S. HRG. 107–60

TAX CODE COMPLEXITY: NEW HOPE FOR FRESH SOLUTIONS

HEARING

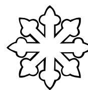
BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED SEVENTH CONGRESS

FIRST SESSION

APRIL 26, 2001



Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

73–267—DTP WASHINGTON : 2001

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TAX CODE COMPLEXITY: NEW HOPE FOR FRESH SOLUTIONS

THURSDAY, APRIL 26, 2001

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:00 a.m., in room 215, Dirksen Senate Office Building, Hon. Charles E. Grassley (chairman of the committee) presiding.

Also present: Senators Hatch, Nickles, Snowe, Kyl, Baucus, Bingaman, and Lincoln.

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. I thank everybody for their kind attention, and appreciate the large turnout that we have for something that is a very interesting subject. But, piece by piece, it could be very boring, as you think about the details of the complexity of the Tax Code.

I always think in terms of 70 percent of the people in this country think the existing Tax Code ought to be thrown out, but only 20 or 25 percent have their mind made up of what ought to take its place.

Until Congress gets a higher consensus among people throughout the country, we will never be able to probably make the dramatic moves that ought to be made towards simplicity.

But we are here because Congress asked for a study, and we are very happy to have the experts that have worked on this report to us. So obviously we are here for really what is an age old problem, the complexity of our Tax Code.

People have been, probably to some degree, more now than earlier, complaining about the complexity of the Tax Code since its enactment the second decade of the last century. If folks thought it was complicated then, obviously they know how complicated it is now.

The twist in this morning's hearings, is we will not only hear about how complicated the Tax Code is, but we have this very important study that was released on possible ways to fix it.

For too many years, more and more tax items have been getting swept under the rug. That rug is getting pretty bumpy and it is time that we stop sweeping and we start doing some very serious cleaning.

It is important that we commit ourselves to tax relief for working men and women, that we also at the same time commit ourselves to simplifying the Tax Code wherever we can.

In creating new tax legislation, there are three principles that I think should be followed: fairness, efficiency, and simplification. Sometimes those work against each other, so it is a very difficult balance.

In the course of our recent hearings on various broad-based tax cuts, Senator Baucus and I have raised simplification issues. We have also been making a real effort to incorporate the concept of simplification in the work of this committee.

For example, the Education Tax Relief bill that we reported here just a few weeks ago contains several provisions that help make the education tax benefits easier to use. The Hope and Lifetime Learning Credits were coordinated with distributions from tax-preferred plans. The student loan interest deduction was simplified and the employer-provided education issue was made permanent.

We need to continue these efforts as the work on the tax cuts continue. It is also important that we not lose sight of the goal of a tax system that people believe in. That is why we need to restore confidence in our Tax Code by making it easier to follow.

So we have had the Joint Committee on Taxation working very hard the last year or more on a simplification study by its chief of staff, Lindy Paull, who is present with us today at the table.[1]

This was a major undertaking. We have 1,300 pages that we are going to be looking at. Maybe not all of it today, but we are going to be getting some reports and generalizations about it, reports on the state of our Federal tax system. It also contains recommendations on how to get our Tax Code cleaned up and put in smooth working order.

The bottom line is that this joint tax study gives us an opportunity to renew our commitment to making our Tax Code better for everyone.

So this morning we will also hear from tax experts who have the talent to help us get our Tax Code into working order for all taxpayers. It is time for us as responsible tax legislators to seize the day and take these recommendations to heart. To the extent these proposals can be worked into our ongoing tax reduction efforts, it will be a win-win situation for many of us.

Finally, I have to thank Lindy, who has worked with this committee in two or three different capacities over a long, long time, for her hard work. I suppose, in turn, she would want us to, and properly so, thank the staff that works with her, particularly the staff that worked on this project for their hard work and dedication to this simplification effort.

Senator Baucus is very much tied up at this particular moment. He is going to be here before the meeting is over. When he comes, if it is his desire, we will stop whatever we are doing for his opening comments.

I am going to move then immediately, since there are no other members here, to our first witness and, in a more formal way, welcome Lindy Paull, chief of staff of the Joint Committee on Taxation.

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[1] *See*: Joint Committee on Taxation committee prints, “Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986, Vols. 1–3, April 2001 (JCS–3–01).

As part of the 1998 legislation that restructured the IRS, Congress requested that the Joint Tax Committee prepare a study on ways to simplify the Tax Code. Today, Lindy Paull will present the results of this in-depth study on simplification. It is my hope that the Finance Committee will be able to incorporate some of the reports and recommendations in the upcoming tax legislation.

We welcome you back to the committee. Over the next three or four weeks, we will be seeing more of each other than probably we want to, considering the tax legislation that we hope comes up and you helped us structure. Thank you very much.

Would you proceed?

STATEMENT OF LINDY L. PAULL, CHIEF OF STAFF, JOINT COMMITTEE ON TAXATION, WASHINGTON, DC

Ms. PAULL. Thank you, Mr. Chairman. It is a pleasure to be back here. Thank you for welcoming us and acknowledging the hard work of our staff. I also want to acknowledge our staff. Virtually the entire staff worked on this project throughout the last 18 months, as well as others. So, we really appreciate your commitment to this issue.

As you know, the report is a result of, first, the National Commission on IRS Restructuring on which you served about four or 5 years ago that led to the IRS Restructuring Reform Act of 1998, and which also asked that we prepare this study for Congress. This is our first study. It was subject to appropriations. The Congress' appropriators did make a commitment to this study.

So today we are transmitting the study, and it is really important that the committee look carefully at the study. I understand, with it being 1,300 pages, you have not had an opportunity to look at it. I would just like to highlight it, and then commit to work with you as we go on.

This is a three-volume report. The first volume contains our analysis of the overall state of the tax system. The second volume contains our lengthy recommendations—there are over 150 of them—on ways to simplify the Tax Code.

That volume also includes a number of recommendations that we looked at, but we felt went beyond simplification. They might be meritorious for the Congress to look at in terms of structural issues with respect to the Tax Code, but significant policy decisions would have to be made and we did not feel like that was the role of the staff in making these recommendations.

The third volume includes some summaries and academic papers that we solicited during the course of our study.

During our study, we looked at materials on simplification that have basically been published over the last 10 years, materials published by the National Taxpayers' Advocate, materials published on complexity and simplification, recommendations made by the American Bar Association, the American Institute of CPAs, and the Tax Executives Institutes, and many others that you have before you. Representatives of those organizations are before you today.

We assembled two groups of advisors to help us, to guide us in our work. The first group was approximately 25 advisors who previously held senior-level positions with the government.

The second group of advisors were roughly about 40 full-time law professors who are distinguished experts in the field and would not have any particular invested interest in any recommendation that we might make.

We held several all-day sessions with those academic advisors and the other advisors. We also held an all-day session with senior staff at the Internal Revenue Service to solicit specific issues upon which they had concern, especially from a standpoint of administrability of the Tax Code.

We are also grateful for the work of the General Accounting Office and the Congressional Research Service, because they provided us a significant amount of the background information that is in volume one relating to the overall state of the Tax Code.

Let me just summarize, as briefly as I can, the report. We do not believe that it is possible to quantify complexity by pointing to one single source of it. We believe that there are many, many sources that cause complexity in the tax system, and we have enumerated a whole variety of those in our report.

We would note that, for example, the Internal Revenue Code consists of nearly 1.4 million words, and includes 693 separate sections that impact individual taxpayers.

As of the middle of last year, the Treasury Department had issued almost 20,000 pages of regulations containing over 8 million words.

For individual taxpayers that file an annual Form 1040, some individual taxpayers could be faced with a Form 1040 that has 79 lines, 144 pages of instructions, 11 schedules totaling 443 lines of instructions. The schedules have 443 lines, and then there are additional instructions that go with it. There are 19 separate worksheets imbedded in the Form 1040 instructions, and the possibility of filing numerous other forms, depending on their circumstances.

Individual taxpayers are relying more and more on paid tax return preparers and computer software for return preparation. The use of paid tax return preparers increased from 48 percent of the returns that were filed in 1990 to 55 percent in 1999, a 27 percent increase.

The use of computer software for tax return preparation increased from 16 percent of returns in 1990 to 46 percent of returns in 1999, a 188 percent increase.

Individuals are increasingly requesting help from the Internal Revenue Service through walk-in and telephone assistance contacts, which increased from 105 million in 1996—well, I have got that number wrong. It is up to 117 million currently.

It is widely written that complexity has adverse effects on the Federal tax system. Some of the effects include decreased levels of voluntary compliance, increased costs of compliance for taxpayers, reduced perceptions of fairness, and increased difficulties in administering the tax law. We explored whether it was possible to quantify these effects, but we did not find any reliable measure of them.

Let me, now, return to a brief highlight of some of our major simplification recommendations. As you said, we would be here a long time if we went through all 150 of them.

The first recommendation we made, and I do not think we made this very lightly, we did it with a lot of consultation and study, is

to recommend the elimination of the Alternative Minimum Tax, both for individuals and for corporations.

We have been called on to analyze the effects of recent legislation both this year and over the last few years, and would indicate, on the individual side, that significant numbers of individuals are going to become Alternative Minimum Tax payers.

We believe that, within 10 years, roughly 11 percent of individual taxpayers will be actually Alternative Minimum Tax payers. In addition to that, there are additional individuals who will be affected by the Alternative Minimum Tax in the sense that their tax credits will be cut back by the AMT.

The purpose for which the Alternative Minimum Tax originally was designed appears to no longer be serving that purpose. Now what we have is a very complicated regime requiring large numbers of individuals to make a whole, separate, second set of computations for their income taxes.

This is true, also, of corporations, larger corporations, because smaller corporations were recently exempted from the Alternative Minimum Tax, where they have to make a significant number of alternative computations. Especially, for example, depreciation might be computed three different ways.

With the changes that were made in the 1986 Tax Reform Act and subsequent changes since then with respect to both depreciation, accounting methods, and a variety of other things, the continuing viability of an Alternative Minimum Tax does not seem to be as useful as it once was.

It is a tremendous source of complexity in the Tax Code. So, that is our first recommendation. The Congress should consider eliminating the AMT, both for the individuals and corporations.

The next recommendation that I would highlight for you is a recommendation with respect to families with children. Families with children have quite a tremendous burden to try to figure out if they qualify for a variety of provisions in the Tax Code, the dependency exemption, the child credit, the Earned Income Tax Credit, the dependent care credit, and in some cases, the head of household filing status.

Basically, families with children have to go through about 17 pages of the publication, Your Federal Income Taxes, to try to determine if their child qualifies them for any of these five provisions.

For the dependency exemption, there are nine pages, including a very lengthy flow chart. For the Earned Income Tax Credit, there are three pages, including another chart illustrating how you qualify your child, and so on.

So, while it seems obvious that there should be one uniform definition of child for all of these purposes in the Tax Code, there is not today. So, this recommendation is to provide a definition of a child.

We went into quite lengthy detail and analysis to provide all of the details you would need for a unified definition of child, because others have talked about that in the past and have not provided as much detail. So, that is another one of our significant individual recommendations.

There are about 44 million returns that claim the dependency exemption that could benefit from this type of an approach. So, I

would think a very widespread application could be used, and major simplification for families with children could be done with that.

Another recommendation we make is with respect to a variety of phase-outs of various tax provisions. There is not one uniform place where phase-outs begin and end in various tax provisions, or one uniform definition of the income that causes you to phase out, or anything like that in the Tax Code.

We identified nine provisions of the Tax Code. The phase-outs did not go to the heart of the provision, the fact that upper-income people would not be allowed these provisions. They really were directed towards progressivity concerns in the Tax Code.

Our recommendation would be to eliminate these complicated phase-outs and address the progressivity through the overall structure of the Tax Code; that is, through the rate structure, rather than through these individual provisions.

Again, we believe, of the nine provisions dealing with on phase-outs, that about 30 million tax returns could be affected by that proposal.

Another proposal that we are recommending is to eliminate the two-tier tax regime that applies to Social Security benefits. About a month ago, I was working in my office late at night before a mark-up and tried to figure out how to compute the tax on Social Security benefits. It is extremely complicated. I would urge everybody to try to do this sometime if you are in the phase-out ranges.

So, our recommendation is to simplify the taxation of Social Security benefits by establishing a single percentage of the benefits that would be includable in income. We do not recommend that percentage. That would be up to the Congress to establish. But it is awfully complicated right now.

The next large proposal that we would make a recommendation on, was capital gains. In 1997, Congress established quite a long list of different top rates for capital gains, depending on the kind of assets. It is extremely complicated. We have 27 million tax returns showing capital gains income right now. So, our recommendation is to go back to the way the capital gains preference used to be done, which is through an exemption or a deduction rather than this top rate-type structure that the current law has.

The CHAIRMAN. Is that 27 percent figure you just gave up dramatically?

Ms. PAULL. It is up dramatically over, I think, the last 5 years. That is correct. I think there are a lot more people invested in marketable securities these days.

Then we have quite a few other individual simplification proposals. We touch on the Earned Income Tax Credit, the head of household filing status, surviving spouse filing status, 2 percent floor on miscellaneous itemized deductions, and the so-called "kiddie tax," the tax for minor children when they have income over $700. It is another area where it is extremely complicated to figure out the rate of tax that applies to the income of children under the age of 14. So, we have a major simplification proposal on that.

In addition, we have made many other recommendations, and I am not going to go through each one of them here, but I welcome

the opportunity to spend time with you to answer any questions for all members of the committee and staff.

We made recommendations in a variety of other areas. For example, in the international area, we have a number of recommendations, including something that has been proposed by a variety of sources in the past, which is to simplify the so-called anti-deferral rules, the rules that require U.S. owners of foreign corporations, foreign entities, to pay tax currently on income earned by those entities.

There are about five different sets of rules that apply. Our recommendation was to bring those down to the two basic sets of rules, which is the Subpart F set of rules and the Passive Foreign Investment Income set of rules, PFIC rules.

We also have a recommendation on expanding cash method of accounting for small businesses. That is one of the areas where small businesses have a hard time keeping an extra set of books for tax purposes, because many of them are forced on the accrual method of accounting under the present law.

There are a variety of proposals dealing with corporate income tax. They are less significant, involving pass-through entities, like-kind exchanges, tax-exempt organizations, tax-exempt financing, excise taxes, financial products, and business tax credits. So, that is just to name a few.

We have 150 recommendations. We hope that each and every one of them will be given serious consideration. Again, I want to thank you for inviting me to testify today, and welcome any questions today or later, and look forward to working with you on this project.

[The prepared statement of Ms. Paull appears in the appendix.]

The CHAIRMAN. I have a few questions. I presume I ought to announce for not only you, but for the other panel, that, even for members that are here, sometimes we have questions for answer in writing. We would appreciate those answers being returned in a couple of weeks.

I presume the questions I have will be about some of the things you have already highlighted. Let me go to the Alternative Minimum Tax, the fact that it should be eliminated.

Our Democratic colleagues have correctly criticized the President's tax proposal because it would add individuals to the AMT. We have a Democratic economic stimulus package, S. 629, that has been introduced. Do you know whether this package eliminates the AMT problem, and if it does not eliminate it, the extent to which it might affect the AMT problem?

Ms. PAULL. Yes. The Senate Democratic proposal kind of suffers from the same criticism, I think, as the President's proposal, but maybe the magnitude is not quite the same.

Any of these proposals that reduce tax rates, without any adjustment to the Alternative Minimum Tax, are going to cause people to be subject to the Alternative Minimum Tax.

So it is happening under present law because there is an indexing under the Alternative Minimum Tax where the major structural features of the regular tax are indexed, and it becomes worse whenever you reduce the regular income tax and do nothing over here.

So both of those proposals suffer from the same problem, which is, you reduce the regular income tax, you cause more people to become Alternative Minimum Tax payers.

Yet, there is not anything about those people that would say, yes, they should be the types of people that would be subject to the Alternative Minimum Tax. All they were trying to do was get a regular income tax rate reduction.

The CHAIRMAN. Yes. Do you know the number of people, under S. 629, that would be affected by the Alternative Minimum Tax? Or if you do not know, maybe submit it for answer in writing.

Ms. PAULL. I would be happy to submit it.

The CHAIRMAN. All right.

[The following information was subsequently received for the record:]

Congress of the United States
JOINT COMMITTEE ON TAXATION
Washington, DC 20515–6453

APR 04 2001

Memorandum

To: Mark Prater

From: Lindy L. Paull

Re: Taxpayers affected by the alternative minimum tax under S. 629

This responds to your request of April 4, 2001, for information concerning taxpayers affected by the alternative minimum tax under present law and under S. 629, the Senate Democratic Economic Stimulus Package. We provided you with a revenue estimate for S. 629 on April 3, 2001.

