Mr. Chairman and Members of the Subcommittee:

My name is Stefan F. Tucker. I appear before you today in my capacity as Chair of the American Bar Association Section of Taxation. This testimony is presented on behalf of the Tax Section. Accordingly, except as otherwise indicated, it has not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, accordingly, should not be construed as representing the policy of the Association.

As you know, the ABA Tax Section is comprised of approximately 18,000 tax lawyers. As the largest and broadest-based professional organization of tax lawyers in the country, we serve as the national representative of the legal profession with regard to the tax system. We regularly and continuously advise individuals, trusts and estates and small businesses, as well as exempt organizations and major national and multi-national corporations. We serve as attorneys in law firms, as in-house counsel, and as advisors in other, multidisciplinary practices. Many of the Section’s members have served on the staffs of the Congressional tax-writing Committees, in the Treasury Department and the Internal Revenue Service, and the Tax Division of the Department of Justice. Virtually every former Assistant Secretary of the Treasury for Tax Policy, Commissioner of Internal Revenue, Chief Counsel of the Internal Revenue Service and Chief of Staff of the Joint Committee on Taxation is a member of the Section.

The Section appreciates the opportunity to appear before the Subcommittee today to discuss simplification. On behalf of the Section, I want to thank the Chairman and the Members of this Subcommittee for their focus on eliminating complexity in the tax code. We are truly looking forward to the introduction by the Chairman of The Tax Simplification and Burden Reduction Act; we are very pleased that the proposed legislation will include several of the Tax Section's proposals. As you are aware, we consider the elimination of complexity to be of the utmost importance, and the Section and its members are ready, willing and able to work with you in order to accomplish needed change.

SIMPLIFICATION AND COMPLEXITY

The ABA and its Tax Section have long been forceful advocates for simplification of the Internal Revenue Code. In resolutions proposed by the Tax Section and passed by the full ABA in 1976 and 1985, the ABA went on record urging tax law simplicity, a broad tax base and lower tax rates. We have reiterated this position in testimony before the House Ways and Means and Senate Finance Committees on numerous occasions.
In recent years, the Code has become more and more complex, as Congress and various administrations have sought to address difficult issues, target various tax incentives and raise revenue without explicit rate increases. As the complexity of the Code has increased, so has the complexity of the regulations that the IRS and Treasury have issued interpreting the Code. Moreover, the sheer volume of tax law changes has made learning and understanding these new provisions difficult for taxpayers, tax practitioners and Service personnel alike.

The volume of changes, especially recent changes affecting average taxpayers, has created the impression of instability and unmanageable tax complexity. This takes a tremendous toll on taxpayer confidence. This Subcommittee often hears how our tax system relies heavily on the willingness of the average taxpayer voluntarily to comply with his or her tax obligations. Members of the Tax Section can attest to the widespread disaffection among taxpayers with the current Code. The willingness and ability of taxpayers to keep up with the pace and complexity of changes is now under serious stress.

Tax law changes are again under discussion. The Tax Section does not take a position with respect to the wisdom of particular levels of taxation or of particular broad-based tax reduction proposals. We do urge, however, that the members of this Subcommittee keep simplification and avoidance of complexity uppermost in their minds as any tax reduction packages are fashioned. Tax relief can be delivered in ways that avoid new, complicated rules, such as phase-outs, multiple choice elections and highly detailed conditions. While simple, broad-based tax reductions may not have the cachet of the newer style, more targeted provisions, they will avoid the layering of new complexity over old. If Congress chooses to reduce taxes, we urge you to do no harm.

To this end, I, on behalf of the Tax Section, earlier this year sent to Secretary Rubin a letter expressing our disappointment that the President’s budget proposes to add a multitude of new tax credits to the Federal income tax system. Our point in that letter was that, although each credit taken in isolation could be viewed as meritorious, that kind of micro-balancing inevitably leads to the type of tax system that is, in total, overly complex and undeserving of public respect. Particularly in light of the various, complicated provisions added by the Taxpayer Relief Act of 1997, Congress and the Administration must focus on the cumulative impact of all new provisions sought to be added. We continue to urge that the leaders of the tax legislative process -- including this Subcommittee -- resist the accretion of income tax benefits and penalties that are unrelated to the administrable measurement of annual taxable income and ability to pay.

My letter to Secretary Rubin also urged that particularly close scrutiny be given to any proposals that include income phaseouts. These phaseouts have gained popularity in the last two decades and are responsible for a significant amount of the complexity imposed on individual taxpayers. Phaseouts create the effect of a marginal rate increase as a taxpayer’s income moves through the phaseout range, and the effects of multiple phaseouts on the same taxpayer can create capricious results. Phaseouts also blunt the intended incentive effect, because taxpayers cannot predict whether benefits will be available to them. Phaseouts also play a significant role in the creation of marriage tax "penalties," and add to the difficulty in addressing that set of issues. We urge you to resist their continued use in the enactment of additional tax incentives.

We do not claim to have all the answers. The Tax Section will continue to point out opportunities to achieve simplification whenever possible, including several ideas that we will discuss later in this testimony. However, it is also necessary that we point out that simplification necessitates hard choices and a willingness to embrace proposals that are often dull and without passionate political constituencies. Simplification also requires that easy, politically popular, proposals be avoided if they would add significant new complexity. Simplification – and preventing greater complexity -- may not garner political capital or headlines, but it is crucial. It requires leadership from the Administration and from the tax-writing committees.
To date, simplification has not achieved the commitment that we believe is required. Too often, other objectives have tended to crowd simplification out as a priority. We urge the members of this Subcommittee to adjust this balance by endorsing simplification as a bedrock principle and communicating that principle to all involved in the tax-writing process.

To that end, the Congress adopted as part of the IRS Restructuring and Reform Act of 1998 a procedure to analyze the complexity of proposals with widespread applicability to individuals or small business. By means of this complexity analysis, the Joint Committee on Taxation will call attention to provisions that could result in substantial increases in complexity, and will suggest ways in which the goals of those proposals can be achieved in simpler ways. We strongly support this increased focus on complexity and urge the members of this Committee, and especially this Subcommittee, to pay heed to the JCT analyses. Only by raising awareness of problems with proposals before they become law will Congress make substantial inroads into the problem.

SPECIFIC PROPOSALS

We would now like to address certain specific areas in which the Tax Section considers the need for simplification immediate. We begin with the alternative minimum tax, which is an area that we believe demands the immediate attention of this Congress. As this Subcommittee is well aware, there is an inherent problem with the individual AMT which, if not dealt with in one way or another, will result in approximately 9 million additional taxpayers becoming AMT taxpayers within the next decade. Many have referred to this problem as a "ticking time bomb". Most of these additional taxpayers are not of the type envisioned as being subject to the AMT when it was revised in 1986. Moreover, many of these individuals will not even be aware they are subject to the AMT until completing their returns or, worse, receiving deficiency notices from the IRS. We are continuing to confer with our counterparts at the Tax Division of the AICPA concerning our respective positions on the AMT, and we have found that our two groups are in accord on the importance of addressing the AMT issue promptly.

