

STATEMENT

of

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on behalf of the

AMERICAN BAR ASSOCIATION
SECTION OF TAXATION

before the

COMMITTEE ON FINANCE

of the

UNITED STATES SENATE

on the subject of

TAX SIMPLIFICATION

April 26, 2001

Mr. Chairman and Members of the Committee:

My name is Richard M. Lipton. 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 Section of Taxation. 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 except as otherwise indicated.

The Section of Taxation appreciates the opportunity to appear before the Committee today to discuss simplification. On behalf of the Section, I want to thank the Chairman and the Members of this Committee for their focus on eliminating complexity in the Internal Revenue Code (the "Code").

The Section of Taxation is comprised of approximately 20,000 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 respect to the tax system and act as "Counsel to the Tax System." We advise individuals, trusts and estates, small businesses, 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 Congressional tax-writing committees, in the Treasury Department and the Internal Revenue Service, and the Tax Division of the Department of Justice.

I am joined by my colleagues from the American Institute of Certified Public Accountants and the Tax Executives Institute. This by itself is not unusual. These organizations often appear on the same panel before the tax writing committees of Congress. What is unusual, however, is that we appear here today to speak to you with one voice.

The ABA and its Section of Taxation have long been forceful advocates for simplification of the Internal Revenue Code. The ABA recently designated tax simplification as one of its top legislative priorities. In resolutions proposed by the Section of Taxation 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, including testimony delivered in each of the last two years. On February 25, 2000, the Section of Taxation, the AICPA Tax Division, and Tax Executives Institute released identical simplification proposals. (See Appendix I for the joint letter to Members of the Tax Writing Committees and *Ten Ways to Simplify the Tax Code*.) We will also devote a significant portion of our upcoming May Meeting to discussion of the simplification proposals included in the anticipated report of the staff of the Joint Committee on Taxation, and we expect to provide additional comments on that report in the future.

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 Internal Revenue Service (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 IRS 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. Our tax system relies heavily on the willingness of the average taxpayer voluntarily to comply with his or her tax obligations. Members of the Section of Taxation 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.

We do not claim to have all the answers. The Section of Taxation 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.

SPECIFIC PROPOSALS

The Code is replete with numerous 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 that 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.” Despite the lack of utility of such provisions (whether in a relative or absolute sense), analysis of the effect of such provisions may nevertheless be required either in the preparation of the tax return or in the consummation of a proposed transaction. Thus, the elimination of such provisions would greatly simplify the law. The following are examples of provisions, that when analyzed do not justify their continuation in the law. Obviously, these are but a few examples, and an extensive analysis of the Code would undoubtedly uncover many more. We have separated our recommendations into categories for alternative minimum tax, individual items, business and administrative.

1. **Alternative Minimum Tax.**

a. Repeal the Individual AMT.

There is no more urgent priority for change in the tax law than repeal of the individual AMT. The individual AMT no longer serves the purpose for which it was enacted, produces enormous complexity, and has unintended consequences for many taxpayers.

Originally enacted in 1969 to address concerns that persons with significant economic income were paying little or no Federal taxes because of investments in tax shelters, the AMT today has little effect on its original target and increasingly affects an unintended class of taxpayers – the middle class – not engaged in tax-shelter or deferral strategies. The individual AMT creates a “parallel tax universe” that imposes a major compliance burden on numerous taxpayers without a significant policy justification. If Congress wants to disallow a deduction, credit or exemption, then Congress should do so for all taxpayers and not just for purposes of an AMT that requires taxpayers to whom it may apply to do the complicated calculations required to determine whether it does apply.

More important for this Committee, however, is what will happen with the individual AMT in the future. The threshold for the AMT is not indexed for inflation and that threshold has not been modified since the late 1980s. The Treasury Department estimates that the number of taxpayers subject to the AMT will increase from the current 1.4 million in 2001 to 17 million in 2010.