Calendar Years [Millions of Returns]

Item	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Present law.....	1.5	3.5	4.3	5.6	7.1	8.7	10.5	2.8	14.9	17.5	20.7
S. 629	1.8	5.6	6.8	8.6	10.7	12.5	14.7	17.5	20.1	23.5	27.6

The CHAIRMAN. Let me ask about the phase-out of personal exemptions and itemized deductions. Again, your report says these should be eliminated. These are what we refer to here on the Hill as the PEASE and PEPs. Could you tell us when the PEP and PEASE phase-outs begin for a family of four?

Ms. PAULL. The PEASE phase-out begins for everybody in roughly around $130,000 of adjusted gross income. For the PEP phase-

out for a family of four, I am not sure. I might have to look this up. It is somewhat higher than that, but it is still in the $100,000's of income.

The CHAIRMAN. Maybe it is around $132,000 for all taxpayers. Does that contribute to the marriage penalty problem then, in turn?

Ms. PAULL. Well, certainly, any sort of phase-out that is not adjusted, is not set at a different level for singles versus married couples, is going to contribute to the marriage penalty. The so-called PEASE, the limitation on itemized deductions, I believe, does not make a distinction between the two.

The CHAIRMAN. Do you have any idea how much a family of four's effective marginal tax rate would be increased by these PEP and PEASE disallowances?

Ms. PAULL. I think it is roughly about 4 percent.

The CHAIRMAN. Four percentage points?

Ms. PAULL. Yes, I think so. So that is another point about these phase-outs. They have a hidden marginal rate associated with them.

The CHAIRMAN. So by eliminating them, then we would reduce the effective marginal tax rate. Would we at the same time then simplify the Tax Code?

Ms. PAULL. Absolutely.

The CHAIRMAN. Do you have any idea how many taxpayers will be affected by these phase-outs during the current year, or maybe over the next 5 years?

Ms. PAULL. I think the PEASE phase-out affects about 6 million, and the personal exemption phase-out, PEP, affects about 2 million, currently.

The CHAIRMAN. All right. I have a question about the top-heavy pension rules. You recommend applying the top-heavy vesting schedules to all plans. The ABA recommends repealing or modifying the top-heavy rules. To what do you attribute this difference, and why do you believe that all plans should have a shorter vesting schedule?

Ms. PAULL. We gave consideration to the repeal of the top-heavy plan rules, but I believe we ultimately concluded that there were some policy decisions that would have to be made, and that that was beyond the scope of our study.

Our recommendation is simply to say there ought to be a uniform vesting rule. We picked the top-heavy vesting rule as the uniform rule that would be applied throughout the Code.

That would provide simplification by having a uniform rule rather than multiple rules. We did not think it was our mission in this report to second-guess the policy behind the top-heavy rules. That would be for you to decide.

The CHAIRMAN. Yes. Well, one of the reasons for my question was because we had the General Accounting Office report to us that, under the present set-up in the Tax Code, there was a bias against small plans.

Ms. PAULL. Right. Right.

The CHAIRMAN. I guess the extent to which we did something in this area, it very definitely would encourage smaller businesses, a larger share of which do not have retirement plans now, to have

retirement plans. That would then consequently help us in the process of our whole retirement plan, Social Security, private savings, and pensions.

Ms. PAULL. Sure. I think there is an argument that could be made that modification, or perhaps elimination, of the top-heavy rules would provide expanded coverage. I think you have a bill that deals with some of these issues.

The CHAIRMAN. We do have. Obviously, I suppose I am trying to lean on you a little bit.

Ms. PAULL. All right.

The CHAIRMAN. Senator Baucus is also a co-sponsor of the same bill.

Ms. PAULL. Yes.

The CHAIRMAN. Then after Senator Baucus, who was not here for his opening statement, then I will call on you, Senator Snowe.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA

Senator BAUCUS. Thank you, Mr. Chairman. Thank you, Senator Snowe. I will be very brief.

I think this is a good opportunity, Mr. Chairman, for us to try again, finally, to begin to do something about this. The Joint Tax Committee's report is a very good starting point, benchmark, beginning for us to stop talking about the undue complexity of the Code and start doing something about it.

I remember, it was a few years ago, I was sitting at my kitchen table trying to figure out my taxes. I had my 1040, and was going through all of the tables and computations. I do not have a very complicated tax return, and I had to, frankly, give up. I felt very un-American. I felt guilty. Here I am, a college graduate, a law school graduate.

Frankly, if I had spent more time, I suppose I could have figured it out, but I just did not have all the time that I knew it would take to adequately and thoroughly complete my tax returns. That is just wrong. It is just wrong. I just think we should have a system that is a lot more simpler than we now have. It would have a lot more credibility among the American people. It would save a lot of useless time and energy.

I might add that the current complexity of the Code is really, in and of itself, an additional tax. It takes the average person, I think, 27 hours or something like that to adequately complete a 1040. That is a few work days.

A few work days is a few work days. Some estimates are, it is up to 10 percent of the revenue that is taken in. In an economy as large as ours, 10 percent is an awful lot of money. So there, in and of itself, is a tax break to the American people, just by eliminating the bulk of the complexity of the Code.

I know that we are the cause of a lot of it, we in the Congress. The House Ways and Means, the Senate Finance Committee, the House and the Senate, conferences. We are all trying to split the difference and try to compromise. It adds complexity. We are caught in this polarity of simplicity on the one end and inequity on the other. There is no easy answer to that question. You have to make choices.

There will be some complexity, for policy reasons. I think you mentioned, Ms. Paull, that a lot of the actions that we take here are really not policy matters, they are just kind of trying to figure out how to dot the i's and cross the t's matters in putting together the Code. It has become that way in the last several years.

There have been some major changes, but a lot of it is just trying to re-jiggle what we have to try to make it fit a little bit better.

So here we are. I, frankly, think we need a kind of commission like we did on Medicare or Social Security, with a lot of good, high-statured people on it. The Greenspan Commission really saved Social Security. Senator Dole, I think, was on that commission. Senator Moynihan was on that commission. It was truly bipartisan. It was an effort that was meaningful, it was real. The members all joined hands, along with President Reagan and members of Congress. I know there are some problems here. That is, it is going to upset some people and not please everybody. But it is the right thing to do for America. Everybody needs to join hands and say, all right, we are going to this. We will jointly take the political heat.

Mr. Chairman, and I say to my good friend, the Senator from Maine, I believe that something like that is necessary here. Bipartisan. Truly bipartisan. There can be no partisanship in this thing. And, primarily private sector driven, with some government people on it, but named with people who are really going to get the job done, not window dressing, not just going through the motions, but clearly with people and with a charge that this is real.

Mr. Chairman, if we do something like that I think we can be performing a real service here. I thank you very much for holding this hearing.

The CHAIRMAN. You did not have any questions?

Senator BAUCUS. I have no questions.

The CHAIRMAN. All right. Senator Snowe?

Senator BAUCUS. Not at this point.

The CHAIRMAN. Yes. All right.

Senator SNOWE. Thank you, Mr. Chairman.

Ms. Paull, thank you for being here. I think it speaks to the problem, when we have three volumes to explain the complexity of the Tax Code. So, we certainly have our work cut out for us. You know the old saying that "Nothing is certain in life but death and taxes?" Well, I read recently where somebody said, "But death does not occur every year." So, we obviously have our work cut out for us.

I think about the 1986 Tax Reform Act. That was a misnomer. There were intentions of simplifying the Tax Code, but obviously that did not result. Obviously we are facing even more complications even from that law today.

We have not had a chance to review the three volumes here with respect to the recommendations that the Joint Committee has made. But could you give the committee some indication of what you would consider perhaps the top five most important changes that would help with simplification of the Tax Code?

Ms. PAULL. Well, I think that we tended to focus most of our attention on individuals, and to the extent we could, on businesses. So I would focus your attention on the individual provisions.

For example, the Alternative Minimum Tax, I think, is a very pervasive problem. It is going to continue to be a pervasive problem in the Tax Code. It is quite complicated.

The uniform definition of a child for the five provisions—I do not know if you were here when I mentioned this—for purposes of determining whether a child qualifies you for a dependency exemption, child credit, Earned Income Tax Credit, head of household status, and dependent care tax credit. That, I think, would affect quite a number of people.

Senator SNOWE. You are saying, a definition of a child?

Ms. PAULL. Of a child. Believe it or not, for people to determine whether or not a child qualifies them for these five purposes in the Tax Code, they have to go through 17 pages of instructions.

We have a table in our report that illustrates the differences between the definition of a child—this is a child under a certain age—and how you qualify for tax benefits.

If you had a uniform definition, people would not have to go through these flow charts for certain things. So that happens to be a provision that would, we think, affect, potentially, 44 million individuals. So, I would rank that fairly high. It sounds like an obvious thing that we should have in the Tax Code, but we do not.

Anyway, I would focus your attention on the individual recommendations in our report. They number about 15 or 16. I think they would probably provide the widest-spread relief. There are some business provisions that would also, I think, provide some help especially for small businesses.

Senator SNOWE. How difficult of a task would it be for the committee, for Congress, to address those issues this year? I mean, from your perspective and your knowledge of our workings, do you know?

Ms. PAULL. Now you are trying to put me on the spot. Let me just say, it took us 18 months to go through all of these materials and work with distinguished experts, and everything. I think you have it right.

You have to prioritize and make progress where you can. I would urge the committee to review and try to prioritize based on the widest-spread application and see if you cannot make some significant reductions in provisions that really affect a lot of people.

Senator SNOWE. Did this result from the regulations that came out of the IRS in response to our changes in the Tax Code? These evolve over time. For example, in defining what are the qualifications for a child.

Ms. PAULL. Well, for example, on the definition of a child for the various provisions, each provision came into the Tax Code at a different point in time. So at that point in time, somebody decided that this is a useful way to define a child for this purpose.

So while the dependency exemption has been in the Tax Code for a long time, the Earned Income Tax Credit came in in the mid-1970's, I believe the dependent care credit did, too, the $500 per child credit just came in 1997. As these things get enacted, there are little tweaks that happen. Then, before you know it, as I said, you have to go through this flow chart and figure out if this child qualifies you for each provision.

People think, well, I have qualified here, I must qualify for everything. You do not, necessarily.

Senator SNOWE. Which of the major provisions that are at least being discussed with respect to a tax package this year would aggravate the complexities of the Tax Code? Would the marginal rate changes enhance the complexity?

Ms. PAULL. Well, the marginal rate changes, in and of themselves, are not adding any complexity because you go to a rate schedule and you figure out the tax you owe on the regular income tax side.

What is happening is, however, because the Alternative Minimum Tax structure is not being touched, and it is not indexed for inflation, and it is not being lowered at the same time as the regular rates are, you have a lot of people flipping over into an Alternative Minimum Tax computation. That will be significantly more complicated for them. So, you need to attend to that issue.

Senator SNOWE. The AMT.

Ms. PAULL. Yes.

Senator SNOWE. Have you determined what the cost of eliminating the AMT would be?

Ms. PAULL. I think, on the individual side, it is roughly about $215 billion over 10 years. But it gets exacerbated when you do it with any rate changes.

Senator SNOWE. Thank you very much.

Thank you, Mr. Chairman.

The CHAIRMAN. All right. Since there are not any other members here, I guess at this point we will——

Senator BAUCUS. Can I ask a couple of questions, Mr. Chairman?

The CHAIRMAN. Of course you can. Yes. Sure.

Senator BAUCUS. Very briefly. Lindy, I am curious whether you are going to address policy questions in your next report.

Ms. PAULL. Well, we left you a road map. We did not think that the statute asked us to do that. However, because we considered quite a few proposals that would have involved significant policy decisions, we discussed many of those in our reports and indicated that there are policy decisions that needed to be decided by the Congress. We felt we left you a significant road map to go down that road, if that is where you wanted to go.

Senator BAUCUS. All right. Now, apparently you have about 150 different suggestions. Is that correct? One hundred and fifty simplifications.

Ms. PAULL. Actual recommendations on simplification. That is correct.

Senator BAUCUS. Now, this is a tough question to answer. But if the complexity of the Code is, today, a 10, where would we be if all of your recommendations were implemented, on a scale from 1 to 10?

Ms. PAULL. It would still be complicated.

Senator BAUCUS. It would be up there at number 9, 9.9?

Ms. PAULL. Probably eight or nine, still.

Senator BAUCUS. What do you think about a bipartisan commission, would that help?

Ms. PAULL. I think, basically, one of the things that we did not do in this in this report—and I do not know if this is what you are

alluding to—is try to compare it to some sort of fundamental change to the Tax Code, because we felt that our mission was to make recommendations on simplifying the policies that have already been decided by the Congress.

If you want to do radical or fundamental tax reform, then you might consider a commission because it is a major undertaking and it is difficult for a committee like this to spend the kind of attention they need to focus on that.

Senator BAUCUS. I would think that perhaps the Joint Tax Committee would want a commission. I just do not know about the propriety of the committee digging into policy issues.

Over the years, we in this committee, and I think many in the Congress, have prided you in Joint Tax as being nonpartisan, nonpolicy implementers in giving us revenue assessments, et cetera, and just being a very top-flight, very professional outfit that has credibility on both sides of the Hill and both sides of the aisle.

I am just thinking out loud here, but if the committee were to get more into policy you would run the risk, at least, of jeopardizing that credibility. Off the top of my head, I think a commission would be good, frankly, to enable us as a country to look not only at the technical matters, but also policy matters, in trying to simplify the Code. The current Code is just a mess. We all know that. We have to go the extra mile to figure out how we build momentum to crack a dent in all of this.

I remember, Mr. Chairman, a few years ago, taking up a tax bill, we have a provision in the law that we have to look at the complexity of the provision, looking at the JTC estimate, to tell us how complex this new proposal is that we are looking at. In fact, I think it was my amendment.

I pressed the adoption of this amendment before we adopted a new measure in this committee. But there are others, whom I will not name at the moment, in a position more senior who suggested, no, it would be afterwards. I thought that was futile. It does not do any good, once the horse is out of the barn, to look at the complexity of a provision. I regret that we did not enact that earlier provision to look at the potential complexity provisions before they are enacted rather than after they are enacted.

Ms. PAULL. Senator, we do try to provide that information at the mark-up, though, upon request. It is not in writing and not circulated because of the time frame and the way things often happen. The mark-up occurs just a couple of days after the Chairman's mark is released.

It is also worthy to note that, at least you have the product from the House, and it is included in the reports. We are still doing those complexity reports.

Senator BAUCUS. I appreciate that, Lindy. But I must say, from my perspective, they are not terribly helpful because of the nature of the beast. We are hurrying here, we are busy.

Ms. PAULL. Right.

Senator BAUCUS. We just do not have the opportunity to focus on the complexity.

Ms. PAULL. Sure.

Senator BAUCUS. To be honest about it, most members do not want to. They do not want to know how complex it is because they

do not want a complexity report to get in the way of their favorite little provision. That is a bit of an overstatement, I grant you, but there is something to it. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Do not be confused by the facts, you know. [Laughter.]

Ms. Paull, thank you very much.

We will call our second panel now.

Ms. PAULL. Thank you for having us. I look forward to working with you on this.

The CHAIRMAN. Absolutely.

Now we are going to bring a panel of people that are in the front lines, working every day with the complicated aspects of the Tax Code. Claudia Hill represents the National Association of Enrolled Agents. She will tell us about some of the headaches tax professionals encounter when they work with this Code, probably most often in the spring. She will have some suggestions on how to address these problems.

Then we have three people, I believe, who have worked as a collegial group, and have taken the extra responsibility of working together to come up with a set of some simplification proposals.

Dick Lipton, chair of the American Bar Association's Tax Section; Pamela Pecarich, testifying in her capacity as chairman of the Tax Executive Committee of the American Institute of Certified Public Accountants; and then we have Betty Wilson, who is here today as president of the Tax Executives Institute.

We will begin with Ms. Hill, then continue across the way. However you folks want to divide up your three presentations, you can do it that way.

STATEMENT OF CLAUDIA HILL, CHAIR, GOVERNMENT RELATIONS, NATIONAL ASSOCIATION OF ENROLLED AGENTS, GAITHERSBURG, MD

Ms. HILL. Mr. Chairman, members, and staff, I am Claudia Hill, an enrolled agenda in private practice in Cupertino, California. I speak from first-hand experience, because I actually prepare tax returns.

I am pleased to testify about the complexity of the Internal Revenue Code on behalf of the National Association of Enrolled Agents, whose members typically specialize in individuals and small business taxes.

Each year, NAEA surveys their members on problems with the filing season. The resounding response we hear, is the biggest problem with the filing season is complexity. It is the number-one problem for taxpayers and their preparers.

Now, there are those who would suggest that the response to the sheer magnitude of the Joint Committee on simplification would be to admit defeat, that simplification is an impossible task. We disagree. We believe that, within the context of the intent of Congress, there are ways that the complexity of the existing Code can be reduced.