We wish to acknowledge the Chairman's understanding of the problems attendant to the AMT, as reflected in the first three items of his list of provisions for his proposed legislation, and for his leadership in seeking to reduce complexity. We are pleased that Congressman Rep. Coyne (D.-PA) has introduced a simplification bill. (See H.R. 1407 (106th Cong.).) We also would like to commend Congressman Rep. Neal (D-MA) for his recognition of the problems that the Tax Section perceives as associated with the individual AMT and for his proposal to repeal the personal exemption phaseout and the overall limitation on miscellaneous itemized deductions – an issue which I will discuss in more detail later in this testimony. (See H.R. 1420 (106th Cong., 1st Session, 1999.).)

A. Alternative Minimum Tax

1. Background

Individuals first became subject to an "add-on" minimum tax in 1969, enactment of which was precipitated by concerns that some taxpayers with significant economic income were paying little or no tax because of excessive investments in tax shelters. This add-on tax ultimately was repealed and replaced with a minimum tax payable to the extent that an individual’s AMT liability exceeded his or her regular tax liability. This minimum tax—which eventually morphed into an entirely separate, parallel, tax system—has been modified several times since enacted.

The current law version of the minimum tax generally involves computing AMT liability by multiplying an AMT rate that is lower than the regular tax rate against a tax base that is broader than the regular tax base. Subject to year-by-year exceptions that have been made, most nonrefundable credits cannot be used to reduce AMT liability. This has the effect of making many credits unavailable to otherwise eligible individuals in cases where use of the credit would cause the amount of the regular tax liability to be less
than the tentative AMT liability. The AMT rate brackets are mildly progressive, but are not indexed for inflation.

The base for the AMT is an individual’s alternative minimum taxable income (AMTI). An individual’s AMTI is determined by adding certain "preference items" to taxable income (such as tax-exempt interest on certain private activity bonds and a portion of the amount excluded from regular taxable income on sales of certain small business stock) and "adjusting" the treatment of certain items to eliminate or reduce benefits associated with the regular tax treatment of those items. Some of these adjustments relate to "business" type items—such as the requirement that depreciation be computed for AMT purposes using a separate system that provides for less accelerated depreciation deductions than under the regular tax system. Other adjustments are purely "personal." For example, adjustments for individuals include: (1) disallowing deductions for State and local taxes; (2) disallowing medical expenses except to the extent they exceed 10 percent of the taxpayer’s adjusted gross income (AGI), and (3) disallowing standard deductions and personal exemptions. Other adjustments that affect individuals relate to investment or employment items. For example, (1) miscellaneous itemized deductions are not allowed, and (2) the special regular tax rules relating to incentive stock options (ISOs) are not allowed. Although an individual is allowed an exemption against his or her AMTI, the exemption amount is not indexed for inflation.

2. Problems with the AMT

As explained below, we believe that there are at least four significant problems with the individual AMT.

First, the AMT no longer is necessary to fulfill its intended purpose. As indicated above, the original AMT was enacted to address concerns that persons with significant economic income were paying little or no Federal taxes due to investments in tax shelters. This reason is no longer compelling in light of numerous changes that have been made to the Tax Code to specifically limit tax-shelter deductions and credits. For example, the Tax Reform Act of 1986 expanded the application of the at-risk rules and enacted rules limiting deductions and credits for passive activity losses, which greatly reduced shelter opportunities.

Second, the AMT increasingly is affecting an unintended class of taxpayers—middle class taxpayers who are not engaged in tax-shelter or deferral strategies. Studies indicate that the AMT increasingly is becoming the tax system for middle-income individuals. For example, a pamphlet prepared last year by the Joint Committee on Taxation ("JCT") indicates that, by 2008, 19.7 percent of taxpayers in the $75,000 to $100,000 bracket will be paying the AMT and that almost 1.75 million AMT returns will be filed by individuals in the $30,000 to $75,000 bracket. Joint Committee on Taxation, Present Law and Issues Relating to the Individual Alternative Minimum Tax ("AMT") (JCX-3-98), February 2, 1998. Another study indicates that, by 2007, almost 95 percent of the revenue from AMT preferences and adjustments will be derived from four items that are "personal" in nature and are not the product of any tax planning strategies — the personal exemption, the standard deduction, state and local taxes, and miscellaneous itemized deductions. In fact, the same study indicates that, in 1994, the disallowance of the deduction for state and local taxes accounted for approximately 47 percent of total AMT preferences; we expect this percentage is even larger today. Harvey and Tempalski, "The Individual AMT: Why It Matters," National Tax Journal, Vol. L, No. 3, September 1997. Further, even those individuals who ultimately do not pay any AMT liability increasingly will lose the benefits of credits that Congress decided were necessary and appropriate and, in some cases, may have been targeted to specific classes of taxpayers. For example, the 1998 JCT pamphlet projects that, by 2008, 7.9 million returns will receive zero or less than the full child care credit due to AMT limitations.

Third, the AMT is too complex and imposes too great a compliance burden. The existence of the AMT system literally requires all people to compute their taxes under two different sets of rules—the regular rules and the AMT rules. Given the complexity associated with the regular tax system, even a small amount of additional complexity from an additional tax system may be too much. However, the AMT
involves more than a small amount of additional complexity. Even individuals who ultimately do not end up paying the AMT have to perform calculations to determine whether or not they need to pay it or whether they are restricted in their use of credits. For example, taxpayers trying to determine whether or not they owe the AMT must complete a 12-line worksheet first, then a 43-line form (and another 22-lines if they have long-term capital gains). Further, some of the adjustments (such as those for depreciation and net operating losses) require the taxpayer to keep two sets of records, one for regular tax purposes and the other for AMT purposes so that proper alternative calculations may be made in the future, even if there is no AMT liability currently. It is no wonder that many individuals fail to make the statutorily required calculations, either because they cannot imagine the AMT would apply to them, or because they simply cannot deal with the excessive complexity.

Fourth, some of the adjustments and preference items are inappropriate from both a policy and a technical perspective. While virtually all of the adjustments and preferences can be, and have been, sharply criticized from a policy standpoint, two adjustments that apply only to individuals seem particularly inappropriate for technical reasons as well. Neither the adjustment to disallow miscellaneous itemized deductions nor the adjustment for ISOs seems supportable from a policy or technical standpoint. The AMT’s main purpose is to blunt the use of tax shelter or uneconomic deductions incurred to reduce income tax excessively. The regular tax system permits as a miscellaneous itemized deduction those expenditures that are employment related or are clearly related to the production of income or the management or maintenance of income-producing property. There is no AMT objective to deny a deduction for the remaining, clearly employment - or income-related, expenses. Certainly they are not the sort of deductions that individuals incur as tax-shelter items or "trump up" artificially to eliminate income tax.

The AMT system also denies regular tax benefits accorded to incentive stock options by requiring that the excess of the fair market value of the stock over the exercise price (i.e., the "bargain" element) be included in income in the year the option is exercised. However, this adjustment improperly taxes the ISO gain at a 28% rate rather than the top capital gain rate of 20%, the rate applicable under the regular tax system. There seems no justification for this denial of capital-gain character of the bargain element now that Congress has expressed its intention in the Taxpayer Relief Act of 1997 that long-term capital gain be taxed under the AMT system at no higher rate than under the regular system.

3. Recommendations

We respectfully suggest that the Subcommittee consider the following alternatives, which we state in our order of preference.