The AMT's failure to achieve its original purpose is attributable to the numerous changes to the Internal Revenue Code since 1969 specifically limiting tax-shelter deductions and credits. Studies indicate that, by 2007, almost ninety-five percent of the revenue from AMT preferences and adjustments will be derived from four items that are “personal” in nature and not the product of tax planning strategies – the personal exemption, the standard deduction, state and local taxes, and miscellaneous itemized deductions. Further, the interaction of the AMT with a number of recently enacted credits intended to benefit families and further education means that even individuals who ultimately have no AMT liability will suffer because the AMT reduces the benefits conferred by those credits. The AMT is too complex and imposes too great a compliance burden. Significant simplification would be achieved by its repeal.

Alternatively, if repeal is not feasible, some simplification could be achieved by (i) excluding taxpayers with average adjusted gross income below a certain threshold from the AMT system, (ii) examining each preference and adjustment item separately to determine whether it should be retained in the AMT system, although, in our view, proper analysis of each item of adjustment and preference would result in the AMT system being repealed, (iii) repealing two preference items that present glaring problems – the denial for AMT purposes of any deduction for miscellaneous itemized deductions and the adjustment for ISO stock, which inappropriately taxes a portion of the gain at a rate in

excess of the maximum twenty percent that Congress intended be applied to long-term capital gains, or (iv) indexing the rate brackets and the exemption amount.

We emphasize our view that what is required is total repeal of the individual AMT, and not just limiting its application to taxpayers with income above a stated threshold. Such a limitation will eliminate the actual impact of the AMT on some taxpayers – which is good – but it will not reduce the compliance burden for millions of taxpayers, and it will create new complexity as a result of thresholds and phase-outs for this new limitation.

b. Repeal the Corporate Minimum Tax As Well.

The corporate AMT suffers from the same infirmities as the individual AMT. It requires corporations to keep at least two sets of books for tax purposes; imposes myriad other burdens on taxpayers (especially those with significant depreciable assets); and has the perverse effect of taxing struggling or cyclical companies at a time when they can least afford it. If repeal of the corporate AMT leaves specific concerns unaddressed, those concerns should be addressed directly by amending the Code provisions causing the concerns, not by preserving a system requiring all taxpayers to compute their tax liability twice.

2. Individual Tax Provisions.

a. Repeal Stealth Taxes.

The PEP and Pease provisions provide limitations on personal exemptions and itemized deductions. The PEP (or personal exemption phase-out) provision reduces otherwise available personal exemptions by 2 percent for each \$2,500 (\$1,500 for married individuals filing separately) of adjusted gross income over the threshold amount (\$150,000 for married couples, \$100,000 for singles). The Pease provision (limitation on itemized deductions) reduces otherwise available itemized deductions by the lesser of 3 percent of adjusted gross income over the “applicable amount” (\$128,950 for both married couples and individuals in 2000) or 80 percent of the amount of itemized deductions otherwise available.

Both of these provisions should be repealed. They are nothing more than hidden rate increases on upper-income taxpayers, and they add considerable complexity to the Code. These limitations prevent a taxpayer from determining his or her tax liability simply by multiplying gross income by the applicable tax rate. That is the definition of a complex, hidden tax.

Congress should repeal these hidden taxes. That is the position not only of the Section of Taxation but of the ABA and its 400,000 members. If Congress is concerned about the revenue loss, then Congress should either substitute an explicit top rate bracket

that would make the provision revenue neutral or reduce the amount of the tax cut for upper-income individuals to offset the repeal of these provisions.

b. Other Phase-Outs.

Many Code provisions confer benefits on individual taxpayers in the form of exclusions, exemptions, deductions, or credits. These provisions, many of which are complex in and of themselves, are further complicated because the benefits are specifically targeted to low and middle income taxpayers. The targeting is accomplished through the phasing out of benefits for individuals or families whose incomes exceed certain levels. We have witnessed, over the past two decades, a veritable explosion in the number of provisions subject to phase-outs, as Congress has moved increasingly toward the use of the Code for incentivizing taxpayer behavior.

The list of provisions including phase-outs is long and varied. Regular and Roth IRAs, education IRAs, the earned income tax credit, the Hope Scholarship and lifetime learning credits, real estate exception to the passive loss rules to name a few. Each has a phaseout, which limits the benefits of the provision to particular classes of taxpayers over and above the technical requirements of the provision.