Now, while there are many aspects of the tax laws that create complexity, we have chosen today to focus on four areas that our

members rank as ones that would affect the most individual taxpayers.

First on our list, is the Alternative Minimum Tax. For 2 years in a row, it has been voted “Tax Headache of the Year” by our members. The main reason they have voted it this, is because they are seeing more and more individual taxpayers blind-sided by falling into this insidious alternative tax system.

You have heard statistics, you will read them in our reports, but what I would like to try to do is take these statistics and make them real for you.

I am going to give you a few example of the people that we saw this current year affected by Alternative Minimum Tax. An elderly taxpayer caring for his wife with Alzheimer’s had to withdraw extra pension money in order to pay his medical bills.

The AMT calculation required him to add back a portion of those medical bills into the AMT base and, combined with his State and local property taxes and income taxes, he ended up in an Alternative Minimum Tax situation and paid the higher tax.

We see employees who incur ordinary and necessary business expenses and whose employers do not necessarily fully reimburse them. These people are injured because the Alternative Minimum Tax does not permit a deduction for such expenses that are required for their employment.

A few years ago, Congress saw a need to provide farmers with a special income averaging method. Unfortunately, when that method lowers the regular tax below the Alternative Minimum Tax, the taxpayers lose the benefit and pay the higher AMT.

Since the personal exemption amount is not allowed as an AMT deduction, large families can find themselves paying the AMT, with their only adjustment being State and local taxes and the deduction for their children. U.S. taxpayers living outside the country are provided, in the law, means to avoid double taxation through the use of foreign tax credits.

Once again, AMT undermines the intent of fairness Congress intended with the credit system by allowing the AMT Federal tax credit to offset no more than 90 percent of the tax, whereas, the regular foreign tax credit can fully offset the tax.

Although Congress may be considering an extension allowing the use of non-refundable credits and educated-related credits against the AMT, general business credits still cannot be used against the Alternative Minimum Tax.

Of course, making the most news the last three months have been those taxpayers who exercised incentive stock options during the year 2000. Many are now faced with paying taxes on virtual income that may never be realized.

Adding to this burden the current AMT structure does not always make it possible to calculate it for the information that you would normally provide on a tax return. This makes the calculations extremely difficult for taxpayers who would prepare their own returns, and it calls into question the IRS’s ability to administer it.

The NAEA recommends the immediate repeal of the individual AMT. Now, if total repeal is not physically possible, the individual AMT must be extensively modified and, as a minimum, remove the

non-preference items from the provisions not deductible under AMT: the standard deduction, the personal exemptions, State and local taxes, and miscellaneous itemized deductions, as well as that medical adjustment that I mentioned earlier.

Rate brackets and exemption amounts should be brought current for the years of adjustments that have been overlooked. The creeping intrusion of the Alternative Minimum Tax, which undermines programs to benefit lower- and middle-income taxpayers, must be stopped.

Our report focused on three other areas of complexity: the Earned Income Credit, which we believe the errors with this program are an embarrassment to the IRS, paid preparers, and the entire tax system. Such error rates, including the failure of eligible taxpayers to claim the credit, should convince us the program is deeply flawed.

The program is a nightmare of eligibility tests, worksheets, and an income phase-out limitation based on filing status, such that being low-income and single is much more beneficial than being low-income and married.

We recommend that Congress simplify the EIC and make this one of their top priorities by appointing a task force to focus specifically on making the program work.

The CHAIRMAN. How much more time do you need?

Ms. HILL. Just another minute.

The CHAIRMAN. Please, go ahead.

Ms. HILL. Thank you.

Phase-outs were our third category. There are over 20 commonly encountered phase-outs of individual returns that would require calculations. I brought along with me a cheat sheet that gives me a quick summary, because I cannot prepare a tax return and explain to a client why they are not getting the benefit of something that Congress told them they were going to get the benefit of because they have been phased out of the deduction. They feel that they have been deceived.

Many of the phase-out provisions related to filing status, and the presence of such calculations exacerbate the marriage penalty. Much relief in the area of marriage penalty reductions would be affected by eliminating the phase-outs.

Our final recommendation is to encourage you to enact the provisions related to penalties that have become so complex and frustrating to taxpayers, and we encourage you to follow through on the recommendations you have had.

We appreciate the committee giving the National Association of Enrolled Agents the opportunity to talk about the Tax Code complexity and new hope for fresh solutions. Our members are dedicated to supporting the system of tax, and stand ready to contribute to a constructive debate on it. Thank you.

[The prepared statement of Ms. Hill appears in the appendix.]

The CHAIRMAN. All right.

Mr. Lipton?

STATEMENT OF RICHARD M. LIPTON, CHAIR, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION, WASHINGTON, DC

Mr. LIPTON. Thank you, Mr. Chairman and members of the committee.

My name is Richard Lipton, and I am the chair of the American Bar Association, Section of Taxation.

My testimony is presented on behalf of the Tax Section, and except as otherwise indicated, should not be construed as representing the policy of the association.

Today I am joining with my colleagues from the AICPA and TEI to speak to you with one voice on tax simplification. I will be addressing three specific issues. My colleagues from the AICPA and TEI will be addressing other issues. I want to emphasize the Tax Section's complete and total support for the statements of the AICPA and TEI.

We all know that the Code is in desperate need of simplification. 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.

Even the most sophisticated of tax advisors can find it difficult to decipher these provisions. This complexity is compounded by the sheer volume of tax law changes. That is why the Board of Governors of the ABA made tax simplification one of its legislative priorities this year.

Turning to specific proposals, our primary simplification priority is repeal of the individual AMT. The AMT was originally enacted in 1969 to ensure that wealth taxpayers paid some tax. Whether or not it achieved its goal then, the individual AMT no longer serves that purpose today.

It creates a parallel tax universe that should be relegated to science fiction. It imposes a major compliance burden on numerous taxpayers without a significant policy justification.

More important, however, is what will happen with the individual AMT in the future. The Treasury Department estimates that the number of taxpayers subject to the individual AMT will increase from the current 1.4 million in 2001 to 17 million in 2011.

Moreover, by 2007, almost 95 percent of the revenue from AMT will result from preferences and adjustments that are personal in nature and not the result of tax planning.

This committee is aware that this is an expensive problem, but the individual AMT is like a car's engine with an oil leak. If you fix the problem today you may be forced to postpone another expenditure, but if you fail to fix it today you will surely incur a larger expenditure when the car's engine explodes.

In our view, the easiest solution to the AMT problem is total repeal. If repeal is not feasible, we believe some simplification could be achieved by excluding certain taxpayers, eliminating certain preferences and adjustments, repealing the denial of the miscellaneous itemized deductions and the adjustments for ISO stock, or indexing the rate brackets and the exemption amount. But we emphasize our view that what is required is total repeal of the individual AMT.

Our second simplification priority is repeal of the stealth taxes. These are the limitations on itemized deductions and personal exemptions, the so-called PEP and PEs provisions.

They are the stealth bombers of the tax system, in that they impose a tax completely without warning. They are nothing more than hidden rate increases on upper income taxpayers that add considerable complexity to the Code.

Congress should repeal these hidden taxes. That is not just the position of the Tax Section, it is the formal position of the ABA. If Congress is concerned about revenue loss, then Congress should either substitute an explicit top rate bracket or reduce the amount of the tax cut for upper income individuals.

Our third priority, is simplification of the Earned Income Tax Credit and family status issues. The EITC rules are among the most complicated 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, 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 that they benefit. Such changes could be expensive, but massive simplification is necessary to make this credit understandable.

There are numerous specific complexity issues raised by the EITC, and time permits me to mention only one here. That involves family status.

The Tax Section strongly urges this committee to rationalize, harmonize, and simplify the definitions and qualification requirements associated with family status, dependency exemptions, and credits.

For example, whether an individual is dependent for purposes of claiming a personal exemption has little bearing on whether the person is a qualified child for purposes of the Earned Income Tax Credit.

This also ties in with the questions that were asked by Ms. Snowe concerning other family status issues and the definition of a child. All of those areas that were discussed by the Joint Committee in its report relate to family status and need to be simplified and harmonized.

Members of the Finance Committee, you have an historic opportunity to enact meaningful and dramatic simplification. For the first time in many years, you have the resources in terms of a large budget surplus. We can think of no better way to use some of this surplus than by making the tax system more rational and less burdensome for your constituents. The need is there, and so is the revenue. Now is the time to act.

Thank you very much.

[The prepared statement of Mr. Lipton appears in the appendix.]

The CHAIRMAN. Thank you.

Ms. Pecarich?

STATEMENT OF PAMELA J. PECARICH, CHAIR, TAX EXECUTIVE COMMITTEE, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, WASHINGTON, DC

Ms. PECARICH. Thank you. Mr. Chairman, members, and staff of this distinguished committee, thank you for having this hearing today. Thank you for inviting us to testify.

My name is Pamela Pecarich and I am chair of the Tax Executive Committee of the American Institute of Certified Public Accountants.

You have heard from the AICPA many times over the last decade about the imperative need for tax simplification. Clearly, this issue is not a new one for us. As CPAs, we are on the firing line with American taxpayers and we are convinced that the time for discussion is past, the time for action is now.

First-hand, we observe how few Americans can really understand and comply with the tax law without expending considerable resources. They have also lost respect for the tax system as it increasingly makes them victims of unintended consequences and outdated policies.

The costly net result to our country is eroded voluntary compliance. If you will, this is empirical evidence of the effect that complexity is taking on our tax system.

Today, Congress and the administration face a unique opportunity. We are in a period of budget surplus, and tax relief of some kind is imminent. We agree that taxpayers are entitled to tax relief, but we recognize it can come in many forms: a reduction in tax rates, additional incentives in the Code, or even perhaps an overall reduction in the cost of compliance. That is our hope. The time is right for simplification relief.

As noted by my colleagues on this panel, the AICPA has worked with TEI and ABA to develop a common goal and common recommendations for simplifying and rationalizing our tax system. We generally endorse their testimonies here today, and that of NAEA.

I would point out to you the consistency between these testimonies, between our recommendations, and between those of the Joint Committee. We are really singing from the same song sheet.

As Congress considers how to allocate the limited resources available for tax relief, we urge in our testimony that priority attention be given three important objectives: fixing structural problems, focusing resources on those provisions that affect large numbers of taxpayers, and avoiding doing further harm.

Very first, Congress must fix structural problems. We put the AMT in this category. Dick Lipton spoke to it very eloquently. The time for repeal is here. We are very pleased to see that the Joint Committee shares that recommendation.

The second priority, is to focus resources on simplifying aspects of the tax law that are complicated for a large number of taxpayers. You have heard today, many provisions we endorse, simplifying the definition of child and making it consistent, the phase-out provision, we very much endorse.

We wanted to mention another point about phase-outs. That is, income level phase-outs, which are staggeringly different throughout the Code. I direct your attention to Appendix B in our testimony, which is a summary of what Claudia also referred to.

The Code has no coherent, consistent framework for defining, providing, or denying benefits to people in low, middle, and upper income categories.

No matter what income ranges you decided upon, having consistency would be a major simplification. A better simplification is repealing phase-outs altogether where you can, and standardizing income limits and eligibility rules.

The other areas that specifically affect individuals are the Earned Income Tax Credit, education credits, the child credit, retirement savings provisions, and taxation of Social Security benefits.

I would like to mention, for a moment, education incentives. We have another appendix to our testimony, Appendix C, that points out the contrast in eligibility in definitions income limits among nine different education incentive provisions. Let me reiterate that, if a provision is not clear, and understandable, and certain to taxpayers, it cannot be an incentive. It just will not work that way.

This year, we saw many taxpayers lose education incentives because of unintended, unexpected interactions with other provisions, most particularly this year, capital gains. Unanticipated income makes you ineligible. There are many other complexities with education incentives that we direct your attention to.

The patchwork approach that exists in these various areas of the Code has been frequently the result of provisions crafted under revenue constraints of prior years. We hope, today, we are in a different environment. Today you have a choice, and we hope that these areas can be rationalized and simplified.

The third objective, is to avoid doing further harm by adding new complexity and new targeted provisions.

Thank you very much for your attention. We stand ready to work with this committee in any such endeavors. Thank you.

[The prepared statement of Ms. Pecarich appears in the appendix.]

The CHAIRMAN. Thank you.

Ms. Wilson?

STATEMENT OF BETTY WILSON, PRESIDENT, TAX EXECUTIVES INSTITUTE, WASHINGTON, DC

Ms. WILSON. Good morning. I am Betty Wilson, vice president of Taxes of MGM Mirage in Las Vegas. I appear today as president of Tax Executives Institute, whose 5,300 members represent the 2,800 largest companies in the United States, Canada, and Europe.

Mr. Chairman, as you learned earlier this month when you addressed TEI's 51st mid-year conference, TEI members agree with the Taxpayer Advocate that complexity of the tax laws is a very significant issue. We commend the committee for holding this hearing.

Two year ago, TEI joined with the AICPA and ABA, Tax Section, to focus attention on this problem. TEI's members work for the large corporations and, quite candidly, will not benefit from many of our recommendations.

We joined the effort, however, because we are convinced that the best chance for real simplification lies in collective, coordinated ac-

tion. In this regard, we are pleased that the NAEA is here today to lend its voice to the topic.

Everyone—Congress, the Treasury Department, the IRS, tax professionals, and taxpayers—all bear the responsibility for the current state of the law.

Before turning to several specific recommendations, I want to address three questions: why simplification, why us, and why now?

Why simplification? Because TEI sincerely believes that, if we do not act, the tax system may collapse of its own weight.

Why us? Because as tax professionals, TEI members are well-positioned to document the problems and to identify the means of dealing with them.

Unlike the other witnesses, I represent a group, not of tax practitioners, but of taxpayers themselves. It is our burdens, our costs, our headaches, and our loss of productivity that we are talking about. But all of us here today deal with the consequences of complexity.

The laws governing the taxation of complex, multifaceted, multinational businesses will never be simple, but they can be made a lot simpler. As tax professionals, we can aid in that effort.

Why now? Because if we do not start the journey, we will never arrive at our destination, and because projected budget surpluses afford Congress greater flexibility to address the complexity than in any time in the past two decades.

TEI has no allusions that we will ever have a perfect, simple tax system. But as one of your predecessors, Russell Long, often remarked, the perfect should not be the enemy of the good. Incremental simplification is better than no simplification, and the time to begin is now.

In my remaining time, I want to highlight a few issues. First, Congress can effect a meaningful simplification by repealing the corporate Alternative Minimum Tax. The corporate AMT suffers from the same deficiencies and structural flaws as the individual AMT.

It requires taxpayers to operate in, and comply with, numerous requirements of two separate tax systems. It creates enormous administrative burdens, and through its depreciation component, it discriminates against capital-intensive companies.

Even assuming that the AMT served a valid purpose when enacted, the burdens it imposes, which grow every day, cannot be justified in today's highly competitive global economy.

We, therefore, agree with the Joint Committee's recommendation that the AMT should be repealed for all taxpayers, individuals and corporations.

Next, TEI believes it is time to reform and simplify the depreciation rules. In 1998, Congress directed the Treasury Department to conduct a comprehensive review of recovery periods and depreciable methods. The resulting study disappointed many of us because it did not include concrete recommendations for modernizing current law.

The study did confirm one very important fact: the current system is hopelessly outdated and needlessly complex. For example, we do not believe that foreign assets should be depreciated at a different rate from that used in respective domestic property.

We also think it is ludicrous to use asset class lives that have not changed since 1981, and indeed in some cases date back to the 1960's. New industries, new technologies, and new manufacturing processes have all developed in the intervening years. The tax law needs to catch up.

Mr. Chairman, when you addressed TEI earlier this month you stated that depreciation was one of the areas that the Finance Committee would deal with this year. TEI applauds that decision.

Third, Congress needs to address the uncertainty and complexity that flow from temporary provisions of the tax law. Most notable are the research credit in Section 41, and the educational assistance exclusion in Section 127.

These provisions cannot serve their legislative purpose if taxpayers do not know whether they will remain in effect from year to year. The on-again/off-again nature of the rules can spawn tremendous compliance burdens. TEI recommends making the R&D credit, Section 127, as well as the Work Opportunity Credit, permanent. Finally, we second your call to take a serious look at the Code's foreign provisions.

Foreign tax credits and Subpart F rules may never be truly simple, but they can be streamlined. Subpart F was enacted as an exception to the deferral principle in order to tax the types of income that were considered to be movable.

In the four decades since its enactment, however, Subpart F has been distended to capture active operating income. One solution to removing Subpart F's artificial barrier to competitiveness would be to exclude foreign-based sales and services income from current taxation.

Other international areas that should be targeted include the rules for translating foreign taxes under Section 986, and the interest allocation rules under Section 861.

