued to an unrelated person if there is a disqualified guarantee of the debt and no gross basis tax (e.g., withholding tax) is imposed with respect to such interest. Treasury issued proposed regulations under the earnings stripping provision in 1991 but these regulations have never been finalized.

When Congress enacted the earnings stripping provision in 1989, it provided, in essence, a safe harbor for U.S. corporations with debt-equity ratios equal to or less than 1.5 to 1. More specifically, if the U.S. corporation had a debt-equity ratio of 1.5 to 1 or less, then it would not be subject to the earning stripping provision and therefore none of its disqualified interest deductions would be disallowed for the year under this provision. In the Conference Report to the Revenue Reconciliation Act of 1989, the conferees noted that they "expect[ed] that the interest deductions of many corporations will not be affected by the [earnings stripping] provision because many corporations with what can fairly be called typical capital structures have debt-equity ratios below the safe harbor ratio in the bill. The conferees understood that the median debt-equity ratio for U.S. corporations is generally measured as less than 1.5 to 1."[107]

In the last five years, there has been renewed Congressional interest in the earnings stripping provision due, in large part, to the publicity surrounding inversion transactions. In an inversion transaction, the corporate structure of a U.S. based multinational group is altered so that the parent corporation of the group, which was a U.S. corporation, is replaced by a foreign parent, typically located in a low-tax or no-tax jurisdiction such as Bermuda or Barbados. As a result of the inversion and additional restructuring facilitated by the inversion, the foreign operations of the group may be moved outside of the U.S. taxing jurisdiction. In most, if not all, inversion transactions, a U.S. subsidiary remains conducting business in the U.S. The U.S. subsidiary may then make large deductible interest payments on intercompany debt to its foreign parent corporation. If the foreign parent is a resident of a country with a tax treaty with the U.S., then the deductible interest payments made by the U.S. subsidiary to the foreign parent may be paid entirely or partially free of U.S. withholding taxes. As a result, the inversion transaction not only avoids U.S. taxation on the foreign operations of the multinational group, but it also may facilitate stripping earnings from the U.S. tax base.

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[107] H.R. Rep. (Conf. Rep.) No. 101-386, 101st Cong., 1st Sess. 567 (1989).

In its 2002 Congressional testimony, the Treasury Department stated that the "real 'juice' in an inversion transaction" is the stripping of earnings from the U.S. tax base.[108] As part of the American Jobs Creation Act of 2004, Congress eliminated much (if not all) of the tax benefits of inversion transactions and, more recently, in the Tax Increase Prevention and Reconciliation Act of 2005, amended the earnings stripping provision to encompass stripping transactions utilizing pass-through entities. As part of the American Jobs Creation Act of 2004, Congress directed the Treasury Department to conduct a study of the effectiveness of the earnings stripping provision and to submit a report by June 30, 2005. Treasury has recently indicated that the report will be submitted late in 2006.

It is believed that many U.S. corporations utilize the debt-equity safe harbor of 1.5 to 1 to avoid the impact of the earnings stripping provision. The Treasury Department has, in the past, recommended that the debt-equity safe harbor be eliminated but it remains in the Code.[109] In calculating a U.S. corporation's debt-equity ratio under the safe harbor, the corporation must use the tax basis in its assets rather than the book value or fair market value of its assets. In many cases, the tax basis will be lower than the book value or fair market value. However, a U.S. corporation's tax basis in its assets is not information that is available from its corporate income tax return. As a result, the IRS cannot calculate a corporation's debt-equity ratio for purposes of the earnings stripping provision by looking at the information provided on the corporate income tax return. The proposal would require that a U.S. corporation that has paid or accrued disqualified interest during the taxable year provide to the IRS its debt-equity ratio for the year and a schedule showing its calculation of the ratio (including the tax basis in its assets).

Although the information required to be provided under the proposal may be requested by the IRS on audit (and arguably the Secretary has the regulatory authority to require such information be provided under present law), imposing the requirement upon taxpayers at the time of filing their income tax returns should save the IRS both time and money and assist the IRS in utilizing its resources more efficiently in this area. On the other hand, the proposal should give rise to little or no incremental cost to taxpayers, as the required information should be readily available at the time of filing their returns. Moreover, the existence of such a requirement may cause a taxpayer to soften an aggressive return filing position.

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[108] Testimony of Pamela Olson, Acting Assistant Secretary (Tax Policy), United States Department of the Treasury before the House Committee on Ways and Means on Corporate Inversion Transactions (June 6, 2002).

[109] *Id.* ("We [Treasury] propose replacing the safe harbor protection currently available under the fixed 1.5 to 1 debt-equity test with a test that would deny a deduction for related party interest to the extent that the corporate group's level of indebtedness in the United States exceeds its worldwide level of indebtedness. This worldwide test would compare (i) the ratio of indebtedness incurred by the U.S. members of the corporate group to their assets, with (ii) the ratio of the entire corporate group's worldwide indebtedness (excluding related party debt) to its worldwide assets. Interest that is paid to related parties and that is not subject to U.S. tax would be denied deductibility to the extent it is attributable to indebtedness in excess of the worldwide ratio.").