The consistent theme of these phase-outs is that there is no consistency between them in the measure of income, the range of income over which the phase-outs apply, or the method of applying the phase-outs. Phase-outs are, in fact, hidden tax increases that create irrational marginal income tax rates for affected taxpayers. For example, assume a tax credit applies to married taxpayers with \$100,000 or less of taxable income but begins to phase out thereafter at \$1 of credit for each \$100 of additional income. One family has \$100,000 of taxable income while a second has \$100,100. Each would be in the 31% bracket. However, instead of paying \$31 (31% x \$100) on its additional \$100 of income, the second family would also lose \$1 of credit. In effect, therefore, that family is paying tax at a 32% rate. Take this principle, apply to different phase-out rates over different phase-out ranges, and what you end up with is a checkerboard of tax rates that cannot be rationalized. The marginal rate of tax that any particular taxpayer pays is entirely arbitrary.

Moreover, phase-outs add significantly to the length of tax returns, increase the potential for error, are difficult to understand, and make it extraordinarily difficult for taxpayers to know whether the benefits the provisions are intended to confer will ultimately be available. For example, taxpayers hoping to make a Roth IRA contribution may be unable to determine the extent to which they will be permitted to do so if they potentially fall within its phase-out range.

With respect to phase-outs other than PEP and Pease discussed above, simplicity would be achieved by (a) eliminating phase-outs altogether where they currently exist, (b)

avoiding enactment of new phase-outs, (c) substituting cliffs for the phase-outs, or (d) providing consistency in the measure of income, the range of phase-out, and the method of phase-out.

c. Simplify the Earned Income Tax Credit.

The earned income tax rules for low-income taxpayers are among the most complicated rules in the Code. It is ironic indeed that complex rules limit tax relief to individuals who are least able to afford the sophisticated assistance needed to claim the EITC. In effect, Congress has given the poor a tax break with one hand and then taken it away with the other by making it too complex to understand.

The rules concerning the EITC should be simplified so that they can be understood by the individuals they benefit. This will require a complete revamping of the rules to eliminate many of the limitations and special provisions. Such changes could be expensive, but massive simplification is necessary to make this credit understandable by the individuals it is intended to benefit.

d. Family Status Issues

The Section strongly urges this Committee to rationalize, harmonize and simplify the definitions and qualification requirements associated with filing status, dependency exemptions, and credits. Complexity in family status issues arise for virtually every taxpayer in one way or another. However, historically (and consistently) most of the problems arise for low and moderate-income taxpayers.

Family status -- such as marital status, whether an individual is a dependent, etc. -- affects various tax provisions designed to accomplish different ends. As might be expected, the eligibility requirements are not identical -- and the differences cause confusion and result in frequent tax return errors. For example, whether an individual is a dependent for purposes of claiming a personal exemption with respect to that person has little bearing on whether the person is a dependent for purposes of the earned income credit. The provisions and their inconsistent definitions are so complex and varied that we doubt that any amount of taxpayer education could ever eliminate the errors that inevitably occur.

Family status issues are further complicated by the increasing number of nontraditional families and living arrangements today, a phenomenon that cuts across all income levels but causes particular difficulty for low income taxpayers trying to prepare their returns. Divorced parents are much more common today than they were even 20 years ago. When both divorced parents or multiple generations provide some measure of assistance to the child, there are competing claims for tax benefits relating to that child. On top of this, many tax benefits are unavailable to married taxpayers who file separately. This further complicates their tax filing decisions and tax calculations -- and increases their combined tax liability over what it would be were they to file jointly.

Given the differing policy considerations underlying the family status provisions, it may not be possible to develop uniform definitions and achieve optimum simplicity. It is possible, however, to simplify and harmonize the eligibility criteria for many of the provisions and to establish safe harbor tests that provide taxpayers with more certainty and comfort. These provisions should focus on providing certainty to taxpayers (many of whom have difficulty coping with complexity), lessening the intrusiveness of audits on eligible taxpayers, while still targeting cases of fraud or abuse. In addition, the proposals would modify many of the definitions throughout the family status issues to make the consistent where possible. Finally, we recommend extending head of household status to noncustodial parents who can demonstrate their payment of more than nominal child support. This proposal acknowledges that children often have more than one household and that the noncustodial parent who pays child support has a reduced ability to pay tax. The benefit would be targeted primarily to those taxpayers who do not itemize deductions. The proposal would also encourage the payment of child support and remove the incentive for fraud or noncompliance (adjusted for inflation), excluding taxable social security, pensions, and unemployment compensation (items easily taken from the face of the tax return).