We understand that Senators Hatch and Baucus are working together on an international tax simplification bill. We look forward to reviewing those proposals.

Once again, TEI commends the Finance Committee for holding this hearing. We look forward to working with you and staff to simplify and approve the tax laws.

Thank you.

[The prepared statement of Ms. Wilson appears in the appendix.]

The CHAIRMAN. Thank you very much. We appreciate all of the hard work that you have put into this. More importantly, however, is the practical application you have of the problems for the work of this committee.

I am going to start with Ms. Hill. By the way, Senator Grassley, Senator Baucus, Senator Snowe, Senator Nickles, and Senator Bingaman, is the order that we will follow for the five-minute turns.

In your testimony, you state that phase-out provisions relating to filing status exacerbate the marriage penalty. In your view, how does the PEASE phase-out contribute to the marriage penalty problem?

Let me also ask about your testimony where you state that the phase-outs create incredible complexity. Maybe you can answer the

question on the marriage penalty, and elaborate on that other point you made.

Ms. HILL. All right. I brought along with me a quick reference guide for the most frequent phase-outs. It is indicating by filing status: joint, head of household, single, and married filing separately.

Let me just name off some of the provisions in the law that have phase-outs where, in the instance where a person files separately, they get no adjustment at all.

For example, the adoption credit with exclusions is allowed within certain ranges for joint returns for a single at the same rate, $75,000 to $115,000, whether it is a single parent or a couple. But if the return is filed separately, there is no credit at all.

Another example, would be the AMT exemption. It is $150,000 to $300,000 on a joint return, whereas, on a single or head of household return, that exemption phases out between $112,000 and $247,000. In other words, the adjustment for two people filing together is not the same as two people filing individually. They are not additive.

Other examples. The education student loan interest. If you file a separate return, you get no deduction at all.

On the IRA deductions, one of our members wrote that the Roth deduction is not allowed for most people if you file separately, and that this was a disadvantage to her in her State. So, in a sense, it made it so that people in her State could not contribute to Roths, because many of them do try to file the returns separately.

The biggest difference between a married and two people who are not married but living together example, is that the phase-outs usually are not double. Because of that, the brackets click in higher, quicker, and so does the elimination of the benefits.

The CHAIRMAN. I am going to go either to Ms. Pecarich or Mr. Lipton, whoever wants to answer, on the capital gains simplification and who would benefit. I think this brings up one of the Tax Code complexities that is a legacy of the Clinton administration, because this is really one of those complicated provisions, the provision, particularly, that took effect at the beginning of the year.

Taxpayers normally would hold property for a year to claim the 20 percent capital gains. Then the whole issue of the 18 percent, and holding for 5 years. You know about it, so I will not give you the background.

But our questions are directly related to, are the only people hit by this super-holding period the wealthy, the sophisticated investor, or are everyday, working Americans caught up in this complicated part of the Code?

Ms. WILSON. Yes, Mr. Chairman. Maybe we could both take a quick answer. Almost 50 percent of taxpayers, the American public, now owns stock. A decade ago, I think that was between 10 and 20 percent. More and more Americans are relying on stock and stock holdings for their retirement.

The complexity in the forms and the time taken is included in our testimony. I think the IRS estimate has gone up to, like, seven hours to fill out a Schedule D now, from a couple of hours 10 years ago.

We now have, I think, five different rates in the Code depending on the kind of asset you have. That is without considering the regime you just mentioned, the new 5-year holding period regime.

The problem with that, we are finding in practice, is that it takes effect today for new asset acquisitions. You are now eligible, if you hold it long enough, but it is also elective for your current holdings. That requires a whole lot of present value analysis and a lot of guesstimating about what the value of the stock is going to be in the future.

So, we think it has a broad effect on many, many taxpayers to complicate capital gains in this way, and we think it is better to unwind it sooner rather than later, frankly.

Mr. LIPTON. Mr. Chairman, if I may very quickly add to what Ms. Pecarich said. This is precisely the type of provision that illustrates the complexity problems in the Code. What you have is a perfectly well-meaning policy idea, which is to encourage lots of individuals to hold property for a period of time to get capital gains.

But by creating different rates and different holding periods, you have created a system that nobody understands. Because they do not understand it, it does not produce the type of benefit, the type of incentives you intend.

That is why a much simpler approach, a single capital gains approach across the board, will give people an incentive to acquire assets. Set whatever time of holding period you want, set whatever definition you want. Have it apply across the board. That would be a simple matter.

The CHAIRMAN. My questioning is over, so I am going to ask you to answer something in writing. But it is because your organizations recommend that we go back to the prior system of having a single, long-term holding period.

Then, Mr. Lipton, your organization suggests an alternative solution of excluding a portion of the taxpayer's long-term capital gains. Then the Joint Committee recommends that the current reduced rate system should be replaced by a partial deduction of the net capital gains.

So I would like to have you compare and contrast these respective suggestions and tell us what you would think would be the most easily understood by the taxpayers and the easiest for the IRS to administer.

Mr. LIPTON. We would be pleased to do so, Mr. Chairman.

[The information referred to can be found on page 56.]

The CHAIRMAN. Now, Senator Baucus.

Senator BAUCUS. Thank you, Mr. Chairman. Mr. Chairman, what concerns me is what I think concerns a lot of people. That is, we know this is a problem. It is a severe problem. But what is going to be done about it?

I mean, look at the room here. There are no TV cameras. The networks do not care at all. This is boring, simplification. There are virtually no members of the committee here. The room is half full, except for the illustrious Senator from Oklahoma.

There is just not a lot of press interest in this subject. Now, I did see an article here, I guess in the New York Times, which was helpful. But I must, embarrassedly, say to all of you that, in my State of Montana, one cannot obtain the New York Times. It is not

available. It is not there. Sometimes you can get the Sunday Times a day late, but other than that you cannot read the New York Times. It is not there.

So the question is, how do we generate momentum and support so that we know we are finally going to get something done here in addition to analyzing and addressing a lot of the problems and a lot of the solutions?

My thought, is that we might need a high-powered commission with deadlines, and that gets press attention, and forces the country to look at the data and the conclusions, one that addresses not only the usual procedural matters that Joint Tax looked at, but also policy matters.

And maybe charging the group not to come up with a whole new tax system, like a value added tax or something like that which gets pretty political pretty quickly, but rather taking the current system, and what do we do with it and, in a very significant way, really make it more simple, without a lot of changes. I mean, we will take changes, but without a lot of changes in the direction that the Code now goes, both individual and corporate.

What do you think? The basic question is, how do we get some momentum here if we want to do something? We could have this hearing here. We could have lots of hearings. But nothing is going to happen unless we make some changes to elevate this issue.

Mr. LIPTON. Mr. Baucus, if I may respond, at least in part, and obviously ask my colleagues here.

Senator BAUCUS. Yes.

Mr. LIPTON. I think that one of the problems with a commission, if I may be blunt about it, is it postpones reaching an answer on where, in some of the problems, the answer is completely clear. You heard from all four people on this panel, you heard from the Joint Committee. We have all identified the same biggest single problem.

Senator BAUCUS. AMT?

Mr. LIPTON. AMT. The answer is very simple: repeal the AMT. If that step is taken, you are going to solve the biggest issue of complexity in the Code. You do not need a commission to tell you that. Frankly, you are not going to need one for long, because the way the AMT is going to creep up into every taxpayer, not to mention that it already hits all of the corporations. There has been a lot of screaming about that for a while.

Senator BAUCUS. All right. I do not think there is much disagreement over that point. We will do all we can. I think I can speak for all of those who are not here and say that we will significantly address the AMT problem.

Someone had suggested to me, it gets pretty expensive if you totally repeal AMT. The numbers get up there pretty quickly. As you know, it is not contained in the President's budget.

Mr. LIPTON. We are certainly aware of that. The problem becomes compounded if you do not totally repeal the AMT. Take one of the examples we have heard floated around, which is to exempt individuals with AGI below a certain level from the AMT.

The trouble is, you are going to immediately create another class of phase-outs, another class of rules that will be complex for people

to try to determine. Most importantly, anyone who is anywhere else to that range is going to still have to run the double tax.

Senator BAUCUS. All right. Let us put AMT aside, because everyone agrees. We can do that without a commission, clearly.

What about the other complexities?

Ms. PECARICH. Senator Baucus, we pointed out in our testimony that there are a lot of parallels in our recommendations here among our groups, and with the Joint Committee's study.

So I guess what we're saying, is we think there is significant progress that can be made by this committee and this Congress now in these areas that we know need to be addressed.

Another item that was mentioned, was a uniform definition of child. There are things we can do. A commission might be useful if we were going to look at a dramatically different structure or an overhaul of the system to make it simpler. I guess we are, at this point, ready to settle for incremental simplification.

Senator BAUCUS. All right. So say we deal with the phase-outs, and the child credit, the EITC problems, and other miscellaneous things. Let us take AMT, the EITC, the PEPs and PEs. How much of the problem will that resolve?

Mr. LIPTON. For many taxpayers, other than on the corporate side—even there, the corporate AMT will solve a major problem—you will have done a lot of good, if you can just solve the three problems you just mentioned.

Senator BAUCUS. How much good? What does "a lot" mean?

Ms. HILL. I guess my reaction, Senator, to your comments about why people are not being more responsive, is frankly, they feel like, is there any chance the Congress will simplify things? They almost have a defeatist attitude.

Senator BAUCUS. Right.

Ms. HILL. I think if Congress were to announce, yes, we will take it seriously, tell us who is affected, I think you will start hearing from more people saying, yes, it affected me, too, and me, too. Over half of the people in this country have their returns prepared by preparers.

Certainly, our organization will be glad to give you more personal examples of people that can be directly benefitted by the examples that we have thrown out to you.

Senator BAUCUS. All right. I see my time is up.

Very briefly, how much of the complexity problem is solved with AMT, PEP, PEASE, and the EITC? Let me ask the other two.

Ms. PECARICH. A very significant proportion. I have a larger shopping list, but those would go along way.

Senator BAUCUS. Significant means 10 percent? Seventy percent? What?

Ms. HILL. The statistics in the Joint Committee's report listed the number of affected taxpayers by category. Because most of the people affected by AMT are not also affected by EIC, you could add these things together and you will see millions of taxpayers.

Senator BAUCUS. I know. That is why I am asking the question.

Mr. LIPTON. I would have been more bold about it. My reaction would be that you would be making a dramatic simplification if you just fixed family status, the phase-out points, and AMT. But most taxpayers, because it does cover the whole array, would say that

you have done something that affected them individually. If you put in the corporate AMT, the corporations will feel similarly.

Senator BAUCUS. All right. Again, I am trying to quantify it a little bit here.

Mr. LIPTON. Percentage-wise, if you add the numbers, if there are 100 million returns that are filed annually by individuals, you are going to be probably talking close to 50 percent of the returns by the time you get done.

Senator BAUCUS. Does anybody disagree with that statement?

Ms. PECARICH. No. We could calculate something and submit it for the record.

Senator BAUCUS. All right. That is helpful.

[The following information was subsequently received for the record:]

NUMBER OF TAXPAYERS AFFECTED BY AREAS IN NEED OF SIMPLIFICATION, AUGUST 2, 2001

Total Number of 1998 Individual and Corporate Income Tax Returns

In 1998, 124.72 million individual income tax returns were filed.

In 1998, 4.85 million corporate income tax returns were filed.

Taxpayers Affected by the Individual Alternative Minimum Tax

In 1998 4.48 million individual tax returns included Form 6251 for the computation of alternative minimum taxable income (AMTI). In 1998 an AMT liability of $5.0 billion was reported based on AMTI of $815.3 billion. The AMT amount for 1998 represents a 25.2 percent increase from the 1997 amounts. The size of AMT exemptions and the AMT income level have not been indexed for inflation, whereas the widths of regular income tax rate brackets and the sizes of personal exemptions have been inflation-adjusted. Thus, year-to-year inflation has caused more taxpayers to fall subject to the AMT. It should also be noted that AMTI, generally, is only shown on filed tax returns if the taxpayer's liability is affected by the alternative minimum tax (AMT). The number of individuals who must calculate AMT, but who are not ultimately affected by the tax, is not easily determinable.

Taxpayers Affected by the Corporate Alternative Minimum Tax

In 1998, 18,360 corporate income tax returns included an AMT liability. The number of corporate taxpayers who calculated AMT, but who where ultimately not affected by the tax, is not easily determinable.

Taxpayers Affected by the Earned Income Tax Credit

In 1998, 19.77 million individual income tax returns reported an earned income tax credit. The number of taxpayers who calculated the EITC but did not qualify is indeterminable. The number of taxpayers who would qualify for the credit, but did not perform the calculation because of the complexity involved, is also undeterminable. The calculation of the EITC has been one of the leading (if not the leading) cause of tax return errors for a number of years.

Taxpayers Affected by the Limitation on Itemized Deductions

In 1998, 4.85 million individual income tax returns reported itemized deductions in excess of the limitation. The number of taxpayers who calculated whether the limitation applied is indeterminable.

Taxpayers Affected by the Personal Exemption Phase-Out

At the time the above data was gathered, the AICPA was unable to obtain information on the number of taxpayers affected by the personal exemption phase-out (PEP). The experience of our members indicates that there would be significant overlap between taxpayers affected by PEP and those affected by the limitation of itemized deductions (detailed above).

SOURCES:

- Internal Revenue Service Statistics of Income Bulletin, Spring 2001, Volume 20, Number 4.

- Joint Committee on Taxation Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Volume I: Study of the Overall State of the Federal Tax System, April 2001.)

Senator BAUCUS. Mr. Chairman, thank you very much.

The CHAIRMAN. Thank you.

Now, Senator Nickles, then Senator Bingaman.

OPENING STATEMENT OF HON. DON NICKLES, A U.S. SENATOR FROM OKLAHOMA

Senator NICKLES. Mr. Chairman, thank you very much. I know we have some confirmations as well.

But I think this is a great hearing. Senator Baucus, I do not know why there are no cameras. But if people were as frustrated as I was in trying to do their income tax return recently, then realizing you have to go through the AMT calculations, realizing you have to go through the capital gains mess, long-term, short-term, when purchased, all this, it really gets complicated. I kind of pride myself in being able to do it.

The capital gains thing which was alluded to, not in your top list of three or four but I put it in there, is enormously complicated. If you happen to have mutual funds or something, it is really silly. I mean, this is a great country when your mutual fund can lose 30 percent and you have a heck of a capital gain, and you get to pay a lot of taxes for the privilege.

So I think we are on to some great things. I appreciate your cooperation on this, and Senator Grassley's.

A couple of comments. I do not think we can get all this done in this tax bill that we are going to be trying to do by the end of this month, or by the end of May. But let me say, I have a real interest in getting a lot of this done this Congress, as soon as possible. There is a lot of merit in simplification.

I mentioned capital gains. It is absolutely absurd, in my opinion, to have 18, 20, long-term, 6 months, 12 months, 5 years. I just think it is absurd. So, we ought to have a uniform rate.

Maybe I will come up with something and we will have a chance to do that this year. Hopefully, we will. But we will just have a flat, here is the capital gains rate. I think it would help immensely. Mr. Lipton, you suggested that. Hopefully, we can do that.

I think most of you mentioned repeal of AMT, corporate and individual. Some of you said individual, some of you said corporate and individual. But it is a mess.

Ms. Wilson, you mentioned foreign simplification. You also mentioned that there are some of us that are working on that. That desperately needs to be done, and it can be done, and should be done.

It is a real challenge and it is not easy. Just getting involved in that is a challenge by itself, but it certainly needs to be done. I think we are exporting jobs because of our complications.

So, I will just say, I might do a field hearing in Oklahoma. I find this very interesting, for some unknown reason. I think we have great potential, with this Congress and with this President, to get a lot of these things done. Again, I do not see all of this coming about in the next tax bill. Sometimes people want to cram everything in to one vehicle.

Senator Baucus mentioned that the President did not have AMT in his list, and all of us know we have challenges on AMT. So, we may not get everything in in this first bill. But it does not mean there will not be subsequent tax bills and some simplification measures that I think all of us could be jointly proud of. I think you all have made some excellent suggestions.

I was reading through some of the examples that were enclosed in some of your statements, and I thank you for those. Those are not going unnoticed. I think they will be helpful for us when we are putting together some of our proposals.

So, I just want to say thank you to our panelists for your contributions to this effort this morning.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Bingaman?

Senator BINGAMAN. Thank you very much, Mr. Chairman. I thank all of the witnesses.

One question I would have as to some of these items. I think there are sort of two questions that come up on each of these proposals. One, is how much revenue will we forego by making the so-called simplification change that is being recommended? Second, how much change will we make in the allocation of the tax burden or the progressive nature of the Tax Code?