Repeal the Individual AMT

As indicated above, the individual AMT is no longer necessary to serve its intended purpose and, if kept in place, will become the regular tax system for more and more individuals. Further, the additional burdens it imposes are not justified by a sufficiently clear policy objective and, if left unchecked, almost certainly will engender further dissatisfaction with the tax system. We realize that repealing the individual AMT is expensive and may raise a political problem if repeal is perceived as aiding people with economic income to avoid paying their fair share of taxes. However, we respectfully submit that, even though it may be expensive to repeal the individual AMT in its entirety now, the cost of repeal will only increase in the future as more people are affected. Further, it is doubtful that repealing the individual AMT will result in a significant "perception" problem akin to that which precipitated the enactment of the original add-on tax in 1969, given the reforms to the Tax Code that have been made in the interim and Congressional willingness to legislate against shelter transactions in general. Indeed, we believe there will be a much worse political problem if the AMT is not repealed and more and more Americans become subject to the AMT, lose credits to which they otherwise would be entitled, or are forced to endure the frustration of spending even more time and effort on filing their income tax returns.
b. **Exclude Taxpayers with Average AGI Below a Certain Threshold from the AMT System Entirely.**

In the Taxpayer Relief Act of 1987, Congress struck a blow in favor of simplicity by excluding certain small corporations from the burden of AMT calculations. This was done on the basis of the average gross receipts of the corporation for the prior three years. Applying a similar approach to individuals could exclude many taxpayers from the individual AMT system while still retaining much of the revenue. For example, based on income distribution tables as of 1994, it might be possible to exclude approximately two-thirds of taxpayers from the AMT system, while retaining nearly two-thirds of the revenue, by excluding entirely from the AMT system any individuals whose average AGI for the prior three years was under $200,000, adjusted for inflation. See Harvey and Tempalski, Table 3 at p. 463. We emphasize, however, that this approach alone does not fully respond to the significant substantive problems with the AMT.

**Partial Repeal.**

Another alternative would be to examine each preference and adjustment item separately and to determine whether it should be retained in the AMT system. However, in our view, proper analysis of each item of adjustment and preference would result in the AMT system being repealed. There is little, if any, justification for the "business" adjustments and preferences, and clearly is no justification for any of the personal adjustments and preferences. Still, if full repeal is not possible, major simplification could be achieved by (1) allowing all credits to reduce the individual’s liability, without regard to the AMT (i.e., making the temporary measure for 1998 returns permanent); (2) removing most of the adjustments and preferences, which are mostly "cats and dogs" anyway, while retaining at most the four or five "core" items that account for almost all the revenue; and (3) removing some of these core items depending upon revenue constraints. As indicated above, however, we strongly urge the Subcommittee to consider repealing the entire system. Individual items can be addressed directly under the regular tax rules, if necessary for revenue purposes.

d. **Fix Problems with the Existing Adjustments and Preferences.**

Even if Congress decides to retain all or most of the existing preferences and adjustments for perception or revenue reasons, we recommend that Congress correct the glaring problems with two preference items that affect only individuals. First, the denial for AMT purposes of any deduction for miscellaneous itemized deductions should be repealed. The regular tax system already denies a deduction for a portion of those expenses, i.e., the portion equal to two percent of AGI. The remaining portion is either an employment-related expense or is clearly related to the production of income or the maintenance of income-producing property. It cannot be said that these deductions are "excessive," uneconomic or otherwise incurred primarily to reduce income tax. There is no reason for these items to be denied under the alternative system when they are sufficiently "income related" to be allowed under the regular tax system. Second, the adjustment for ISO stock should be modified or eliminated as it inappropriately taxes a portion of the gain at a rate in excess of the maximum 20% that Congress intended be applied to long-term capital gain. As noted earlier, because the entire gain will be treated as capital gain if the stock is held for more than 12 months after the option is exercised, the so-called bargain element should also be treated as capital gain under the AMT system and taxed at a top rate of 20%.

**Index the Rate Brackets and the Exemption Amount.**

Studies have shown that indexing the rate brackets and exemption amount would solve a significant part of the second problem highlighted above — that more and more people will be affected by the AMT each year. For example, the above-cited article by Harvey and Tempalski indicates that, if the AMT exemption, the income level at which the phaseout of the AMT exemption begins, and the income level at which the AMT marginal rate switches from 26 to 28 percent were indexed, approximately 8.2 million fewer taxpayers would be affected by the AMT in 2007 than if nothing were done. Indexing the
parameters of the AMT is less optimal than full repeal, however, because it will do little to alleviate the compliance burden associated with the AMT system. That is, people will still have to make the calculations to determine whether they must pay the AMT or whether they will lose the benefit of certain credits. For these reasons, we view indexing as our last choice and as only a partial response to the problem.

We urge this Subcommittee in the strongest possible terms to solve the problems with the AMT once and for all. There is universal acknowledgement that the effects we have described are unintended and unjustified. It is also acknowledged that the revenue cost associated with a permanent solution will only increase over time and may eventually become prohibitive. It would be a travesty if a permanent solution to the AMT became caught on the merry-go-round of expiring provisions. A permanent solution should not be deferred merely because it competes with other, more popular proposals for tax reduction.

B. Phaseout of Itemized Deductions and Personal Exemptions

At the urging of the Tax Section, the American Bar Association earlier this year adopted a recommendation that the Congress repeal the phaseout for itemized deductions (the so-called "Pease provision") and the phaseout for personal exemptions (the "PEP provision"). The ABA also recommends that the revenue that would be lost by repeal be made up with explicit rate increases. This would address any revenue neutrality concern, as well as any concern with respect to the distributional effects of repeal.

It may be difficult for members of Congress to appreciate the level of cynicism engendered by these two phaseouts. Countless times, taxpayers who might not otherwise be troubled by the amount of tax they are paying have reacted in anger when confronted with the fact that they have lost – either wholly or partially – their itemized deductions and personal exemptions. They are no more comforted when told that these phaseouts should really be viewed as substituting for an explicit rate increase. Almost without exception, they react by asking why Congress refuses to impose the additional rate rather than trying to pull the wool over their eyes.

We have no answer to that question. We take pride in the fact that the ABA is willing to recommend a simplification proposal funded by a marginal rate increase on the same taxpayers benefiting from the simplification. We urge this Subcommittee to give serious consideration to the ABA’s recommendation.

C. Additional Simplification Proposals

Although the alternative minimum tax certainly causes great complexity in the Code (and its application is much more widespread than ever envisioned), the Code is replete with numerous other provisions, the complexity of which are much greater than the perceived abuse to which the provision was directed or the benefit that was deemed gained by its addition. Furthermore, the Code contains many provisions which at the time of enactment may well have been desirable, but with the passage of time or the enactment of other changes, have truly become "deadwood". However, despite the lack of utility of such provisions (whether in a relative or absolute sense) analysis of the same may well be required either in the preparation of the tax return or in the consummation of a proposed transaction. The elimination of such provisions would greatly simplify the law. The following are examples of such provisions, that when analyzed do not justify their continuation in the law. Obviously, these are but a few such examples, and an extensive analysis of the Code would undoubtedly uncover a legion of the same. We have separated our recommendations into categories for individual, business, and administrative items.