The family status issues we have targeted have been a continuous problem for many years. Their solution would eliminate many sources of controversy from the Code. While we do not know the revenue cost associated with any such fix, instinctively we do not believe it would be high. We urge this Committee to explore and implement these proposals.

e. 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 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.

f. Simplify the Capital Gains Provisions.

The capital gains regime applicable to individuals is excessively complex. The system imposes difficult record-keeping burdens on taxpayers. The significant differences in capital gain rates encourage taxpayers to engage in transactions such as investments in derivatives or short sales to qualify for the lower capital gains rates. A special rule permits taxpayers holding property acquired before 2001 to 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 a special eighteen percent rate if it is held for another five years. Determining whether to make this election will require taxpayers to make economic assumptions and complete difficult present value calculations. While each item of fine-tuning in this area may be defensible in isolation, the cumulative effect has been to create a structure that is incomprehensible to taxpayers and to the people who prepare their tax returns. The taxation of capital gains would be simplified by establishing a single preferential rate and a single long-term holding period for all types of capital assets. Alternatively, to assure that any benefit is extended to all taxpayers regardless of their tax brackets, the concept of a special capital gain rate might be replaced by an exclusion for a percentage of long-term capital gains.

g. 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), elections and safe harbors, even those enacted in the name of simplification, often increase complexity. The availability of an election frequently requires taxpayers to make multiple computations to determine the best approach, 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 yields 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.

h. Transfer Tax Simplification Generally.

The Estate and Gift Taxes Committee of the Section of Taxation has been considering simplification possibilities in this area, assuming that transfer taxes will continue to be in effect. The Section of Taxation does not have a position on the issue of transfer tax repeal. We do urge that any enactment of repeal include consideration of easing burdens of estate planning, income tax planning, and compliance under any new law. For example, shortening any phase-out period would reduce complexity

The following items represent some of the simplification ideas under discussion within the Section of Taxation's Estate and Gift Taxes Committee. While these do not represent Section of Taxation positions at this time, they are worth mentioning in the context of this hearing.

Credit Amount Increases; Related Simplification Measures. A meaningful increase in the applicable credit amount would remove a significant number of taxpayers from the transfer tax system. Much attention has been focused on specific provisions designed to alleviate the impact of the gift and estate tax on specific groups, such as the owners of family farms, ranches and businesses. As a result of that attention, specific

relief has been enacted to assist those affected individuals. However, despite the best intentions of these provisions, qualification for and compliance with them are onerous, and in many cases business decisions are driven purely by planning for a tax result instead of being based on sound economics. A truly meaningful increase in the applicable credit amount would remove a number of taxpayers from the system who otherwise might find it necessary to seek to comply with complex and restrictive planning provisions. It would also allow the repeal of those special interest relief provisions (for example, sections 2032A and 2057) whose maximum benefit would then be less than the increased applicable exemption amount.

Valuation Discounts. Appraisals to determine and substantiate valuation discounts of partial interests are heavily fact-driven, and are expensive, yet they provide no guarantees of finality in the transfer tax arena. Litigation concerning these discounts has generally become a battle between the experts (appraisers). These disputes (and efforts to avoid them) have become very costly for both taxpayers and the Internal Revenue Service (in terms of the administrative resources required to be devoted to them). One response could be to allow a safe harbor valuation discount for all partial interests in unmarketable entities -- whether representing a minority or controlling interest in the entity. This discount could be applied to the value of the assets of the entity (like a holding company), without any additional discounts for interests in other entities. (For example, if an LLC owned a 30% interest in a partnership, 30% of the value of the partnership's assets would be added to the value of the LLC's other assets, and then the safe harbor discount would be applied to the LLC's assets.) This discount would be an elective safe harbor -- no appraisal of the interest would be required to substantiate the discount, and the discount would not be subject to challenge on audit. If a taxpayer instead should elect to claim a more substantial discount based on the particular facts, then current rules and procedures would apply.