Now, taking phase-outs, as an example. Do we know what the loss of revenue is from eliminating these phase-outs in the various places where they occur in the Code here? I mean, essentially what we are saying is there are exclusions, exemptions, deductions, and credits which should be available to everybody, regardless of what their income is. That is what we mean by eliminating a phase-out. That is going to cost the Treasury some money. Do we know how much?

Ms. PECARICH. Senator, no, we do not have an estimate in our testimony. Our recommendations are consistent with what the Joint Committee on Taxation has in their report, and perhaps they have a better idea of what some of those would cost.

I will point out that, in our testimony, we recommend, if you cannot get rid of the phase-outs, that you standardize them by income class so that we have consistency in the various provisions that are supposed to affect low, middle, and upper income taxpayers.

You can set those numbers wherever you need to, but having some consistency is a step towards simplification if you cannot get rid of them. I will note, and I think it was prior to your availability today, that Ms. Paull pointed out that you can take care of the progressivity that you are going to lose when you get rid of phase-outs by adjusting the rates.

That is the way it should be done. That is why we would argue, and hope, that you would do simplification first, then adjust the rates however you decide that you want to, and however you can afford.

Senator BINGAMAN. So you think that, in fact, we have got the cart before the horse here, in that we are rushing forward to adjust rates, and talking about doing simplification later on. We should be doing it the other way around.

Ms. PECARICH. Yes, sir. These provisions do affect marginal rates, so it is not either/or. You can really get to where you need to be, we think, with a simpler and progressive system.

Senator BINGAMAN. Do any of the rest of you have a comment on that? Mr. Lipton?

Mr. LIPTON. I would have just, of course, added to, and support, what Ms. Pecarich said. Our focus was on the PEP and PEASE limitations.

The ABA's position has long been that those are nothing other than a hidden rate. The way to deal with them is to get rid of the limitations, get rid of the phase-outs, which is what they are, and simply adjust the rates to whatever Congress, which makes policy decisions, determines those rates should be.

Senator BINGAMAN. All right. I guess, on the issue of the Alternative Minimum Tax, we have agreed that we do not know what it is going to cost to do what you are recommending, repeal of the Alternative Minimum Tax.

Ms. PECARICH. Ms. Paull reported this morning, $210 billion over 10 years.

Senator BINGAMAN. Is that consistent with what the rest of you think?

Mr. LIPTON. We certainly do not question her estimates.

Senator BINGAMAN. That is more than a simplification when it is costing $210 billion over a 10-year period. Obviously, that is a major policy decision. But you are saying that that $210 billion could be recaptured by essentially increasing rates.

Now, there have not been a lot of members of Congress who have been talking about increasing rates in this current environment. But you are saying that is what we should be doing in order to be able to repeal the Alternative Minimum Tax and have it be a revenue-neutral proposal. Is that what I am understanding?

Mr. LIPTON. I want to emphasize, we do not want to tell the members of Congress what we think rates should be, or should be set at. That is purely a policy point. But I cannot emphasize strongly enough that the AMT, on the compliance burden side, is the single biggest problem.

When Chairman Grassley pointed out how basically there is an extra tax imposed on every American, computing whether or not you are, as an individual, subject to the AMT, running the AMT numbers for all corporations is a major cost you are currently imposing on everyone.

That $210 billion, which is a lot of money over 10 years, the compliance costs you are imposing, I do not know what the precise number is. Again, I would defer to the Joint Committee. But it is a large percentage of that. It is, really, you are taking from one pocket and putting it in another.

Ms. PECARICH. And with increasing numbers of taxpayers affected by AMT, all of those affected taxpayers are paying a higher rate. They just do not know it until they do the calculation on the tax software that they have to have to figure out if it affects them.

Senator BINGAMAN. Yes. Ms. Hill?

Ms. HILL. I wanted to make one additional comment. It is something that grows out of the phase-outs. That is, taxpayers feel de-

ceived when Congress tells them that they are going to get a specific benefit, and find out later they are not.

The problem with enacting reductions this current year that are targeted to lower and middle income families, is that unless you enact a major change to AMT, these people will not see the benefit. When those changes reduce regular tax below AMT, they lose the benefit. They do not get it.

Senator BINGAMAN. My time is up.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Baucus would like to have another turn.

Senator BAUCUS. Mr. Lipton, could you comment on the complexity, or lack of complexity, on the two various alternatives with Federal estate tax? As you know, one is essentially repealed in 10 years, then with a carry-over basis, a non-stepped-up basis. There are various versions of that. Senator Kyl has a hybrid of that.

Another alternative, is to significantly increase the unified credit and maybe lower some rates. But if we are going to enact a change in the Federal estate tax, and my guess is we are, we should probably do it in a way that makes good sense from a policy perspective, but also not add more complexity.

Mr. LIPTON. Mr. Baucus, I am certainly happy to answer your question. I should start, though, by pointing out that the Section of Taxation has no position with respect to transfer tax repeal. We purposely did not appear at the hearings that addressed that because we do not have a formal position on it.

Senator BAUCUS. Your personal view.

Mr. LIPTON. Since I am here as chair of the section, I am not going to state any personal view. The section simply does not have a position.

But I do want to comment, at least briefly, on simplification, which is the question that you asked.

Senator BAUCUS. Sure. Right.

Mr. LIPTON. On the simplification standpoint, whichever way you go, there is a major simplification problem. If you repeal the estate taxes, simplification needs to be addressed int terms of how you deal with basis, the integration of the estate tax system which serves as a backup to the income tax system. You have to address that problem. I think that has been well pointed out in some of the reports and the commentary that has been submitted.

If you do not repeal the system and what you do is increase exclusions, there are still a number of problems that are covered. Those were in our written testimony that we submitted in connection with this hearing.

Those included dealing with the valuation discounts, present interest rules, the Section 6166 rules, which may not make a lot of sense depending on where you set things. So there are a lot of other simplification issues.

Obviously, any time you completely change the system, you may have more things to address. But, on the other hand, there may be ways to deal with that. We would be pleased to work with the committee in that regard.

Senator BAUCUS. The law of unintended consequences is sometimes very powerful.

Ms. Wilson, on international taxation, could you just indicate to us, just briefly, what the biggest problem is, as you see it? I guess, from a competitiveness point of view, to what degree does our current corporate tax system and foreign provisions impede American competitiveness?

Ms. WILSON. I think there are a number of areas that do impede American competitiveness. I think we talked about the Subpart F rules in our submission, and I think those are very important.

Those have been distended at this point to take in active income that I do not think was ever intended to be pulled into taxation, active business income. Certainly there are other areas in the interest allocation rules which are extremely cumbersome and difficult to deal with that make us noncompetitive.

We would certainly be willing to provide some additional input to you in writing if there are other specific things you would like us to deal with in the foreign area, and would be happy to do that.

Senator BAUCUS. If you would, please. While we have the opportunity, we might as well take advantage of it.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

This will end this hearing. I thank you all very much, not only for what you have done to prepare for this, but the extent to which you cooperated with the study committee, and more importantly, the extent to which I anticipate you would respond to our requests if we have some ideas that will end up in legislation.

Thank you all very much.

[Whereupon, at 11:50 a.m., the hearing was concluded.]

APPENDIX

Additional Material Submitted for the Record

Prepared Statement of Claudia Hill

I am honored Mr. Chairman to testify about complexity of the Internal Revenue Code on behalf of the National Association of Enrolled Agents (NAEA). There are approximately 35,000 Enrolled Agents, more than 10,000 of whom are members of our organization. Enrolled Agents represent over 5 million taxpayers and small businesses at all administrative levels of the IRS. Typically, our members provide their clients tax preparation, planning and other financial services. In order to be enrolled before the Department of Treasury, a practitioner must pass a detailed exam covering the administrative procedures and practical tax laws affecting real people and small businesses, or have significant experience working at the IRS. In addition to demonstrating ongoing competency each year through continuing education requirements, our members must undergo a thorough background check and abide by a strong code of conduct. Our members are proud to be the federal tax code specialists.

WHY IS SIMPLIFYING THE TAX CODE IMPORTANT?

Each year, in order to assist Enrolled Agents and to help the Internal Revenue better administer our nation's tax laws, we survey our members on problems with the filing season. While our near term objective is to facilitate the quick resolution of filing and return processing problems, the overwhelming response from tax practitioners has been more fundamental: Complexity of the tax laws is the number one problem for taxpayers and their return preparers. In addition to making filing season less burdensome, finding solutions to this problem would provide relief in a number of ways.

First, complexity costs taxpayers money. According to the National Taxpayer Advocate's Report to Congress, complexity is the most serious and burdensome problem facing American taxpayers. While practitioner cost is one of the most obvious examples, there are the added costs of record keeping and compiling data, effort to learn and comply with the laws, and the consequences when one does not. Needless complexity adds hours to the cost of compliance, not to mention taking taxpayers away from more productive activities.

Second, complexity costs the government money and affects the level of taxpayer confidence in the system. Complexity adds significantly to the cost of administration. From drafting of the forms, to employee training, taxpayer education, returns processing, audit and collection, complexity of the tax laws adds layer after layer of cost for the agency. On a related theme, Congress constantly changing the law is one of the greatest sources of complexity both for the taxpayer and the tax collector. This creates an atmosphere of instability for taxpayers and suggests the tax laws have become so complex as to be unmanageable. Combine this concern with declining audit rates and the incentive to voluntarily comply with the tax laws is compromised.

Finally, complexity costs the economy. Overly complex tax laws divert precious time and resources away from more productive activities. While a number of respected academicians have attempted to place an exact cost on the economy for tax compliance, what percentage of that figure simplifying the code can mitigate is something I will leave to the economists to argue. What is important is to understand, however, that even if the figure representing direct and indirect costs for complexity were as small as 10 percent of the total compliance expense, the cost savings to the economy for just that small fraction would be huge.

APPLICATION OF CRITERIA FOR SIMPLIFICATION

We would suggest a special public/private commission focused on finding which sections of the Code could be eliminated or simplified with minimal net cost to the Treasury. Further, the NAEA supports an annual process whereby Congress does a section-by-section review of the Code, beginning with the highest priority sections identified according to complexity-identifying criteria. Then, within the budget constraints of that fiscal year reform, Congress could focus on the top 5 to 10 most egregious sections of the Code. While the following criteria are often subjective, they would provide a framework for Congress to review simplification and form a consensus for reform.

1. Does the current section affect a significant population of taxpayers?
2. Does complexity add significant time and cost to the system?
3. What is the level of sophistication of taxpayers being forced to deal with the requirements of the law and does the law often catch people unaware of the requirements?
4. Could complexity be avoided without significant policy ramification?
5. Could complexity be mitigated without causing the federal budget significant revenue impact?

THE NATIONAL ASSOCIATION OF ENROLLED AGENT'S TOP SELECTIONS FOR REFORM

While there are many aspects of the tax laws that create complexity, we have chosen today to focus on four areas that our member rank as ones that would affect the most individual taxpayers.

INDIVIDUAL ALTERNATIVE MINIMUM TAX

Each year, we ask our members to choose the most complex item in the Internal Revenue Code. We have dubbed their selection "The Tax Headache of the Year." For the second time in two years, the overwhelming response has been the same—the individual alternative minimum tax. Why is the AMT now The Tax Headache of the Year? Our members tell us of increasing numbers of their clients who were blindsided by falling into this insidious alternative tax system.

By the year 2010, over 17 million taxpayers will be subject to the AMT and taxpayers with an adjusted gross income of less than $100,000 will owe 60 percent of the taxes paid under the AMT. Many of these taxpayers will not even be aware of the requirements of the AMT until they receive a notice from the IRS.

Here are a few examples:

One of our Enrolled Agents in Youngstown, Ohio wrote to us to say how deeply troubled she was to see an elderly client "clobbered by the AMT." The taxpayer was caring for his wife with Alzheimer's, and had to withdraw extra pension money to pay medical bills. The AMT calculation required him to add-back into AMT a portion of his otherwise deductible medical bills and his state income and property taxes. This caused the AMT to exceed the regular tax. He didn't think it was a good alternative!

In my state of California, I find that many middle-income taxpayers fall unwittingly into the AMT because of the high cost of property taxes on their homes and equally high state income taxes. When these taxpayers also happen to be employees who incur ordinary and necessary business expenses and whose employers either do not reimburse expenses or do not use "accountable plans," they are injured even more, since those miscellaneous deductions are also added back to the AMT base. None of these normally allowable deductions are permitted against AMT.

Our members are reporting that farm families are being hit with the AMT. Congress saw a need to provide farmers a special income averaging method a few years ago. Unfortunately, when that method lowers the regular tax below AMT, the taxpayer loses the benefits, and must pay the higher AMT.

U.S. taxpayers living outside our country are provided in the law a means to avoid double taxation through the use of foreign tax credits (FTC). Once again, AMT undermines the intent of fairness Congress intended with the credit system, by allowing the AMT FTC to offset no more than 90% of the AMT while the regular tax can be completely offset. The taxpayer is injured once again.

Although Congress may be considering an extension allowing use of non-refundable child and education related credits against AMT, general business credit still cannot be used against the AMT. As an example, for taxpayers who are affected, the benefits of the low-income housing credit are not allowed against the AMT—a Code provision that is essential for providing affordable houses in high-cost states.

With increasing emphasis on equity-based compensation, the use of employee stock options as part of a worker's compensation package has become mainstream.

Nearly 30 percent of those surveyed as part of the 35th Index of Investor Optimism reported that they or their spouse had received options at some point in their career. Of this group, 43 percent said options were part of their 2000 compensation and comprised approximately 11 percent of their total income last year. However, during this past year a hidden danger of employee stock options became apparent. When employees exercises their right to acquire incentive stock options at a price below the fair market value of the shares on the date of exercise, the "virtual income" (difference in values) is included in the AMT base but not in the regular tax base. The date of exercise value sets the preference—regardless of what eventually happens with the value of the shares if they are not disposed of in the same calendar year as exercised. If employees choose to hold the stock for the one year period prescribed in the law to obtain capital gains treatment of the income, they may find themselves expected to pay taxes on income they never really receive.

There have been many accounts in the media recently of taxpayers who have been injured by this "preference" because of dramatic volatility in the stock market this past year. We have heard from taxpayers and their advisors with egregious examples of phantom income far exceeding any economic benefit the taxpayers will ever receive, being taxed due to the provisions of the Alternative Minimum Tax (specifically IRC 55 and 56 and Regs. Sections 1.421 and 1.422). A taxpayer from San Luis Obiso, CA wrote,

> "Ideally, "ISOs work for both employer and employee. It gives the employee an incentive to stay with the company and it gives the company ways to reward the employee without increasing salary costs...I exercised the stock options not realizing that the price of the stock on the day I exercise will be used to figure out my income WHETHER I ACTUALLY SELL THE STOCK OR NOT. Now that the value of our stock has been depressed over 60%, I am being taxed on income that was never realized and have what is call a PHANTOM INCOME. This made my effective tax rate to be 290%!"

This certainly was not what Congress intended.

Further, the complexity of the AMT is not limited to taxpayers with unique tax situations. The AMT cannot always be calculated directly from information on the tax return. This makes the calculations extremely difficult for taxpayers who would prepare their own returns, and calls into question the ability of IRS to track compliance.

Recommendations:

The NAEA recommends the repeal of the individual AMT. If total repeal is not fiscally possible, the individual AMT must be extensively modified. Congress should consider removing the "non-preference" items from the provisions not deductible under the AMT: the standard deduction, personal exemptions, state and local taxes and miscellaneous itemized deductions. The rate brackets and exemption amounts were never indexed, as are regular tax rates and exemption amounts. If AMT is not eliminated, the rate brackets and exemption amounts must be brought current for the years of adjustments that have been overlooked. The creeping intrusion of the alternative minimum tax, undermining programs to benefit lower and middle-income taxpayers, must be stopped.

Three other aspects of the law scored very high on the complexity barometer with our members: the Earned Income Credit, the myriad variety of phase-out calculations, and the tax penalties.

Earned Income Tax Credit

Each year the IRS lists the top errors in filed returns. Earned Income Credit issues make up almost half the list. It is easy to see why. While the rules governing eligibility, calculating income, and establishing dependent status are some of the most complicated in the Internal Revenue Code, the target group for the credit is by and large the most unsophisticated set of taxpayers in the economy. When these taxpayers are brave enough to venture forward into this unforgiving territory, they can be comforted knowing that Congress has provided hundreds of millions of dollars to the IRS over the last few budgets cycles to find them and ensure that they are in full compliance with the unfathomable rules.

For the majority of these taxpayers the outcome of all of this complexity is a growing dependency on unlicensed, unregulated return preparers. Our members express dismay at the number of taxpayers who come to them asking for their assistance either because they find the forms and worksheets incomprehensible or because having heard enough about the program they would like assistance in "working the system" to obtain benefits to which they are not entitled. Is spite of due diligence standards Congress put into place two years ago, there are still those preparers who are only too glad to assist in obtaining benefits to which taxpayers are not entitled.