1. Individual Tax Provisions
a. Simplify Phaseouts
Numerous sections in the Code provide for the phaseout of benefits from certain deductions or credits over various ranges of income based on various measures of the taxpayer's income. There is no consistency among these phaseouts in either the measure of income, the range of income over which the phaseouts apply or the method of applying the phaseouts. Even without the inconsistencies, the phaseouts cause problems. They add significantly to the length of tax returns, increase the potential for errors, are difficult to comprehend, and make it extraordinarily difficult for families to know whether the benefits the provisions confer will be available. The inconsistencies exacerbate these problems, causing inordinate complexity, particularly for taxpayers attempting to prepare their tax returns manually. Simplicity would be achieved by (a) eliminating phaseouts altogether, (b) substituting cliffs for the phaseouts, or (c) providing consistency in the measure of income, the range of phaseout and the method of phaseout.

Rationalize Estimated Tax Safe Harbors.

Section 6654 imposes an interest charge on underpayments by individuals of estimated income taxes, which generally are paid by self-employed individuals. This interest charge generally does not apply if the individual made estimated tax payments equal to the lesser of (x) 90 percent of the tax actually due for the year or (y) 100 percent of the tax due for the immediately prior year. The availability and computation of the prior year safe harbor has been adjusted regularly by the Congress over the past decade. Presently, for individuals with adjusted gross income exceeding $150,000, the prior year safe harbor percentage increases and decreases from year to year over a range from 105 to 112 percent. The purpose of these increases and decreases is to shift revenues from year to year within the five and ten year budget windows used for estimating the revenue effects of tax legislation. Congress should determine an appropriate safe harbor percentage and apply that amount for all years, avoiding the complexity the increasing and decreasing percentages bring.

c. Repeal the Two Percent Floor on Miscellaneous Itemized Deductions.

The two percent floor on miscellaneous itemized deductions contained in Section 67 was enacted as a simplification measure intended to relieve taxpayers of recordkeeping burdens and the Internal Revenue Service ("IRS") of the burden of auditing deductions insignificant in amount. Experience indicates that taxpayers continue to keep records of such expenses to determine deductible amounts in excess of two percent of adjusted gross income. Moreover, the existence of the limitation and the need to identify the deductions to which it applies introduces needless computational and substantive complexity to the preparation of tax returns.

d. Increase the Floor for Itemized Deductions for Medical Expenses and Increase the Personal Exemption Amount for Taxpayers 65 or Over.

A deduction is allowed for medical expenses in excess of 7.5 percent of adjusted gross income. Despite the current 7.5 percent floor, which limits the deduction to extraordinary unreimbursed medical expenses, the existence of the deduction requires taxpayers to identify medical as compared to personal expenses and to maintain detailed records of the former. An increase in the floor to 10 percent of adjusted gross income would reduce the number of returns claiming the medical expense deduction and alleviate substantiation and audit verification problems and numerous definitional issues. An increase in the floor to a catastrophic level would also likely reduce the number of taxpayers maintaining medical records. The personal exemption amount for taxpayers 65 and older could be increased to offset any adverse effect on elderly taxpayers.

e. Reduce Family Unit Tax Complexity.

A number of provisions make the filing of tax returns and computation of tax liability particularly complicated for low and moderate income taxpayers. Certain provisions necessitate the filing of returns by individuals who would otherwise have no tax liability and no need to file. The complexity of the calculations coupled with definitional issues make it extremely difficult for low and moderate income
taxpayers to complete their returns without paid assistance, which they cannot afford. These provisions result in a significant number of adjustments to tax returns, causing considerable administrative difficulties for the IRS in making the adjustments and collecting the amounts due. In addition, the adjustments result in additional liability for interest and penalties on the part of a group of taxpayers that has difficulty satisfying the tax liability, let alone additional sums.

f. Earned Income Credit.

The Earned Income Credit (EIC) contained in Section 32 provides a substantial, refundable tax credit to low income workers, both with and without children. The EIC, as presently designed, creates several layers of complexity.

The EIC requires many taxpayers to file a return whose income would otherwise fall below filing thresholds.

The definition of a "qualifying child" under Section 32(c)(3) differs from the definition of a dependent child, and treats foster children differently from biological or adoptive children.

The AGI tie-breaker rule does not resolve the perceived abuse it targets while its application often incorrectly denies the credit to people who should be eligible, insofar as it does not focus on a clear and reasonable definition of what constitutes a "household".

g. Child Credit.

The Child Credit, contained in Section 24, on account of its multiple calculations and "integration" with the child and dependent care credit, the earned income credit, the alternative minimum tax, and social security tax creates unnecessary complexity for taxpayers who would otherwise be able to file simple returns.

h. Dependent Care Credit.

The Dependent Care Credit, contained in Section 21, is of limited benefit to low income working families because it is not refundable. Further, it does not benefit higher-income working families because the credit rate caps at relatively low income levels and does not reflect the true cost of child or dependent care.


The treatment of child support payments as a nondeductible expense creates confusion and leads to many noncustodial parents claiming dependency exemptions for children without obtaining the required Form 8332. It places the burden on the IRS administratively to identify and audit such claims, and makes the dependency exemption an element of horse-trading in domestic relations disputes, catching taxpayers in a conflict between state domestic relations orders and Federal income tax laws. The disparate treatment of alimony and child support adds the complexity of the tax law to negotiations that are often difficult and unpleasant.

j. Dependency Definition.

The current definition of "dependent" under Sections 151 and 152 is confusing and difficult to administer. In particular, problems arise with regard to the treatment of (1) children of separated or divorced spouses; (2) other "custodians" of dependent children; and (3) "custodians" of disabled or elderly individuals.

Further, as noted previously, the definition of a dependent child is not harmonized with the definition of a "qualifying child" under the earned income credit, nor is the concept of "support" identical to the concept
of "maintaining a household" for purposes of head of household status under Section 2(b). Finally, foster children are treated differently from biological or adopted children.

k. Simplification Alternatives for Family Status Issues.

Simplification for low and moderate income taxpayers could be pursued at a macro level, with a wholesale revision of the provisions intended to provide benefits to this group of taxpayers, or at a micro level by addressing individual issues described above. On the macro level, replacing "head of household" status, dependent child exemptions, and the child credit with one "mega-" program that provides the economic value of these benefits to taxpayers with children, with the same overall distribution of benefits as under current law could result in significant simplification for low and moderate income taxpayers. Definitions would be coordinated with those utilized in the EIC program. The exemption amount could differ depending on whether the taxpayer is single or married (or married filing separately). With this kind of macro revision, taxpayers would only have to walk through two sets of coordinated rules - the mega-exemption and the EIC.

On a micro level, the following alternatives address particular problems and could significantly reduce complexity in those areas.

Apply one standard for qualification as a dependent child, qualifying child for purposes of the EIC, and head of household status (if retained) that equates support with the cost of maintaining a taxpayer's household and is based on the child residing in the taxpayer's home for more than half the tax year. Provide safe harbors for taxpayers awarded custody by court order or other agreement. (Taxpayers could check a box signifying the existence of such an order or agreement.)