Present Interest Rule. The "present interest rule" applicable to the annual \$10,000 gift exclusion is a source of estate planning complexity (including for persons without large estates) and tax disputes. As an alternative, donors could be allowed a limited number of, or total dollar amount of, annual exclusions under a revised rule that would allow the exclusion to apply to gifts of future interests.

Section 6166. Section 6166 could be modified to provide availability of deferred tax payments based on the amount of nonliquid assets in an estate, rather than focusing on the highly detailed "family business" rules of current law. Under current law, in order to be sure that an estate will meet the percentage test to qualify for tax deferral under section 6166, taxpayers may forgo the opportunity to transfer or sell business interests and/or other assets during life, even when there are sound economic and other reasons for doing so. Similarly, since certain assets will not qualify for this tax deferral, otherwise beneficial and commercially prudent decisions concerning the structure of business entities are often not made in order to be sure that tax deferral will be available on death. In addition, a significant portion of the litigation and disputes on audit of estate tax returns concern whether or not an estate qualifies for this tax deferral. The availability and administration of section 6166 can be the cause of significant audit and litigation time

and expense.

Unified Credit Portability Between Spouses. The unused applicable exclusion amount and GST tax exemption amount of the first spouse to die could be deemed to be transferred to and usable by the surviving spouse. If this provision were enacted, it might also be worthwhile to consider changing the current unified credit into a deduction, in order to preserve similar progressive rate structures for couples regardless of their division of property holdings and types of property transfers included in their wills. This proposal would greatly simplify estate planning for married couples by reducing the complexity of pre-death planning and the cost associated with trust administration. It would eliminate the need for the division and reallocation of assets between spouses solely for tax purposes. In addition, it is consistent with one of the underlying goals of the unlimited marital deduction to treat spouses in common law and community property jurisdictions in a similar fashion.

Statute of Limitations. There are separate statutes of limitations applicable to the estate tax, the gift tax, and the generation-skipping transfer tax. A global statute applicable to all three taxes would reduce the complexity of estate administration and provide finality to transfer tax issues after passage of an appropriate period of time.

3. Business Tax Provisions.

a. Expand the Use of the Cash Method of Accounting.

Current law requires businesses that purchase, sell, or produce merchandise to apply the inventory accounting rules and use the accrual method of accounting. Although taxpayers and the IRS have spent considerable resources contesting whether particular items constitute merchandise, the issue has never been consistently resolved. The result is some businesses cannot easily determine if they have merchandise inventory that requires them to use the accrual method of accounting. Additional issues continue to arise as taxpayers provide new products and services.

The Treasury Department issued Revenue Procedure 2000-22, 2000-20 I.R.B. 1008, permitting businesses with gross receipts of \$1 million or less to use the cash method of accounting. Subsequent modifications made by Revenue Procedure 2001-10, 2001-2 I.R.B. 1 simplified some of the requirements in Revenue Procedure 2000-22. Although we applaud the Treasury Department for taking these steps, we do not believe \$1 million in gross receipts provides sufficient relief from the complexity the accrual method of accounting creates.

Considerable simplification could be achieved by amending sections 446 and 448 to allow small businesses to elect to use the cash method of accounting even when the purchase, production, or sale of merchandise is an income-producing factor. We suggest that utilization of the \$5 million gross receipts test already included in section 448 to identify small businesses eligible for this election would provide simplification for more

taxpayers, minimize the confusion likely to result from different dollar thresholds, and reduce controversy that is similarly likely to result from applying different dollar thresholds for different types of businesses. A gross receipts threshold at least equal to the threshold provided for service businesses in section 448 is appropriate because the profit margin often is lower for businesses selling merchandise than for businesses providing services.

b. Inventory Accounting.