Our members do not participate in such activities. They are held to strict codes of professional conduct, from our own organization and from the IRS. Return standards, registration with IRS and continuing education are not required for the vast majority of paid-preparers in this country.

The statistics on error rates with the administration of this program are an embarrassment to the IRS, paid preparers and the entire tax system. Such error rates, including the failure of eligible taxpayers to claim the EIC, should convince us the program is deeply flawed. The program is a nightmare of eligibility tests, worksheets, and an income phase-out limitation based on filing status such that being low-income and single is much more beneficial than low-income and married.

Under current law, taxpayers are forced to face a variety of different tests to qualify for various child benefits such as dependency, head of household status, EIC benefits, dependent care benefits and the child credit. There is such inconsistency among the criteria for each category of benefit and variations in the definitions of common terms, no wonder it is difficult to comply. Each has its own set of rules and definitions that few tax preparers, much less typical taxpayers, understand.

Simplication in this area is absolutely essential. It will serve the needed objectives of making the program administrable, reduce unintended as well as intentional noncompliance, and actually get the benefits into the hands of those whom Congress intended.

Recommendations:

The NAEA urges Congress to make simplifying EIC one of its top priorities by appointing a task force to focus specifically on making this program work. With the combined efforts of such groups as those supporting this session today as well as major return preparation firms and the American Tax Policy Institute, we could see major results in the efficiency and functionality of this program. Finally, we urge you to consider registration of all commercial tax preparers. This would level the playing field so that return preparers who submit paper returns are held to the same standards as Electronic Return Originators and as Circular 230 practitioners—Enrolled Agents, CPAs and attorneys.

Phase-outs

There are over twenty commonly encountered aspects of individual returns that require phase-out calculations. To mention a few: limits for deductible IRA contributions, earned income credit, limitations on the use of education credits, child credits, elderly credits, student loan interest, personal exemptions, itemized deductions, social security taxability, passive activity losses and credits and the AMT exemption amount. When taxpayers are told Congress has provided incentives or rate reductions for their benefit, and realize when they actually file their returns that they don't "qualify" for the benefits, they feel deceived.

Lack of consistency in the methodology and income ranges applicable to the various provisions containing phase-out calculations creates incredible complexity. Some are based on a total measure of income while some are based on filing status. The method to determine how the phase-out is calculated varies from calculation to calculation.

Since many of the phase-out provisions are related to filing status, the presence of such calculations exacerbate the "marriage penalty." Much relief in the area of marriage penalty reduction would be achieved by eliminating phase-out calculations.

Recommendations:

Phase out calculations provide needless complexity and undermine consistency in the way tax rules are applied. Congress should eliminate them. In the event elimination would be too costly, the variety and number of phase-outs should be reduced, and a standardized schedule for phasing out tax benefits should be considered. This schedule should provide phase-out ranges for both low and middle-income taxpayers and should be marriage neutral.

Penalties and Interest

Congress and the Executive branch, in consultation with all the practitioner groups, have undertaken an extensive review of the Internal Revenue Code rules governing penalties and interest. Congress should move this year to enact the most important of these recommendations. Taxpayers of all income groups are continuously confused and frustrated by the complexity and unfairness of the penalty and interest rules under the Code. Too often, the primary consideration for the establishment of penalties has been to raise revenues, in direct conflict wit the stated objective of penalties as a means to affect compliance. Historically Congress has not placed focus on coordination between penalties and interest payments and on applying the resulting rules fairly and simply.

Although there are many penalty issues deserving of Congressional attention, we will mention only one: penalties for the underpayment of estimated taxes are the most frequently cited compliant by individual taxpayers. In the past six years, avoiding the penalty has become a moving target for taxpayers with AGI over $150,000. Taxpayers with lesser incomes are given a "safe harbor" equivalent to 100% of the prior year's tax. Taxpayers whose income is higher have had to work within the following constraints:

Safe Harbor Percentages—AGI over $150,000

AGI over $150,000 in Current Tax Year	Percentage of Prior Year
1996–1997	110
1997–1998	100
1998–1999	105
1999–2000	108.6
2000–2001	110
2001–2002	112
2002–2003	110

The taxpayers most likely to deal with these frustrations are small businesses and retirees, many of whom especially resent the government assessing them a penalty retroactively because they could not accurately predict their income! For many, it increases their cost to comply with the law because they pay additional tax services to redetermine their liability over the course of the year.

Recommendations:

At the very least, simplify the underpayment of estimated tax penalty rules by restoring them to 100% of prior year tax for all taxpayers, and change the name of the penalty to "interest on underpayment of estimated taxes." Proceed with identification and enactment of the most important of the penalty reform recommendations that have come from your recent joint studies.

Finally, NAEA wishes to acknowledge IRS efforts to administratively assist taxpayers through simplification of rulings or regulations. Examples include changes that permit many small businesses to use the cash rather than the accrual method of accounting and the simplification of the Required Minimum Distribution rules for over 70.5 year-old taxpayers. We also appreciate IRS efforts to simplify the compliance burden of small businesses with the recently released "Small Business and Self Employed Community" Web site.

Conclusion

I appreciate the Committee giving the National Association of Enrolled Agents the opportunity to talk about tax code complexity and new hope for fresh solutions today. Our members are dedicated to supporting our system of tax and the American taxpayer. We know complexity undermines compliance and look forward to constructively contributing to the debate on tax simplification. Thank you.

Prepared Statement of Richard M. Lipton

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 multinational 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 en-

acted, 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 record-keeping 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 701/2. Section 401(k) states that plan benefits may not be distributed before certain stated events occur, including attainment of age 591/2. Further, section 72(t) provides that premature distributions from a qualified retirement plan, including most in-service distributions occurring before an employee attains age 591/2, 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 undermine 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 20002, 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.

* * *

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.

(APPENDIX I)

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February 25, 2000

The Honorable William V. Roth, Jr.
Committee on Finance
United States Senate
104 Hart Senate Office Building
Washington, DC 20510

Dear Senator Roth:

The ABA Section of Taxation strongly believes that major simplification of the tax laws should be viewed as an urgent and continuing priority on the part of the Congress. In collaboration with our professional colleagues in the American Institute of Certified Public Accountants Tax Division and the Tax Executives Institute, we have identified in the enclosed statement several areas in which simplifying legislative initiatives would be especially welcomed. This is not the first time we have joined with the AICPA and TEI to address tax simplification. In December of last year, we wrote to you to emphasize the importance of simplification as a critical component of an effective federal tax system. In those letters, we advised you of the joint effort the ABA Section of Taxation, AICPA, and TEI were undertaking. The enclosed statement reflects the first fruits of that effort. These Recommendations are presented on behalf of the ABA Section of Taxation. They have 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 policies of the Association.

Concern about the critical need for simplification is not limited to tax professionals. In his most recent report to the Congress, the National Taxpayer Advocate confirms that complexity of the tax law "continues to be the most serious and burdensome problem facing America's taxpayers." His concerns were echoed by others at the Senate Finance Committee's IRS Oversight Hearing on February 2, 2000. The heavy burden of complexity affects the entire spectrum of taxpayers, from low-income individuals to multi-billion dollar corporations. It also impedes greatly the continuing efforts of the Internal Revenue Service to better administer and enforce the nation's tax laws.

Complexity is manifested by Internal Revenue Code provisions which contain either vague or highly technical requirements, often riddled with exceptions, limitations, and other special rules that even the most sophisticated of tax advisers can find difficult, if not impossible, to decipher. Added to that is the fact that many provisions, complex on their own, often must be applied in tandem with other complex provisions. Even if a complex provision, standing alone, works appropriately, when coupled with another complex provision the result may be simply horrendous. Constant changes and amendments to the tax laws, along with accompanying effective date and transition rules, also breed complexity, as well as uncertainty, confusion, and frustration throughout the taxpayer population. The constant changes, moreover, spawn a steady stream of new and often voluminous Treasury regulations, which require an enormous expenditure of time on the part of IRS National Office and Treasury Department personnel, and, unfortunately, sometimes exacerbate rather than ease the complexity of the underlying statutory provision. Short term extensions of popular provisions or relief from unpopular provisions cause administrative difficulties for the Internal Revenue Service and make it impossible for taxpayers to plan with any degree of certainty.

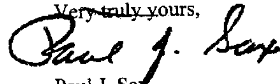
In joining our professional colleagues in this simplification effort, we encourage Congress to change fundamentally the way it considers tax legislation and tax simplification. Addressing the IRS Modernization Conference last month, Treasury Secretary Lawrence Summers observed, "Policy design is almost meaningless without policy implementation." We agree wholeheartedly with his statement. We recognize that most complex provisions of the Internal Revenue Code have had behind them laudable goals. In many cases, however, it is our considered judgment that the burdens the complex provisions impose on taxpayers and the Internal Revenue Service quite simply outweigh the benefits of attaining those goals. We also note that many times goals are superseded by changes in society or the economy or by other changes in the law so that complex provisions no longer serve their intended purpose, yet the provision remains in the law.

The enclosed statement sets forth recommendations for reform of provisions ranging from the earned income credit to the alternative minimum tax to the worker classification rules, all of which affect a significant number of taxpayers. We do not purport by any means to have compiled an exhaustive list of all areas in need of simplification. Indeed, this is no more than the tip of the iceberg. Nor do we intend to suggest any particular order of priority among the various recommendations made. We do

believe, however, that implementation of simplification measures in the areas identified would significantly reduce complexity for large numbers of both individual and business taxpayers, and have the concomitant effect of making the tax laws far more administrable.

In conclusion, we respectfully urge the Congress to seize on a bipartisan basis every possible opportunity for developing and enacting simplification measures along the lines of the enclosed recommendations. We will continue our efforts with the AICPA and TEI to develop additional simplification recommendations and to refine the enclosed recommendations. Needless to say, the ABA Section of Taxation stands ready to provide whatever assistance and support you may find helpful in the critical task of simplifying the tax laws.

Very truly yours,



Paul J. Sax
Chair,
ABA Section of Taxation

Enclosure

cc: Members, Senate Committee on Finance

August 10, 2001

Mr. John Angell	Mr. Kolan Davis
Majority Staff Director	Republican Staff Director/Chief Counsel
Senate Finance Committee	Senate Finance Committee
United States Senate	United States Senate
219 Dirksen Office Building	219 Dirksen Office Building
Washington, DC 20510	Washington, DC 20510

Re: Tax Code Complexity Hearing

Dear Messrs. Angell and Davis:

This letter is sent in response to a request from Senator Grassley that I submit additional information discussing my recommendations for reducing complexity in calculating taxes on capital gain income.

The capital gain regime applicable to individuals is excessively complex. Seventeen different rates of tax may apply to capital gain income.[1] Individuals with net capital gain compute their tax liability by completing a 36-line tax computation on Schedule D of Form 1040. For taxable years beginning after 2000, additional lines will be needed to take into account five-year gains.

In our testimony, we noted that the taxation of capital gain would be simplified by establishing a single preferential rate and a single long-term holding period for all types of capital assets. Alternatively, in order to assure that the benefit is extended to all taxpayers regardless of their tax bracket, the special capital gain rate might be replaced by an exclusion for a specified percentage of long-term capital gain.

The Joint Committee on Taxation recommended in its simplification study that the current rate system for capital gain be replaced with a deduction for a fixed percentage of net capital gain.[2] The recommendation would reinstate a deduction

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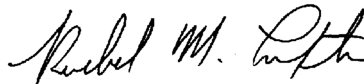
[1] Joint Committee on Taxation, Study of the Overall State of the Federal Tax System and Recommendations for Simplification, pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986, JCS-3-01, Volume II, p. 102, April 2001.

[2] Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. I.R.C. § 1211(b).

similar to the capital gain deduction in effect prior to the Tax Reform Act of 1986, and is substantively equivalent to the exclusion we recommended in our testimony.[3]

The enactment of any of these recommendations would be a significant step in reducing complexity for individual taxpayers.

Very truly yours,



Richard M. Lipton
Chair, Section of Taxation

cc: Senator Charles Grassley

[3] Joint Committee on Taxation, Study of the Overall State of the Federal Tax System and Recommendations for Simplification, pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986, JCS-3-01, Volume II, p. 106, April 2001. The recommendation would not change the exclusions for small business stock, D.C. Enterprise Zone stock, or Renewal Community stock.

PREPARED STATEMENT OF LINDY L. PAULL

Mr. Chairman and Members of the Committee, as Chief of Staff of the Joint Committee on Taxation, it is my pleasure to present the written testimony of the staff

of the Joint Committee on Taxation (the "Joint Committee staff") at this hearing concerning simplification of the Federal tax system.

A. OVERVIEW

Under the Internal Revenue Code, the Joint Committee is required to report, at least once each Congress, to the Senate Committee on Finance and the House Committee on Ways and Means on the overall state of the Federal tax system.[1] This study is required to include recommendations with respect to possible simplification proposals and such other matters relating to the administration of the Federal tax system as the Joint Committee may deem advisable. The Joint Committee staff has just completed work on this study and I am pleased to have this opportunity to present the Joint Committee staff findings to you.

In the course of this study, the Joint Committee staff:

(1) Undertook an extensive review of prior simplification proposals, including review of legal and economic literature making simplification and other legislative recommendations during the past 10 years; prior published and unpublished work of the Joint Committee staff with respect to simplification; various published Treasury studies; materials published by the National Taxpayer Advocate and the Commissioner of Internal Revenue, including the Tax Complexity Study issued by the Commissioner on June 5, 2000; and published simplification recommendations of various professional organizations, including the American Bar Association, the American Institute of Certified Public Accountants, and the Tax Executives Institute;

(2) Assembled two groups of advisors (approximately 40 academic advisors and approximately 25 individuals who previously held senior-level tax policy positions in the Federal government) to assist in the analysis of various simplification proposals and to solicit simplification ideas that may not have been previously advanced;

(3) Conducted a full-day meeting with representatives of the Internal Revenue Service ("IRS") to solicit comments and suggestions on specific issues under the Federal tax system and a separate meeting with the IRS and the Director of the American University Washington College of Law Tax Clinic on issues relating to the present-law earned income credit;

(4) Requested that the General Accounting Office provide information that would assist in measuring the effects of complexity on taxpayers, including the size of the Code, the number of forms, instructions, and publications, and taxpayer errors and requests for assistance to the IRS; and

(5) Requested the Congressional Research Service to provide information regarding legislative and regulatory activity relating to the Federal tax system and information on the efforts of foreign countries to simplify their tax laws.

The Joint Committee staff (1) collected background information on the Federal tax system, (2) identified the sources and effects of complexity in the present-law tax system, (3) identified provisions adding complexity to the present-law tax system, and (4) developed simplification recommendations.

B. BACKGROUND INFORMATION ON THE FEDERAL TAX SYSTEM

The Joint Committee staff collected background information on the sources of complexity in the Federal tax law and data concerning the filing of tax forms, taxpayer assistance, and information on error rates and tax controversies. Some of the information collected by the Joint Committee staff (with the assistance of the General Accounting Office) included the following:

(1) Over 100 million individual income tax returns are filed annually on behalf of roughly 90 percent of the U.S. population;

(2) The Internal Revenue Code consists of approximately 1,395,000 words;

(3) There are 693 sections of the Internal Revenue Code that are applicable to individual taxpayers, 1,501 sections applicable to businesses, and 445 sections applicable to tax-exempt organizations, employee plans, and governments;

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[1] Internal Revenue Code ("Code") sec. 8022(3)(B). This provision was added by section 4002(a) of the Internal Revenue Service Restructuring and Reform Act of 1998 (Pub. L. No. 105–206). The requirement for a study stemmed from recommendations of the National Commission on Restructuring the Internal Revenue Service in 1997. Report of the Commission on Restructuring the Internal Revenue Service: *A Vision for a New IRS: Report of the National Commission on Restructuring the Internal Revenue Service*, June 27, 1997. Preparation of the Joint Committee study is subject to specific appropriations by the Congress. For fiscal year 2000, the staff of the Joint Committee on Taxation ("Joint Committee staff") advised the House and Senate Committees on Appropriations that an appropriation of $200,000 would be required for the Joint Committee staff to undertake the study and amounts were appropriated for this purpose.