Define dependent to include foster children residing in a home for more than half the tax year. In the case of a court order or other official "placement" of the child (e.g., by order of the local Department of Social Services, a child welfare agency, or other placement agency), qualification could be established by attaching a copy of the order to the return or checking a box signifying the existence of such an order. In the case of the informal placement of a foster child, the taxpayer would have to establish residence for more than half the tax year.

Equalize the treatment of alimony and child support by making child support deductible by the payor and included in income by the payee. This will remove much of the "gaming" involved with duplicate claims for dependency exemptions, the earned income credit and head of household status, and problems arising from state domestic relations orders, since it gives taxpayers who pay child support some tax benefit for their payments. Since dependent exemptions will only be claimed by custodial parents or other custodial individuals, nonworking custodial parents will usually not have to file. Those custodial parents who do file will claim dependency exemptions and other child-related credits.

Increase the dependency exemption to ensure it reflects the cost of maintaining a home for a child. An increase in the amount of the dependency exemption in conjunction with standard deductions that more accurately reflect minimum cost of living would reduce the number of taxpayers who must file returns.

Replace the "AGI tie-breaker" rule in the EIC with a definition of "household" that more accurately targets the perceived abuse of two unmarried taxpayers living together and gaming the system.

Facilitating or mandating advance EIC payments through integration of Forms W-4 and W-5 and employee withholding systems would eliminate the need for many taxpayers to file returns.

Establish a uniform credit rate for the dependent care credit and make the credit refundable so it truly benefits lower income working families.

Simplify the Capital Gains Provisions.
The capital gains regime applicable to individuals is frighteningly and unnecessarily complex. As a result of Congressional determinations that some assets are worthier of tax benefits than others and that investment in capital assets should be encouraged but only if the tax benefits affect revenue some time in the future, the Code contains a bewildering variety of rules under which different types of assets are subject to different rates and the rates applicable to long-term gains vary depending on the holding period. This system imposes difficult record-keeping burdens on taxpayers and encourages taxpayers to try to manipulate the system through investments in derivatives, short sales, and similar techniques. In addition, taxpayers holding property acquired before 2001 can elect to have the property treated as if it had been sold on the first business day after January 1, 2001, thereby becoming eligible for the special 18% rate if it is held for another five years. Determining whether to make this election will require taxpayers to make economic assumptions and do difficult present value calculations. While there may be some justification for each item of fine-tuning in this area, their cumulative effect has been to create a structure that is incomprehensible to taxpayers and to the people who prepare their tax returns.

Simplification can take several forms. First, different rates for different types of assets (e.g., collectibles) should be eliminated. Second, different rates for long-term assets held for different holding periods should be eliminated; there is no reason to have a special ultra-low rate for assets held for more than five years. Third, to assure that any benefit is extended to all taxpayers regardless of their tax brackets, the concept of special capital gain rates might be replaced by an exclusion for a percentage of long-term capital gains.

m. Harmonize and Rationalize Education Incentives.

The Code contains a variety of provisions granting taxpayers educational incentives. These provisions include education IRAs, the Hope Credit, the Lifetime Learning Credit, exclusions for employer-provided educational assistance, and interest deductions on student loans. The sheer number of alternatives creates complication. Moreover, the targeting of the provisions makes them particularly complicated and difficult to comprehend. The restrictions on their use can mean that taxpayers unexpectedly find they have lost the benefit of a particular incentive. The education incentives should be harmonized and rationalized so that taxpayers have a simple and clear menu of options from which to choose in planning for educational expenses that yields predictable results.

n. Eliminate Elections.

Many provisions allow taxpayers to elect special treatment. While some elections are necessary and appropriate (e.g., election to be treated as an S corporation), it is often the case that elections and safe harbors, even those enacted in the name of simplification, increase complexity. The availability of an election oftentimes requires taxpayers to make multiple computations to determine the best result, thereby adding significant complexity. For example, the various elections available under recently enacted Section 6015 with respect to innocent spouse relief increase planning and procedural complexity significantly. Likewise, some recent proposals for eliminating or reducing the so-called marriage penalty would effectively require married couples to compute their income twice to determine which approach yielded a lower tax payment. In lieu of providing multiple approaches to the same goal, Congress should develop a single legislative solution to address a specific problem, and should make such a solution as simple and fair as possible.

o. Increase the Estate and Gift Tax Unified Credit.

The Code requires the estates of decedents with gross estates in excess of the exclusion amount ($650,000 in 1999) to file estate tax returns. According to the latest published IRS statistics (calendar year 1996), approximately 79,346 estate tax returns were filed that year. Fewer than half of the returns filed (47.5 percent) reported estates that were subject to tax. Of those subject to tax, the largest 14 percent of estates (over $2.5 million gross estate) bore 69 percent of the total estate tax paid. Conversely, the lowest 86 percent of gross estates paid only 31 percent of the total estate tax revenues received ($4.51 billion out of $14.49 billion). In 1997, Congress put in place a gradual phase-up of the exclusion amount to $1 million
in 2006, which will eliminate the filing requirements for a substantial number of estates otherwise required to file returns and reduce to zero the tax owed by many of those estates. An additional increase in the unified credit (beyond $1 million) would further relieve an additional significant number of decedents’ estates from the burden of filing returns and paying estate tax without a significant decrease in Federal revenue. More importantly, such a change would relieve many such individuals during their lifetimes of the burden of estate planning oriented almost entirely toward minimizing their estate tax liability, rather than family and business succession considerations.

p. Repeal Sections 2032A and 2057.

Section 2032A (enacted in 1976) provides special valuation rules for farms and real property used in a trade or business. Section 2057 (enacted in 1997) provides a deduction for a limited amount of the value of a closely held business. The maximum reduction in the value of a decedent’s estate from use of Section 2032A is $750,000; the maximum deduction under Section 2057 is $675,000 (not taking into account the interaction with the unified credit). The limited benefits provided by these Sections, which is limited to a select group of taxpayers, should be contrasted with the substantial complexity they produce. In addition to their statutory and administrative complexity, the provisions encourage extensive tax planning and invite manipulation of ownership interests and asset use.

q. Simplify Transfer Tax Valuation of Minority Interests in Non-Publicly Traded Family-Owned Businesses.

Significant taxpayer planning and government administrative expenses are incurred when a discount is claimed with respect to the value of ownership interests in non-publicly traded business enterprises controlled by a family. Significant simplification could be achieved if the value of stock in a non-publicly traded corporation were deemed to be equal to its pro rata share of all the stock of the same class in such corporation, unless a different value is established by clear and convincing evidence. Under this test, all stock held, directly or indirectly, by an individual or by members of such individual’s family will be treated as held by one person. Similar rules would apply to ownership interests in other entities.


a. Simplify the Minimum Distribution Requirements.

Under Section 401(a)(9), qualified retirement plan benefits must be distributed to a participant or his or her beneficiary(ies) within a prescribed period of time that is dependent upon a number of variables, including the identity of the participant’s beneficiary(ies) and the circumstances under which benefits are paid. Section 408(a)(6) extends these distribution requirements to IRA benefits. The distribution rules in Section 401(a)(9) complicate the administration of qualified retirement plans and IRAs, and present conceptual difficulties for participants. Moreover, although intended to preclude the unreasonable deferral of benefits, benefits deferred are subject to income taxation upon eventual distribution and may be subject to estate taxation upon a participant’s death. The provisions of Section 401(a)(9), other than those dealing with the required beginning date for distribution of retirement benefits, should be replaced with the incidental death benefit rule in effect prior to the enactment of the Employee Retirement Income Security Act of 1974 (hereafter "ERISA").

b. Eliminate the Half-Year Age Conventions.