Further simplification could be achieved by amending section 471 to allow small businesses with gross receipts of \$5 million or less to elect not to maintain inventories even if the purchase, production, or sale of merchandise is an income-producing factor. Although allowing a small business to deduct in the current year the cost of goods to be sold in a future year would result in some mismatch of income and expense, we believe the mismatch would be minimal for the simple reason that small businesses generally cannot afford to maintain large quantities of inventories. Although we expect there will be concern expressed over the possibilities for abuse such a proposal entails, we do not believe this should be a significant concern because we do not believe it will result in small businesses purchasing additional inventory to manipulate taxable income. Inventory purchases entail carrying costs and risks of ownership. The result is that small businesses seeking to manipulate taxable income would incur in excess of \$1.00 in costs to save 35 cents in tax. We do not believe most small businesses will adopt such a course of conduct. In addition, case law provides that sham inventory purchases or purchases not for use in the ordinary course of a taxpayer's business are to be disregarded. Thus, the courts have made it clear that the IRS can address abusive situations.

If small businesses are allowed to elect not to maintain inventories, such businesses should also be permitted to elect to deduct materials and supplies as purchased to avoid the complexity and controversy likely to result from assertions that amounts previously viewed as merchandise must be capitalized as materials and supplies under section 1.162-3 of the regulations.

While small businesses that predominantly provide services have been involved in many of the litigated cases regarding the definition of merchandise, other small businesses with gross receipts of \$5 million or less that do not primarily perform services may have relatively more significant inventory levels. Our proposal would allow these small businesses to elect not to maintain inventories as well. We believe this approach achieves maximum simplification. Should the Committee find this approach unacceptable, a different test should be developed to determine whether inventories must be maintained by taxpayers with gross receipts of \$5 million or less. For example, rather than requiring inventories only if gross receipts exceed \$5 million, inventories could be required if the taxpayer's total purchases of merchandise, materials, and supplies during the year exceeded a stated percentage, perhaps twenty percent, of its total gross receipts. Alternatively, inventories could be required if the taxpayer either (i) keeps a record of consumption or (ii) takes physical inventories. These alternatives, while more

complicated than a \$5 million gross receipts test, would nevertheless represent substantial simplification for many taxpayers.

c. 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 the calendar year in which the employee attains 70½. Section 401(k) states that plan benefits may not be distributed before certain stated events occur, 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 attains age 59½, are subject to an additional ten percent tax. The half-year age conventions complicate retirement plan operation because they require employers to track dates other than birth dates. Changing the age requirements to 70 from 70-1/2 and to 59 from 59-1/2 would have a significant simplifying effect.

d. Repeal or Modify the Top Heavy Rules.

Congress enacted section 416 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, current law includes (i) limitations on the compensation with respect to which qualified retirement plan benefits can be provided, (ii) overall limitations on qualified retirement plan benefits, and (iii) non-discrimination rules that 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).

e. 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 also adopt an aggregation concept. 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.

f. Worker Classification.

Determining whether a worker is an employee or independent contractor is a particularly complex undertaking because it is based on a twenty-factor common law test. The factors are subjective, given to varying interpretations, and there is precious little guidance on how or whether to weigh them. In addition, the factors are not applicable in all work situations, and do not always provide a meaningful indication of whether the worker is an employee or independent contractor. Moreover, the factors do not take into consideration the differential in bargaining power between the parties. The consequences of misclassification are significant for both the worker and service recipient, including loss of social security and benefit plan coverage, retroactive tax assessments, imposition of penalties, disqualification of benefit plans, and loss of deductions. Legislative safe harbors provide relief only for employment taxes. The current complex and highly uncertain determination should be replaced with an objective test that applies for federal income tax and ERISA purposes. Alternatively, changes could be made to reduce differences between the tax treatment of employees and independent contractors. Judicial review by the United States Tax Court of worker classification disputes should be available to both workers and employers.

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. It is imperative that this enormous drain on both Government and taxpayer time and resources be alleviated by developing objective, administrable tests. 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 also* I.R.C. § 263(d) (repair allowance percentage for railroad rolling stock). We suggest that Congress urge the Treasury Department and the IRS to issue regulations setting forth unambiguous principles to be applied in distinguishing between deductible and capital expenditures. We also suggest that Congress urge that IRS and Treasury seek to minimize the additional record keeping burdens and other costs of compliance for taxpayers when formulating these principles.