(4) As of June 2000, the Treasury Department had issued almost 20,000 pages of regulations containing over 8 million words;

(5) During 2000, the IRS published guidance for taxpayers in the form of 58 revenue rulings, 49 revenue procedures, 64 notices, 100 announcements, at least 2,400 private letter rulings and technical advice memoranda, 10 actions on decision, and 240 field service advice;

(6) For 1999, publications of the IRS included 649 forms, schedules, and separate instructions totaling more than 16,000 lines, 159 worksheets contained in IRS instructions to forms, and approximately 340 publications totaling more than 13,000 pages;

(7) A taxpayer filing an individual income tax return could be faced with a return (Form 1040) with 79 lines, 144 pages of instructions, 11 schedules totaling 443 lines (including instructions), 19 separate worksheets embedded in the instructions, and the possibility of filing numerous other forms (IRS Publication 17, Your Federal Income Tax (273 pages), lists 18 commonly used forms other than Form 1040 and its schedules);

(8) In 1997, of the more than 122 million individual income tax returns filed, nearly 69 million were filed on Form 1040, as opposed to Form 1040A, Form 1040EZ, or Form 1040PC;

(9) In 1999, taxpayers contacted the IRS for assistance approximately 117 million times, up from 105 million contacts in 1996; and

(10) The use of paid return preparers increased from 48 percent of returns filed in 1990 to 55 percent of returns filed in 1999 (a 27 percent increase) and the use of computer software for return preparation increased from 16 percent of returns filed in 1990 to 46 percent of returns filed in 1999 (a 188 percent increase).

C. SOURCES OF COMPLEXITY IN THE PRESENT-LAW FEDERAL TAX SYSTEM

In the course of its study, the Joint Committee staff identified various sources of complexity in the present-law Federal tax system. No single source of complexity can be identified that is primarily responsible for the state of the present-law system. Rather, the Joint Committee staff found that, for any complex provision, a number of different sources of complexity might be identified.

Among these sources of complexity the Joint Committee staff identified are: (1) a lack of clarity and readability of the law; (2) the use of the Federal tax system to advance social and economic policies; (3) increased complexity in the economy; and (4) the interaction of Federal tax laws with State laws, other Federal laws and standards (such as Federal securities laws, Federal labor laws and generally accepted accounting principles), the laws of foreign countries, and tax treaties. The lack of clarity and readability of the law results from (1) statutory language that is, in some cases, overly technical and, in other cases, overly vague; (2) too much or too little guidance with respect to certain issues; (3) the use of temporary provisions; (4) frequent changes in the law; (5) broad grants of regulatory authority; (6) judicial interpretation of statutory and regulatory language; and (7) the effects of the Congressional budget process.

D. EFFECTS OF COMPLEXITY ON THE FEDERAL TAX SYSTEM

There are a number of ways in which complexity can affect the Federal tax system. Among the more commonly recognized effects are (1) decreased levels of voluntary compliance; (2) increased costs for taxpayers; (3) reduced perceptions of fairness in the Federal tax system; and (4) increased difficulties in the administration of tax laws. Although there is general agreement among experts that complexity has these adverse effects, there is no consensus on the most appropriate method of measuring the effects of complexity. The Joint Committee staff explored certain information that may be helpful in assessing the possible effects of complexity in the present-law Federal tax system.

It is widely reported that complexity leads to reduced levels of voluntary compliance. Complexity can create taxpayer confusion, which may affect the levels of voluntary compliance through inadvertent errors or intentional behavior by taxpayers. The Joint Committee staff found that it is not possible to measure the effects of complexity on voluntary compliance because (1) there has been no consistent measurement of the levels of voluntary compliance in more than a decade and (2) there is no generally agreed measure of changes in the level of complexity in the tax system over time.

Commentators also state that complexity of the Federal tax systems results in increased costs of compliance to taxpayers. The Joint Committee staff explored some of the commonly used measures of the costs of compliance, such as the estimate of

time required to prepare tax returns, but found that there is no reliable measure of the change in costs of compliance. The Joint Committee staff did find, however, that individual taxpayers have significantly increased their use of tax return preparers, computer software for tax return preparation, and IRS taxpayer assistance over the last 10 years.

Complexity reduces taxpayers' perceptions of fairness of the Federal tax system by (1) creating disparate treatment of similarly situated taxpayers, (2) creating opportunities for manipulation of the tax laws by taxpayers who are willing and able to obtain professional advice, and (3) disillusioning taxpayers to Federal tax policy because of the uncertainty created by complex laws.

Finally, complexity makes it more difficult for the IRS to administer present law. Complex tax laws make it more difficult for the IRS to explain the law to taxpayers in a concise and understandable manner in forms, instructions, publications, and other guidance. In addition, the IRS is more likely to make mistakes in the assistance provided to taxpayers and in the application of the law.

E. IDENTIFYING PROVISIONS ADDING COMPLEXITY

In conducting this study, the Joint Committee staff looked at a variety of factors that contribute to complexity. Although the Joint Committee staff's focus was on complexity as it affects taxpayers (either directly or through the application of the law by tax practitioners), the Joint Committee staff also took into account complexity encountered by the IRS in administering the tax laws.

The Joint Committee staff generally did not take into account the level of sophistication of taxpayers or the complexity of transactions in identifying complex provisions; however, as discussed below, such factors were taken into account in making recommendations for simplification.

Factors the Joint Committee staff analyzed in identifying provisions that add complexity include the following:

(1) The existence of multiple provisions with similar objectives;

(2) The nature and extent of mathematical calculations required by a provision;

(3) Error rates associated with a provision;

(4) Questions frequently asked the IRS by taxpayers;

(5) The length of IRS worksheets, forms, instructions, and publications needed to explain and apply a provision;

(6) Recordkeeping requirements;

(7) The extent to which a provision results in disputes between the IRS and taxpayers;

(8) The extent to which a provision makes it difficult for taxpayers to plan and structure normal business transactions;

(9) The extent to which a provision makes it difficult for taxpayers to estimate and understand their tax liabilities;

(10) Whether a provision accomplishes its purposes and whether particular aspects of a provision are necessary to accomplish the purposes of the provision;

(11) Lack of consistency in definitions of similar terms;

(12) The extent to which a provision creates uncertainty;

(13) Whether a provision no longer serves any purpose or is outdated;

(14) Whether the statutory rules are easily readable and understandable;

(15) The extent to which major rules are provided in regulations and other guidance rather than in the Code; and

(16) The existence of appropriate administrative guidance.

F. SUMMARY OF JOINT COMMITTEE STAFF RECOMMENDATIONS

1. Overview

The Joint Committee staff analyzed each possible simplification recommendation from a variety of perspectives, including:

(1) The extent to which simplification could be achieved by the recommendation;

(2) Whether the recommendation improves the fairness or efficiency of the Federal tax system;

(3) Whether the recommendation improves the understandability and predictability (i.e., transparency) of the Federal tax system;

(4) The complexity of the transactions that would be covered by the recommendation and the sophistication of affected taxpayers;

(5) Administrative feasibility and enforceability of the recommendation;

(6) The burdens imposed on taxpayers, tax practitioners, and tax administrators by changes in the tax law; and

(7) Whether a provision of present law could be eliminated because it is obsolete or duplicative.

In developing possible simplification recommendations, the Joint Committee staff applied one overriding criterion: the Joint Committee staff would make a simplification recommendation only if the recommendation did not fundamentally alter the underlying policy articulated by the Congress in enacting the provision. As a result of applying this criterion, the Joint Committee staff did not make certain simplification recommendations reviewed in the course of this study. However, further simplification could be achieved by addressing certain of the policy decisions made in developing various provisions of present law.

Among the types of issues with respect to which the Joint Committee staff did not make specific simplification recommendations because of policy considerations are the following: (1) reducing the number of individual income tax filing statuses; (2) determining marital status; (3) reducing the number of exclusions from income; (4) making structural modifications to above-the-line deductions and itemized deductions; (5) increasing the standard deduction; (6) making structural changes to the dependency exemption, the child credit, and the earned income credit; (7) modifying the treatment of home mortgage interest of individuals; (8) modifying the distinction between ordinary income (and losses) and capital gains (and losses); (9) integrating the corporate and individual income tax; (10) altering the basic rules relating to corporate mergers and acquisitions; (11) eliminating the personal holding company and accumulated earnings tax provisions; (12) reducing the number of separate tax rules for different types of pass-through entities; (13) determining whether an expenditure is a capital expenditure that cannot be currently expensed; (14) modifying the rules relating to depreciation of capital assets; (15) providing uniform treatment of economically similar financial instruments; (16) modifying the rules relating to taxation of foreign investments; (17) modifications to the foreign tax credit; (18) altering the taxation of individual taxpayers with respect to cross border portfolio investments overseas; (19) changing the determination of an individual's status as an employee or independent contractor; (20) clarifying the treatment of limited partners for self-employment tax purposes; (21) providing alternative methods of return filing; and (22) eliminating overlapping jurisdiction of litigation relating to the Federal tax system.

The Joint Committee staff did not conclude that a simplification recommendation was inconsistent with the underlying policy of a provision merely because the recommendation might alter the taxpayers affected.

In some instances, the Joint Committee staff concluded that a provision did not accomplish the underlying policy articulated when the provision was enacted. In such instances, the Joint Committee staff concluded that recommending elimination or substantial modification of a provision was not inconsistent with the underlying policy.

2. Alternative minimum tax

The Joint Committee staff recommends that the individual and corporate alternative minimum taxes should be eliminated. The individual and corporate alternative minimum taxes contribute complexity to the present-law tax system by requiring taxpayers to calculate Federal income tax liability under two different systems.

The Joint Committee staff believes that the individual alternative minimum tax no longer serves the purposes for which it was intended. The present-law structure of the individual alternative minimum tax expands the scope of the provisions to taxpayers who were not intended to be alternative minimum tax taxpayers. The number of individual taxpayers required to comply with the complexity of the individual alternative minimum tax calculations will continue to grow due to the lack of indexing of the minimum tax exemption amounts and the effect of the individual alternative minimum tax on taxpayers claiming nonrefundable personal credits. By 2011, the Joint Committee staff projects that more than 11 percent of all individual taxpayers will be subject to the individual alternative minimum tax.

Furthermore, legislative changes since the Tax Reform Act of 1986 have had the effect of partially conforming the tax base for alternative minimum tax purposes to the tax base for regular tax purposes. Thus, the Joint Committee staff finds it appropriate to recommend that the alternative minimum tax be eliminated.

3. Individual income tax

Uniform definition of a qualifying child

The Joint Committee staff recommends that a uniform definition of qualifying child should be adopted for purposes of determining eligibility for the dependency exemption, the earned income credit, the child credit, the dependent care tax credit,

and head of household filing status. Under this uniform definition, in general, a child would be a qualifying child of a taxpayer if the child has the same principal place of abode as the taxpayer for more than one half the taxable year. Generally, a "child" would be defined as an individual who is (1) the son, daughter, stepson, stepdaughter, brother, sister, stepbrother, or stepsister of the taxpayer or a descendant of any of such individuals, and (2) under age 19 (or under age 24 in the case of a student). As under present law, the child would have to be under age 13 for purposes of the dependent care credit. No age limit would apply in the case of disabled children. Adopted children, children placed with the taxpayer for adoption by an authorized agency, and foster children placed by an authorized agency would be treated as the taxpayer's child. A tie-breaking rule would apply if more than one taxpayer claims a child as a qualifying child. Under the tie-breaking rule, the child generally would be treated as a qualifying child of the child's parent.

Adopting a uniform definition of qualifying child would make it easier for taxpayers to determine whether they qualify for the various tax benefits for children and reduce inadvertent taxpayer errors arising from confusion due to different definitions of qualifying child. A residency test is recommended as the basis for the uniform definition because it is easier to apply than a support test.

This recommendation would provide simplification for substantial numbers of taxpayers. Under present law, it is estimated that, for 2001, 44 million returns will claim a dependency exemption for a child, 19 million returns will claim the earned income credit, 6 million returns will claim the dependent care credit, 26 million returns will claim the child credit, and 18 million returns will claim head of household filing status.

Dependent care benefits

The Joint Committee staff recommends that the dependent care credit and the exclusion for employer-provided dependent care assistance should be conformed by: (1) providing that the amount of expenses taken into account for purposes of the dependent care credit is the same flat dollar amount that applies for purposes of the exclusion (i.e., $5,000 regardless of the number of qualifying individuals); (2) eliminating the reduction in the credit for taxpayers with adjusted gross income above certain levels; and (3) providing that married taxpayers filing separate returns are eligible for one half the otherwise applicable maximum credit.

The recommendation would eliminate the confusion caused by different rules for the two present-law tax benefits allowable for dependent care expenses. The recommendation also would simplify the dependent care credit by eliminating features of the credit that require additional calculations by taxpayers.

This recommendation could provide simplification for as many as 6 million returns, the number of returns estimated to claim the dependent care credit in 2001.

Earned income credit

The Joint Committee staff recommends that the earned income credit should be modified as follows: (1) the uniform definition of qualifying child (including the tie-breaking rule) recommended by the Joint Committee staff should be adopted for purposes of the earned income credit; and (2) earned income should be defined to include wages, salaries, tips, and other employee compensation to the extent includible in gross income for the taxable year, and net earnings from self employment.

Applying the uniform definition of child recommended by the Joint Committee staff to the earned income credit would make it easier for taxpayers to determine whether they qualify for the earned income credit and would reduce inadvertent errors caused by different definitions. The elimination of nontaxable compensation from the definition of earned income would alleviate confusion as to what constitutes earned income and enable taxpayers to determine earned income from information already included on the tax return.

This recommendation could provide simplification for as many as 19 million returns, the number of returns estimated to claim the credit in 2001.

Head of household filing status

The Joint Committee staff recommends that head of household filing status should be available with respect to a child only if the child qualifies as a dependent of the taxpayer under the Joint Committee staff's recommended uniform definition of qualifying child. Applying the uniform definition of child recommended by the Joint Committee staff would make it easier for taxpayers to determine if they are eligible for head of household status due to a child and reduce taxpayer errors due to differing definitions of qualifying child.

This recommendation could provide simplification for up to 18 million returns that are estimated to be filed in 2001 using head of household filing status.

Surviving spouse status

The Joint Committee staff recommends that surviving spouse status should be available only for one year and that the requirement that the surviving spouse have a dependent should be eliminated. The recommendation would eliminate confusion about who qualifies for surviving spouse status.

Phase-outs and phase-ins

The Joint Committee staff recommends that the following phase-outs should be eliminated: (1) overall limitation on itemized deductions (known as the "PEASE" limitation); (2) phase-out of personal exemptions (known as "PEP"); (3) phase-out of child credit; (4) partial phase-out of the dependent care credit; (5) phase-outs relating to individual retirement arrangements; (6) phase-out of the HOPE and Lifetime Learning credits; (7) phase-out of the deduction for student loan interest; (8) phase-out of the exclusion for interest on education savings bonds; and (9) phase-out of the adoption credit and exclusion.

These phase-outs require taxpayers to make complicated calculations and make it difficult for taxpayers to plan whether they will be able to utilize the tax benefits subject to the phase-outs. Eliminating the phase-outs would eliminate complicated calculations and make planning easier. These phase-outs primarily address progressivity, which can be more simply addressed through the rate structure.

This recommendation would provide simplification for up to 30 million returns that are subject to one or more of the present law phase-outs and phase-ins.

Taxation of Social Security benefits

The Joint Committee staff recommends that the amount of Social Security benefits includible in gross income should be a fixed percentage of benefits for all taxpayers. The Joint Committee staff further recommends that the percentage of includible benefits should be defined such that the amount of benefits excludable from income approximates individuals' portion of Social Security taxes. The recommendation would eliminate the complex calculations and 18-line worksheet currently required in order to determine the correct amount of Social Security benefits includible in gross income. This recommendation could provide simplification for as many as 12 million returns that show taxable Social Security benefits; 5.7 million of such returns are in the income phase-out range.

Individual capital gains and losses

The Joint Committee staff recommends that the current rate system for capital gains should be replaced with a deduction equal to a fixed percentage of the net capital gain. The deduction should be available to all individuals. The recommendation would simplify the computation of the taxpayer's tax on capital gains and streamline the capital gains tax forms and schedules for individuals for as many as 27 million returns estimated to have capital gains or losses in 2001.

The Joint Committee staff recommends that, for purposes of ordinary loss treatment under sections 1242 and 1244, the definition of small business should be conformed to the definition of small business under section 1202, regardless of the date of issuance of the stock. The recommendation would reduce complexity by conforming the definition of small business that applies for purposes of preferential treatment of capital gain or loss.

Two-percent floor on miscellaneous itemized deductions

The Joint Committee staff recommends that the two-percent floor applicable to miscellaneous itemized deductions should be eliminated. The Joint Committee staff finds that the two-percent floor applicable to miscellaneous itemized deductions has added to complexity because it has: (1) placed pressure on individuals to claim that they are independent contractors, rather than employees; (2) resulted in extensive litigation with respect to the proper treatment of certain items, such as attorneys' fees; (3) resulted in inconsistent treatment with respect to similar items of expense; and (4) created pressure to enact deductions that are not subject to the floor. Although the two-percent floor was enacted, in part, to reduce complexity, it has instead shifted complexity to these other issues relating to miscellaneous itemized deductions.