Section 401(a)(9) provides that retirement plan benefits must commence, with respect to certain employees, by April 1 of the calendar year following that in which the employee attains 70½. Section 401(k) states that plan benefits may not be distributed before certain stated events, including attainment of age 59½. Further, Section 72(t) provides that premature distributions from a qualified retirement plan, including most in-service distributions occurring before an employee’s attainment of age 59½, are subject to an additional 10% tax. Changing these age requirements to age 70 and age 59, respectively, would simplify plan administration.
c. **Repeal or Modify the Top Heavy Rules.**

Section 416 was enacted to limit the ability of a plan sponsor to maintain a qualified retirement plan benefiting primarily the highly paid. Section 416 is both administratively complex and difficult to understand. Furthermore, under current law, there are limitations on the compensation with respect to which qualified retirement plan benefits can be provided, there are overall limitations on qualified retirement plan benefits, and non-discrimination requirements limit the ability of sponsors to adopt benefit formulas favoring the highly paid. Given the other limitations in the Code, Section 416 adds an unnecessary layer of complexity to employee plan administration.

If Section 416 is retained, the rule attributing to a participant stock owned by a member of the participant’s family for purposes of determining whether or not the participant is a key employee should be eliminated. This change would be consistent with the recent repeal of the family aggregation rules under Sections 401(a)(17) and 414(q).

d. **Replace the Affiliated Service Group and Employee Leasing Rules.**

Sections 414(b) and 414(c) treat businesses under common control as a single employer for purposes of determining whether a retirement plan maintained by one or more of these businesses qualifies under Section 401. Two other Code provisions adopt an aggregation concept as well. Specifically, Section 414(m) generally treats all employees of members of an affiliated service group as though they were employed by a single employer, and Section 414(n) states that, under certain circumstances, a so-called leased employee will be deemed to be employed by the person for whom the employee performs services. No regulations have been finalized under these provisions. They are difficult to comprehend and to apply.

Sections 414(m) and 414(n) should be replaced with provisions explicitly describing and limiting the circumstances under which employees of businesses that are not under common control must be taken into account for purposes of determining the qualified status of a sponsor’s retirement plan, and the discretion granted under Section 414(o) to develop different rules should be repealed.

e. **Worker Classification.**

Determining whether a worker is an employee or independent contractor is a particularly complex undertaking because it is based on a 20-factor common law test. The factors are subjective and given to varying interpretations and no guidance exists on how or whether to weight them. In addition, the factors are not applicable in all work situations, and, in some work situations, the factors do not provide a meaningful indication of whether the worker is an employee or independent contractor. The consequences of misclassification are significant for both the worker and employer, including retroactive tax assessments, imposition of penalties, disqualification of benefit plans, and loss of deductions.

Complexity would be significantly reduced by enactment of an objective test to replace the subjective 20-factor test and making it applicable for Federal income tax and ERISA purposes. In the alternative, changes could be made to reduce the differences between the tax treatment of employees and independent contractors. Efforts to make the tax law more neutral with respect to whether a worker is an employee or independent contractor would reduce the importance of the worker classification rules because the consequences of misclassification would be less significant.

f. **Expand the Use of the Cash Method of Accounting.**

Small C corporations, qualified personal service corporations, sole proprietors and certain passthrough entities are excepted from the required use of the accrual method under Section 448. This exception does not cover more than *de minimis* amounts of inventory, however, and there are no specific rules delineating when inventory is *de minimis*. In addition, the applicability of the inventory rules, which were written for the industrial age, is not at all clear for businesses operating in the information age. For example, it is not clear whether a business developing software sold via the Internet is required to use an inventory method.
Thus, some businesses cannot easily determine if they have inventory that requires the use of the accrual method of accounting. Moreover, many of these businesses otherwise use the cash method of accounting, so that requiring the use of the accrual method and the keeping of inventories subjects them to complex rules and recordkeeping.

Considerable simplification could be achieved by amending Sections 446 and 448 to allow small taxpayers to use the cash method of accounting. Consistent with Section 448, small taxpayers (even those with inventory) could be defined as those with average annual gross receipts in the three prior years of $5 million or less. This rule would enable small businesses (even those with inventory) to use the cash method should they find it simpler. This proposal should not result in taxpayers manipulating their income because such businesses generally cannot afford to maintain large quantities of inventory on hand and the inventory levels of small businesses, in particular, would not be extensive. Further simplification could be achieved by increasing the Section 448 gross receipts threshold to $10 million.

g. Provide Clear Rules Governing the Capitalization and Expensing of Costs and Recovery of Capitalized Costs.

Although the IRS clearly stated that the Supreme Court's decision in INDOPCO v. Commissioner, 503 U.S. 79 (1992), did not change fundamental legal principles for determining whether a particular expense may be deducted or must be capitalized, nonetheless, since INDOPCO, whether an expense must be capitalized has become the most contested audit issue for businesses. A future benefit test derived from the INDOPCO decision has been used by the IRS to support capitalization of numerous expenditures, many of which have long been viewed as clearly deductible. Almost any ongoing business expenditure arguably has some future benefit. The distinction between an "incidental" future benefit, which would not bar deduction of the expenditure, and a "more than incidental" future benefit, which might require capitalization, generally is neither apparent nor easy to establish to the satisfaction of parties with differing objectives. In addition, the administrative burden associated with maintaining the records necessary to permit the capitalization of regular and recurring expenditures is significant. Development of objective, administrable tests governing the deduction of expenses or the capitalization of categories of expenditures would significantly reduce controversy, just as the enactment of Section 197 significantly reduced controversy regarding the amortization of intangible assets. For example, repair allowance percentages such as those previously provided under the Class Life Asset Depreciation Range (CLADR) System would significantly reduce controversy regarding capitalization of repair expenditures. See Rev. Proc. 83-35, 1983-1 C.B. 745 (CLADR repair allowance percentages); see alsoSection 263(d) (repair allowance percentage for railroad rolling stock).

h. Modify the Uniform Capitalization Rules.

The uniform capitalization ("UNICAP") rules in Section 263A are extraordinarily complex. Compliance with the UNICAP rules consumes significant taxpayer resources; yet, for many taxpayers, the UNICAP rules do not result in capitalization of any significant amounts not capitalized under prior law. Modification of the UNICAP rules to limit their application to categories of expenditures not addressed comprehensively under prior law (e.g., self-constructed assets) or to large taxpayers would reduce complexity for many taxpayers.

i. Simplify S Corporation Qualification Criteria.