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 seventy-five 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 fifteenth 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 add complexity. Late elections are common occurrences because taxpayers are unaware of or simply miss the election deadline. Section 1362(b)(5) permits the IRS to treat a 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 the *General Utilities* doctrine, it is questionable whether the personal holding company rules should remain in the Code at all. Regardless of this debate, however, the rules should be significantly simplified to eliminate the substantial burden they impose on closely held corporations.

l. Repeal the Collapsible Corporation Provision.

The repeal of the General Utilities doctrine in 1986 rendered section 341 redundant. By definition, a collapsible corporation is a corporation formed or availed of with a view to a sale of stock, or liquidation, before a substantial amount of the corporate

gain has been recognized. Since 1986, a corporation cannot sell its assets and liquidate without recognition of gain at the corporate level; likewise, the shareholders of a corporation cannot sell their stock in a manner that would allow the purchaser to obtain a step-up in basis of the assets, without full recognition of gain at the corporate level. Because it was the potential for escaping corporate taxation that gave rise to section 341, it is now deadwood and should be repealed. Repeal of section 341 would result in the interment of the longest sentence in the 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 the underlying provision initially addressed. It is not clear, however, that the reasons originally leading to the differences justify the complexity the current attribution rules create. The attribution rules should be reexamined in light of the underlying concerns to harmonize and, if possible, standardize the rules. Even without reexamination, the attribution rules could be simplified by providing consistently either an “equal to” standard or a “greater than” standard for application of the ownership percentages.

n. Simplify the Loss Limitation Rules.

The Code contains multiple rules limiting the ability of a taxpayer claim to use losses including: (i) 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; (ii) section 469, which limits losses incurred in “passive activities”; (iii) 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 (iv) 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. As a result, 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. Substantial simplification could be achieved by treating members of an affiliated group as a single corporation for purposes of the active trade or business requirement.

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. The consolidated return rules, are laced with numerous traps for the unwary and are virtually incomprehensible to experienced tax practitioners unless they spend an entire career practicing in the consolidated return area. With the advent of single-member limited liability companies (“LLCs”) and the check-the-box regulations, many taxpayers may be able to avoid or ameliorate the complexity of the consolidated return rules. For taxpayers that desire or are required to use a C corporation, however, the consolidated return rules still present a major source of complexity. Accordingly, simplification of the consolidated return rules would be a major step towards the ultimate goal of simplifying the tax laws. For example, in the small business context, all wholly owned subsidiaries could be treated as flow-through entities.

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. A great deal of complication remains, however, and further simplification is necessary. We recommend, for example, that Congress eliminate the application of the PFIC rules to smaller investments in foreign companies whose stock is not marketable.

r. Simplify the Foreign Tax Credit Rules.

The core purpose of the foreign tax credit (“FTC”), which has been part of the Code for more than eighty years, is to prevent double taxation of income by both the

United States and a foreign country. The FTC rules are complex in large measure, but not exclusively, because the global economy is complex. The section 904(d)(1) basket regime, which includes nine separate baskets for allocating income and credits and is intended to prevent inappropriate averaging of high-and-low-tax earnings, is especially complicated to apply.

The FTC rules may never be truly simple, but actions can be taken to temper the extraordinary complexity of the current regime. At a minimum, Congress should (i) consolidate the separate baskets for businesses that are either starting up abroad or that have only small investments abroad; and (ii) eliminate the alternative minimum tax credit limitations on the use of the FTC.

In addition, Congress should consider accelerating the effective date of the "look-through" rules for dividends from so-called 10/50 companies. The Tax Reform Act of 1986 created a separate FTC limitation for foreign affiliates that are owned between ten and fifty percent by a U.S. shareholder. The requirement for separate baskets for dividends from each 10/50 company was among the most complicated provisions of the 1986 Act, and in 1998, Congress acted to afford taxpayers an election to use a "look-through" rule for dividends (similar to the one provided for controlled foreign corporations under section 904(d)(3)). The implementation of the rule was delayed, however, until 2002. In addition taxpayers must maintain a separate "super" FTC basket for dividends received after 2002 that are attributable to pre-2003 earnings and profits. The current application of both a single basket approach for pre-2003 earnings and a look-through approach for post-2002 earnings results in unnecessary complexity. Congress should eliminate the "super" basket and accelerate the effective date of the look-through rule.

s. Simplify Application of Subpart F.