The definition of an "S corporation" contained in Section 1361 establishes a number of qualification criteria. To qualify, the corporation may have only one class of stock and no more than 75 shareholders. Complex rules provide that the shareholders must be entirely composed of qualified individuals or entities. On account of state statutory changes and the check-the-box Regulations, S corporations are disadvantaged relative to other limited liability entities, which qualify for a single level of Federal income taxation without the restrictions. The repeal of many of the restrictions would simplify the law and prevent inadvertent disqualifications of S corporation elections.
j. **Modify the S Corporation Election Requirement.**

Section 1362(a)(2) requires all shareholders to consent to an S corporation election, as well as that the election be made on or before the 15th day of the third month of the taxable year. There are also election deadlines for qualified subchapter S subsidiaries and qualified subchapter S trusts, which adds complexity. Late elections are common occurrences because taxpayers are unaware of or simply miss the election deadline. If the election is filed late, Section 1362(b)(5) permits the IRS to treat the late election as timely if the IRS finds reasonable cause for the late election. This provision has saved hundreds of taxpayers from the consequences of a procedural mistake; it has also generated considerable administrative work for the IRS as is evidenced by the hundreds of rulings granting relief. The election deadline was intended to prevent taxpayers from waiting until income and expenses for the taxable year were known before deciding whether to make an S corporation election. The differences that exist between the taxation of S and C corporations are so significant, however, that it is unlikely a taxpayer's decision over whether to make an S corporation election would be determined by the events during a single taxable year. Even if that were the case, it is difficult to understand the compelling policy reason to require taxpayers to guess at their financial operations for the year in determining whether to make an S corporation election at the beginning of the year rather than making an informed decision. The ability to pass through losses has been substantially restricted by various provisions of the Code. Thus, concerns about passing through losses are likely more theoretical than real. In addition, as a practical matter, taxpayers cannot wait until the end of the taxable year to make a decision because the need to make estimated tax payments compels a decision before the date the first estimated tax payment is due. Thus, the separate filing of the election itself is a mere procedural requirement leading to frequent procedural foot faults, but little else.

The most obvious time for the filing of an election is with a filing that is otherwise required. Significant simplification could be achieved by requiring the election to be made on the corporation's timely filed (including extensions) Federal income tax return for the year of the election. The same rule should apply to the qualified subchapter S subsidiary and qualified subchapter S trust elections.

k. **Repeal or Simplify the Personal Holding Company Rules.**

The personal holding company rules were enacted in 1934 to tax the so-called "incorporated pocketbook". With differentials in the corporate and individual tax rates, individuals could, for example, place their investments in a corporation and substantially lower the Federal income tax paid on income generated by those investments, especially if the income was held in the corporation and reinvested for a long period of time. The personal holding company provisions attack this plan by imposing a surtax on certain types of passive income earned by closely held corporations that is not distributed (and thus taxed) annually. Over time, the personal holding company rules have been broadened to include many closely held corporations, both large and small, with passive income (whether or not such corporations are, in effect, "incorporated pocketbooks") and, thus, may create a trap for the unwary. In addition, the rules have become very complex and difficult for the IRS to administer and for taxpayers to comply with, and sometimes require taxpayers to rearrange asset ownership to comply with the rules. With maximum corporate and individual rates coming closer together and the repeal of General Utilities, it is questionable whether the personal holding company rules should remain in the tax code at all. Regardless of this debate, however, the rules should be significantly simplified in order to eliminate the substantial burden they impose on closely held corporations.

l. **Repeal the Collapsible Corporation Provision.**

Since the repeal of the *General Utilities* doctrine in 1986, Section 341--the "collapsible corporation" provision--is essentially deadwood. By definition, a collapsible corporation is a corporation availed of
with a view to a sale of stock before a substantial amount of the corporate income has been recognized. After 1986, a sale of corporate stock or a sale of all of a corporation's assets prior to the realization of corporate income cannot escape corporate taxation. Section 384 assures that a purchaser of stock of a corporation with built-in gain property cannot utilize its losses to shelter that gain. Since 1964, a corporation could escape the rigors of Section 341 by effecting a Section 341(f) election, i.e., the corporation agrees to recognize gain on the disposition of subsection (f) assets, notwithstanding any otherwise applicable non-recognition provisions of the Code. The repeal of General Utilities renders Section 341(f) redundant. More accurately, it renders Section 341(a) redundant because no corporate gain can now escape corporate tax. Since it was that avoidance or potential avoidance that gave birth to Section 341, it is now deadwood and should be repealed. Its repeal would result in the interment of the longest sentence in the Internal Revenue Code – Section 341(e).

m. Simplify the Attribution Rules.

The attribution rules throughout the Code contain myriad distinctions, many of which may have been reasonably fashioned in light of the particular concern of the underlying provision. For example, should siblings be included in the rules? Should the ownership test be 80% or 50%? Whatever the reasons originally driving the differences among the attribution rules, those reasons may simply be outweighed by the need to simplify the Code. Consequently, the attribution rules and the concerns underlying them should be reexamined in light of concerns about complexity with a view to harmonizing and standardizing the rules, unless there are truly compelling reasons to do otherwise. At a minimum, and without reexamination, it is clear the rules could be simplified by standardizing whether the percentage is equal to or greater than and not have both.

n. Simplify the Loss Limitation Rules.

The Code contains multiple rules limiting the availability of a taxpayer claim to use losses. These include Section 465, which limits the deductibility of losses of individuals and certain C corporations to the amount at risk—that is, generally, the amount of the investment that could be lost plus the taxpayer's personal liability for additional losses; Section 469, which limits losses incurred in "passive activities"; Section 704(d), which limits a partner's distributive share of a partnership's losses to the partner's basis in the partnership interest; and Section 1366(d), which limits an S corporation shareholder's loss in similar fashion.

There are numerous limitations and qualifications layered on each of these rules and definitions, and Sections 465 and 469, in particular, are extremely complicated and difficult to comprehend. Section 465 originally applied only to certain types of activities deemed especially prone to abuse, such as the production and distribution of films and video tapes, but, in 1978, it was extended to virtually all other income-producing activities. Since the enactment of Section 469, Section 465 has become superfluous because there are very few situations in which a deduction would be denied because of the applicability of Section 465 that would not also be denied because of the applicability of Section 469.

Substantial simplification could be achieved by combining, rationalizing and harmonizing the loss limitation provisions.

o. Simplify Section 355.

Section 355 permits a corporation or an affiliated group of corporations to divide on a tax-free basis into two or more separate entities with separate businesses. Under Section 355(b)(2)(A), which currently provides an attribution or "lookthrough" rule for groups of corporations that operate active businesses under a holding company, "substantially all" of the assets of the holding company must consist of stock of
active controlled subsidiaries. Under this rule, holding companies that, for very sound business reasons, own assets other than the stock of active controlled subsidiaries are required to undertake one or more preliminary (and costly) reorganizations solely for the purpose of complying with this provision. Treating members of an affiliated group as a single corporation for purposes of the active trade or business requirement will simplify numerous corporate transactions.

p. Simplify the Consolidated Return Rules.

Affiliated groups of corporations can elect to file a single consolidated income tax return. The dominant theory governing the development of the consolidated return regulations is that the consolidated group should be treated as a single entity. As evidenced by the hundreds of pages of regulations and excruciating detail, this seemingly simple concept has evolved into one of the most complex and burdensome areas of the tax law. These rules, which are laced with numerous traps for the unwary, are virtually incomprehensible, even to experienced tax practitioners if they do not spend an entire career in the consolidated return area. With the advent of single-member limited liability companies (LLCs) and the check-the-box regulations, many companies may be able to avoid or ameliorate the complexity of the consolidated return rules by simply inserting single-member LLCs into their corporate structure. For companies that desire or are required to use a C corporation, however, the consolidated return rules still present a major stumbling block in terms of complexity. Accordingly, simplification of the consolidated return rules would be a major step towards the ultimate goal of simplifying the tax laws.

q. Simplify the PFIC Rules.