In general, ten percent or greater U.S. shareholders of a controlled foreign corporation ("CFC") are required to include in current income certain income of the CFC (referred to as "Subpart F" income). The Subpart F rules are an exception to the Code's general rule of deferral and were initially enacted in 1962 to tax passive income or income that is readily moveable from one taxing jurisdiction to another to, for example, take advantage of low rates of tax. Congress subsequently expanded the Subpart F rules to capture more and more categories of active operating income. Nevertheless, taxation of CFC income may be deferred under various "same-country" exceptions to the Subpart F provisions. U.S.-based companies incur substantial administrative and transaction costs in navigating the maze of the Subpart F rules to minimize their tax liability.

The Subpart F rules sorely need to be updated to deal with today's global environment in which companies are centralizing their services, distribution, and invoicing (and often manufacturing operations). We recognize that the Treasury Department is preparing a study on the policy goals and administration of the Subpart F

regime, which we eagerly await. Whatever effect this study may eventually have, substantial simplification could be achieved now through the following basic measures:

1. Except smaller taxpayers or smaller foreign investments from the Subpart F rules;
2. Exclude foreign base company sales and services income from current taxation; and
3. Treat countries of the European Union as a single country for purposes of the same-country exception.

t. 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 unwary 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.

4. Administrative Provisions.

a. Deposit Penalty.

The failure to timely deposit taxes is subject to penalty, pursuant to section 6656, in amounts ranging from two percent to fifteen 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 for which the payroll deposit is normally less than \$100,000 per pay period and are permitted at least semi-weekly deposits (*i.e.*, a three-day deposit rule) may be adversely affected. In order to pay out all, or almost all, of the corporation’s income, such corporations frequently make bonus payments on the last day of the taxable year (often December 31). The amount of the bonus payment for each

employee, a prerequisite to determining the appropriate withholding tax, cannot be ascertained until the annual books are closed. The books cannot be closed until receipts and expenses for the last day of the taxable year are recorded.

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 two percent penalty is excessive for a deposit that is only one day late, particularly if 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* I.R.C. § 6656(c)(2)(B). While this amendment 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 that is likely to occur annually. Section 6302 (or the regulations) should be modified to require next day electronic depositing only in those instances in which next day depositing (*i.e.*, a deposit of \$100,000 or more) is required of that taxpayer with respect to ten 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 threshold has never been adjusted for inflation. Section 6045(f) now requires reporting of gross payments to attorneys (including law firms and professional corporations) even if the payment is less than \$600 if the portion constituting the legal fee is unknown. The IRS cannot process many Form 1099 information returns from non-financial institutions and as a result such returns do not provide truly useable information. Anecdotal evidence suggests the IRS may not use the information on these information returns in examinations of the taxpayers and that these information returns 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 Section of Taxation believes that reform of the penalty and interest provisions is appropriate. 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 Section of Taxation is concerned that these provisions often catch individuals unaware, and that the system lacks adequate flexibility to achieve equitable results.

d. Extenders.

Uncertainty in the tax law breeds complexity. The constant need to extend certain Code provisions (such as AMT relief for individuals, the research and experimentation tax credit, and the work opportunity tax credit) adds confusion to the law. In many cases, temporary extension undermines the policy reasons for enacting the incentives in the first place because the provisions are intended to encourage particular activities but uncertainty surrounding whether the provisions will be extended leaves taxpayers unable to plan for those activities. The on-again, off-again nature of these provisions, coupled in some cases with retroactive enactment (which often necessitates the filing of an amended return), contributes mightily to the complexity of the law. These provisions should be enacted on a permanent basis.

e. 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 (i) ninety percent of the tax actually due for the year or (ii) one hundred percent of the tax due for the immediately prior year. The criteria for the prior year safe harbor have been adjusted regularly by the Congress during the past decade. Between 1998 and 2002, 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 (perhaps 100%) and apply that amount for all years. Consideration should also be given to simplifying estimated taxes (for example, by the enactment of a meaningful safe harbor) for all corporations.

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We appreciate your interest in these matters. The Section of Taxation would be pleased to work with the Committee and its staff on these important issues.