In 1997, the passive foreign investment company ("PFIC") rules were greatly simplified by the elimination of the controlled foreign corporation-PFIC overlap and by allowing for a mark-to-market election for marketable stock. However, a great deal of complication remains in the PFIC area, suggesting that further simplification is necessary. Considerable simplification could be achieved by eliminating the application of the PFIC rules for smaller investments in foreign companies whose stock is not marketable.

r. Simplify the Foreign Tax Credit Rules.

The foreign tax credit area is subject to significant complication, particularly because of the nine separate baskets for allocating income and credits set forth in Section 904(d)(1). Consolidating these baskets for businesses that are either starting up abroad or that constitute small investments would provide some relief from the complexity. In addition, treating the European Union as a single country would eliminate another complication faced by US taxpayers competing in this newly unified marketplace. Lastly, the elimination of the alternative minimum tax credit limitations on the use of foreign tax credits would greatly simplify this area for all US taxpayers operating abroad without permitting tax motivated behavior.

s. Simplify the Subpart F Rules.

The Subpart F rules present a host of difficulties in their application. While the rules may be necessary to prevent tax avoidance by large and sophisticated taxpayers, smaller taxpayers or smaller foreign investments could be excepted from the application of these rules, which would greatly simplify the tax system, without creating the potential for the tax avoidance the rules were intended to prevent.

t. Clarify Treatment of Check-the-Box Entities for Subpart F Purposes.

Notices 98-11 and 98-35 caused considerable confusion in planning with respect to international tax matters. Notice 98-35 suggests potential rules that, once implemented, could adversely affect the use of so-called "check-the-box" entities (that is, entities that are either disregarded or treated as partnerships for Federal income tax purposes but are treated as taxable entities under local law) in international
transactions. The suggested rules are leaving many taxpayers with uncertainty in their international planning. Congressional clarification of what factors should be relevant in computing "foreign personal holding company" income under Subpart F would greatly simplify the task of international tax compliance.

u. Repeal Section 514(c)(9)(E).

In general, income of a tax exempt organization from debt financed property is treated as unrelated business taxable income. Debt financed property is defined in Section 514 as income producing property subject to "acquisition indebtedness," which generally does not include debt incurred to acquire or improve real property. Section 514(c)(9)(E) (the "fractions rule") provides, in general, that debt of a partnership will not be treated as acquisition indebtedness if the allocation of income and loss items to a tax exempt partner cannot result in the share of the overall taxable income of that organization for any year exceeding the smallest share of loss that will ever be allocated to that organization. This provision was enacted to prevent disproportionate allocations of income to tax exempt partners and disproportionate allocations of loss items to taxable partners. The provision has become a trap for the unware as well as a tremendous source of planning complexity even for those familiar with it. Anecdotal evidence suggests that few practitioners understand the provision completely, and almost no IRS agents or auditors raise it as an issue on audits. Instead, because of its daunting complexity, it has become a barrier to legitimate investment in real estate by exempt organizations. At the same time, other provisions in the tax law (such as the requirement of substantial economic effect under Section 704(b)) substantially limit the ability to shift tax benefits among partners. Therefore, Section 514(c)(9)(E) could be repealed without substantial risk of abuse.

Administrative Provisions

a. Deposit Penalty.

The failure to timely deposit taxes is subject to penalty, pursuant to Section 6656, in amounts ranging from 2 percent to 15 percent of the underdeposit, depending on the lateness of the deposit. The deposit rules are unnecessarily complex and adversely affect small businesses as they move from one payroll deposit category to another.

For example, professional corporations may be severely impacted where their payroll deposit is normally less than $100,000 per pay period which permits at least semi-weekly deposits (i.e., a three-day deposit rule). However, at each year end, in order to pay out all, or almost all, of the corporation’s income, bonus compensation distributions are frequently required. The amount of the bonus distributions for each employee, a prerequisite to determining appropriate withholding tax, cannot be ascertained until the annual books are closed. Closing of the books requires receipts, expenses, etc. for the last day of the taxable year to be considered. Bonuses must also be paid by the last day of the taxable year (often December 31) to be tax deductible for such year.

Financial intermediaries generally require at least one day’s advance notice to make electronic federal withholding tax deposits. Banks and taxpayer businesses are frequently shorthanded at year end and find it difficult to determine the amount of the Federal tax deposit due until after the financial intermediaries’ cutoff time to make withholding tax deposits on the next business day. This is particularly true for taxpayers in the western U.S. time zones. A 2 percent penalty is excessive for a deposit that is only one day late, particularly where the depositor is normally a semi-weekly depositor but is required to make a one-day deposit.

Congress recently recognized that the changing of deposit requirement time frames is a complexity that causes great confusion and that waiver of the penalty should be permitted for the first change period. See Section 6656(c)(2)(B). While this solution helps, it does not fully address the problem. The current
provision requires an administrative waiver request that may be expensive and time consuming and applies only to the first instance of a problem which by nature is likely to occur annually. Section 6302 (or the regulations) should be modified to require next day electronic depositing only in those instances where next day depositing (i.e., $100,000 or more deposit) is required of that taxpayer with respect to 10 percent or more of its deposits. Alternatively, taxpayers could be given a minimum of two days to make deposits of $250,000 or less.

b. Information Returns.

Sections 6041 and 6041A generally require reporting of all payments made in connection with a trade or business that exceed $600 per year. The $600 per year has never been adjusted for inflation. Section 6045(f) now requires reporting of all gross payments to attorneys (includes law firms and professional corporations) where the portion constituting the legal fee is unknown even if the payment is less than $600. Many Form 1099 information returns from non-financial institutions cannot be processed by the IRS or do not provide truly useable information. Anecdotal evidence suggests the information on these information returns may not be used in examinations of the taxpayers and cannot be reconciled to tax returns. The reporting threshold should be increased to $5,000 (which harmonizes with Section 6041A(b)) and adjusted for inflation in full $1,000 increments.

c. Penalty Reform.

The 1998 IRS Restructuring Act instructs both the Joint Committee on Taxation and the Treasury Department to conduct separate studies of the penalty and interest provisions of the Code and to make recommendations for the reform of the same.

The Tax Section believes that reform of the penalty and interest provisions is appropriate at this time and looks forward to working with the JCT and Treasury. There are many cases in which the application of penalty and interest provisions takes on greater significance to taxpayers than the original tax liability itself. The Tax Section is concerned that these provisions often catch individuals unaware, and that the system lacks adequate flexibility to achieve equitable results. In light of the significant changes being made by the IRS, the completion of this study and eventual enactment of the recommendations will be welcome.

The Tax Section has submitted preliminary comments to the staff of the Joint Committee on Taxation that we hope will be useful in developing alternatives.

CONCLUSION

Thank you again for the opportunity to testify at this very important hearing. We wish you, and concomitantly all individual and small business taxpayers, success in your endeavors. We would be happy to work with the Committee and this Subcommittee as legislation is developed to address the twin tasks of simplification and avoidance of complexity.