Provisions relating to education

Definition of qualifying higher education expenses

The Joint Committee staff recommends that a uniform definition of qualifying higher education expenses should be adopted. A uniform definition would eliminate the need for taxpayers to understand multiple definitions if they use more than one

education tax incentive and reduce inadvertent taxpayer errors resulting from confusion with respect to the different definitions.

Combination of HOPE and Lifetime Learning credits

The Joint Committee staff recommends that the HOPE and Lifetime Learning credits should be combined into a single credit. The single credit would: (1) utilize the present-law credit rate of the Lifetime Learning credit; (2) apply on a per-student basis; and (3) apply to eligible students as defined under the Lifetime Learning credit.

Combining the two credits would reduce complexity and confusion by eliminating the need to determine which credit provides the greatest benefit with respect to one individual and to determine if a taxpayer can qualify for both credits with respect to different individuals.

Interaction among education tax incentives

The Joint Committee staff recommends that restrictions on the use of education tax incentives based on the use of other education tax incentives should be eliminated and replaced with a limitation that the same expenses could not qualify under more than one provision. The recommendation would eliminate the complicated planning required in order to obtain full benefit of the education tax incentives and reduce traps for the unwary. The recommendation would eliminate errors by taxpayers due to the provisions that trigger adverse consequences as a result of actions by persons other than the taxpayer.

Student loan interest deduction

The Joint Committee staff recommends that the 60-month limit on deductibility of student loan interest should be eliminated. The recommendation would make determining the amount of deductible interest easier because taxpayers would not need to determine the history of the loan's payment status.

Exclusion for employer-provided educational assistance

The Joint Committee staff recommends that the exclusion for employer-provided educational assistance should be made permanent. The recommendation would reduce administrative burdens on employers and employees caused by the present practice of allowing the exclusion to expire and then extending it. The recommendation would make it easier for employees to plan regarding education financing. The recommendation would eliminate the need to apply a facts and circumstances test to determine if education is deductible in the absence of the exclusion.

Taxation of minor children

The Joint Committee staff recommends that the tax rate schedule applicable to trusts should be applied with respect to the net unearned income of a child taxable at the parents' rate under present law. In addition, the Joint Committee staff recommends that the parental election to include a child's income on the parents' return should be available irrespective of (1) the amount and type of the child's income, and (2) whether withholding occurred or estimated tax payments were made with respect to the child's income. Utilizing the trust rate schedule would eliminate the complexity arising from the linkage of the returns of parent, child, and siblings. Expanding the parental election would decrease the number of separate returns filed by children.

4. Individual retirement arrangements, qualified retirement plans, and employee benefits

Individual retirement arrangements ("IRAs")

The Joint Committee staff recommends that the income limits on eligibility to make deductible IRA contributions, Roth IRA contributions, and conversions of traditional IRAs to Roth IRAs should be eliminated. Further, the Joint Committee staff recommends that the ability to make nondeductible contributions to traditional IRAs should be eliminated. The Joint Committee staff recommends that the age restrictions on eligibility to make IRA contributions should be the same for all IRAs.

The IRA recommendations would reduce the number of IRA options and conform eligibility criteria for remaining IRAs, thus simplifying taxpayers' savings decisions.

Recommendations relating to qualified retirement plans

Definition of compensation

The Joint Committee staff recommends that: (1) a single definition of compensation should be used for all qualified retirement plan purposes, including determining plan benefits, and (2) compensation should be defined as the total amount that the employer is required to show on a written statement to the employee, plus elective

deferrals and contributions for the calendar year. The recommendation would eliminate the need to determine different amounts of compensation for various purposes or periods.

Nondiscrimination rules for qualified plans

The Joint Committee staff recommends that: (1) the ratio percentage test under the minimum coverage rules should be modified to allow more plans to use the test, (2) excludable employees should be disregarded in applying the minimum coverage and general nondiscrimination rules, and (3) the extent to which cross-testing may be used should be specified in the Code. The first recommendation would simplify minimum coverage testing by eliminating the need for some plans to perform the complex calculations required under the average benefit percentage test. The second recommendation would simplify nondiscrimination testing by eliminating the need to analyze the effect of covering excludable employees under the plan. The third recommendation would provide certainty and stability in the design of qualified retirement plans that rely on cross-testing by eliminating questions as to whether and to what extent the cross-testing option is available.

Vesting requirements

The Joint Committee staff recommends that the vesting requirements for all qualified retirement plans should be made uniform by applying the top-heavy vesting schedules to all plans. A single set of vesting rules would provide consistency among plans and will reduce complexity in plan documents and in the determination of vested benefits.

SIMPLE plans

The Joint Committee staff recommends that the rules relating to SIMPLE IRAs and SIMPLE 401(k) plans should be conformed by (1) allowing State and local government employers to adopt SIMPLE 401(k) plans, (2) applying the same contribution rules to SIMPLE IRAs and SIMPLE 401(k) plans, and (3) applying the employee eligibility rules for SIMPLE IRAs to SIMPLE 401(k) plans. This recommendation would make choosing among qualified retirement plan designs easier for all small employers.

Definitions of highly compensated employee and owner

The Joint Committee staff recommends that uniform definitions of highly compensated employee and owner should be used for all qualified retirement plan and employee benefit purposes. Uniform definitions would eliminate multiple definitions of highly compensated employee and owner for various purposes, thereby allowing employers to make a single determination of highly compensated employees and owners.

Contribution limits for tax-sheltered annuities

The Joint Committee staff recommends that the contribution limits applicable to tax-sheltered annuities should be conformed to the contribution limits applicable to comparable qualified retirement plans. Conforming the limits would reduce the recordkeeping and computational burdens related to tax-sheltered annuities and eliminate confusing differences between tax-sheltered annuities and qualified retirement plans.

Minimum distribution rules

The Joint Committee staff recommends that the minimum distribution rules should be simplified by providing that: (1) no distributions are required during the life of a participant; (2) if distributions commence during the participant's lifetime under an annuity form of distribution, the terms of the annuity will govern distributions after the participant's death; and (3) if distributions either do not commence during the participant's lifetime or commence during the participant's lifetime under a nonannuity form of distribution, the undistributed accrued benefit must be distributed to the participant's beneficiary or beneficiaries within five years of the participant's death. The elimination of minimum required distributions during the life of the participant and the establishment of a uniform rule for post-death distributions would significantly simplify compliance by plan participants and their beneficiaries, as well as plan sponsors and administrators.

Exceptions to the early withdrawal tax; half-year conventions

The Joint Committee staff recommends that the exceptions to the early withdrawal tax should be uniform for all tax-favored retirement plans and that the applicable age requirements for the early withdrawal tax and permissible distributions from section 401(k) plans should be changed from age 59–1/2 to age 55. Uniform rules for distributions would make it easier for individuals to determine whether

distributions are permitted and whether distributions will be subject to the early withdrawal tax.

Allow all governmental employers to maintain section 401(k) plans

The Joint Committee staff recommends that all State and local governments should be permitted to maintain section 401(k) plans. This will eliminate distinctions between the types of plans that may be offered by different types of employers and simplify planning decisions.

Redraft provisions dealing with section 457 plans

The Joint Committee staff recommends that the statutory provisions dealing with eligible deferred compensation plans should be redrafted so that separate provisions apply to plans maintained by State and local governments and to plans maintained by tax-exempt organizations. This will make it easier for employers to understand and comply with the requirements applicable to their plans.

Attribution rules

The Joint Committee staff recommends that the attribution rules used in determining controlled group status under section 1563 should be used in determining ownership for all qualified retirement plan purposes. Uniform attribution rules would enable the employer to perform a single ownership analysis for all relevant qualified retirement plan purposes.

Basis recovery rules for qualified retirement plans and IRAs

The Joint Committee staff recommends that a uniform basis recovery rule should apply to distributions from qualified retirement plans, traditional IRAs, and Roth IRAs. Under this uniform rule, distributions would be treated as attributable to basis first, until the entire amount of basis has been recovered. The uniform basis recovery rule would eliminate the need for individuals to calculate the portion of distributions attributable to basis and would apply the same basis recovery rule to all types of tax-favored retirement plans.

Modifications to employee benefit plan provisions

Cafeteria plan elections

The Joint Committee staff recommends that the frequency with which employees may make, revoke, or change elections under cafeteria plans should be determined under rules similar to those applicable to elections under cash or deferred arrangements. Applying simpler election rules to cafeteria plans would reduce confusion and administrative burdens for employers and employees.

Excludable employees

The Joint Committee staff recommends that a uniform definition of employees who may be excluded for purposes of the application of the nondiscrimination requirements relating to group-term life insurance, self-insured medical reimbursement plans, educational assistance programs, dependent care assistance programs, miscellaneous fringe benefits, and voluntary employees' beneficiary associations should be adopted. A uniform definition of excludable employees would eliminate minor distinctions that exist under present law and make nondiscrimination testing easier.

5. Corporate income tax

Collapsible corporations

The Joint Committee staff recommends that the collapsible corporation provisions should be eliminated. This recommendation would eliminate a complex provision that became unnecessary with the enactment of the corporate liquidation rules of the Tax Reform Act of 1986.

Active business requirement of section 355

The Joint Committee staff recommends that the active business requirement of section 355 should be applied on an affiliated group basis. Thus, the "substantially all" test should be eliminated. This recommendation would simplify business planning for corporate groups that use a holding company structure.

Uniform definition of a family

The Joint Committee staff recommends that a uniform definition of a family should be used in applying the attribution rules used to determine stock ownership. For this purpose, a "family" should be defined as including brothers and sisters (other than step-brothers and step-sisters), a spouse (other than a spouse who is legally separated from the individual under a decree of divorce whether interlocutory

or final, or a decree of separate maintenance), ancestors and lineal descendants. An exception would be provided with respect to limiting multiple tax benefits in the case of controlled corporations (section 1561), in which case the present-law rules of section 1563(e) would be retained. A single definition of a family would eliminate many of the inconsistencies in the law that have developed over time and would reflect currently used agreements relating to divorce and separation.

Redemption through use of related corporations (section 304)

The Joint Committee staff recommends that section 304 should apply only if its application results in a dividend (other than a dividend giving rise to a dividends received deduction). The recommendation would limit the application of a complex set of rules.

Corporate reorganizations

The Joint Committee staff recommends that assets acquired in a tax-free reorganization pursuant to section 368(a)(1)(D) or 368(a)(1)(F) should be allowed to be transferred to a controlled subsidiary without affecting the tax-free status of the reorganization. This recommendation would harmonize the rules regarding post-reorganization transfers to controlled subsidiaries and eliminate the present-law uncertainties with respect to such transfers.

The Joint Committee staff recommends that the rules relating to the treatment of property received by a shareholder in reorganizations involving corporations under common control or a single corporation (or a section 355 transaction) should be conformed to the rules relating to the redemption of stock. This recommendation would simplify business planning by conforming the rules for determining dividend treatment if a continuing shareholder receives cash or other "boot" in exchange for a portion of the shareholder's stock.

Corporate redemptions

The Joint Committee staff recommends that a stock redemption incident to a divorce should be treated as a taxable redemption of the stock of the transferor spouse, unless both parties agree in writing that the stock is to be treated as transferred to the other spouse prior to the redemption. If one spouse actually receives a distribution and purchases the other spouse's stock, the form of the transaction would be respected. The recommendation would eliminate uncertainty and litigation regarding the treatment of the parties when a corporate stock redemption occurs incident to a divorce.

6. Pass-through entities

Partnerships

The Joint Committee staff recommends that references in the Code to "general partners" and "limited partners" should be modernized consistent with the purpose of the reference. In most cases, the reference to limited partners could be updated by substituting a reference to a person whose participation in the management or business activity of the entity is limited under applicable State law (or, in the case of general partners, not limited). In a few cases, the reference to limited partners could be retained because the provisions also refer to a person (other than a limited partner) who does not actively participate in the management of the enterprise, which can encompass limited liability company owners with interests similar to limited partnership interests. In one case, the reference to a general partner can be updated by referring to a person with income from the partnership from his or her own personal services. The recommendation would provide simplification by modernizing these references to accommodate limited liability companies, whose owners generally are partners within the meaning of Federal tax law, but are not either general partners or limited partners under State law.

The Joint Committee staff recommends that the special reporting and audit rules for electing large partnerships should be eliminated and that large partnerships should be subject to the general rules applicable to partnerships. The recommendation would simplify the reporting and audit rules by eliminating the least-used sets of rules.

The Joint Committee staff recommends that the timing rules for guaranteed payments to partners and for transactions between partnerships and partners not acting in their capacity as such should be conformed. The timing rule for all such payments and transactions should be based on the time the partnership takes the payment into account. The recommendation would provide simplification by eliminating one of two conflicting timing rules applicable to similar types of situations.

S corporations

The Joint Committee staff recommends that the special termination rule for certain S corporations with excess passive investment income should be eliminated. In addition, the corporate-level tax on excess passive investment income should be modified so that the tax would be imposed only on an S corporation with accumulated earnings and profits in any year in which more than 60 percent (as opposed to 25 percent) of its gross income is considered passive investment income. The recommendation would eliminate much of the uncertainty and complexity of present law for S corporations that are required to characterize their income as active or passive income, and at the same time would conform the tax with the personal holding company rules applicable to C corporations (that address a similar concern).

The Joint Committee staff recommends that the special rules for the taxation of electing small business trusts should be eliminated and that the regular rates of Subchapter J should apply to these trusts and their beneficiaries. Under this recommendation, no election to be a qualified subchapter S trust could be made in the future. The recommendation would eliminate some of the complexity regarding the operating rules for electing small business trusts as well as the overlapping rules for electing small business trusts and qualified Subchapter S trusts.

7. General business issues

Like-kind exchanges

The Joint Committee staff recommends that a taxpayer should be permitted to elect to rollover gain from the disposition of appreciated business or investment property described in section 1031 if like-kind property is acquired by the taxpayer within 180 days before or after the date of the disposition (but not later than the due date of the taxpayer's income tax return). The determination of whether properties are considered to be of a "like-kind" would be the same as under present law.

The Joint Committee staff recommends that, for purposes of determining whether property satisfies the holding period requirement for a like-kind exchange, a taxpayer's holding period and use of property should include the holding period and use of property by the transferor in the case of property (1) contributed to a corporation or partnership in a transaction described in section 351 or 721, (2) acquired by a corporation in connection with a transaction qualifying as a reorganization under section 368, (3) distributed by a partnership to a partner, and (4) distributed by a corporation in a transaction to which section 332 applies. In addition, the Joint Committee staff recommends that property whose use changes should not qualify for like-kind exchange treatment unless it is held for productive use in a trade or business or investment for a specified period of time.

The recommendation would reduce complexity by allowing taxpayers to reinvest the proceeds from the sale of business or investment property into other like-kind property directly without engaging in complicated "exchanges" designed to meet the statutory and regulatory rules regarding deferred exchanges. In addition, the recommendation would remove the confusion and uncertainty under section 1031 with respect to whether a taxpayer is considered to hold property for productive use in a trade or business or for investment when the property has been recently transferred.

Low-income housing tax credit

The Joint Committee staff recommends that the payout period for the low-income housing tax credit should be conformed to the initial compliance period (15 years). This recommendation would eliminate the present-law credit recapture rules, which are a significant source of complexity for the credit.

Rehabilitation tax credit

The Joint Committee staff recommends that the 10-percent credit for rehabilitation expenditures with respect to buildings first placed in service before 1936 should be eliminated. Thus, the rehabilitation credit would not be a two-tier credit, but instead would provide only a 20-percent credit with respect to certified historic structures.

The recommendation would achieve simplification in two respects. First, it would eliminate the overlapping categories of "old" and "historic" buildings eligible for different levels of credit under present law. Second, it would eliminate the record-keeping burden currently imposed under the 10-percent credit.

Orphan drug tax credit

The Joint Committee staff recommends that the definition of qualifying expenses for the orphan drug tax credit should be expanded to include expenses related to human clinical testing incurred after the date on which the taxpayer files an appli-

cation with the Food and Drug Administration for designation of the drug under section 526 of the Federal Food, Drug, and Cosmetic Act as a potential treatment for a rare disease or disorder. As under present law, the credit could only be claimed for such expenses related to drugs designated as a potential treatment for a rare disease or disorder by the Food and Drug Administration in accordance with section 526 of such Act. The recommendation would reduce complexity by treating all human clinical trial expenses in the same manner for purposes of the credit and any allowable deduction.

Work opportunity tax credit and welfare-to-work tax credit

The Joint Committee staff recommends that the work opportunity tax credit and welfare-to-work tax credit should be combined and subject to a single set of rules. The combined credit would be simpler for employers because they would use a single set of requirements when hiring individuals from all the targeted groups of potential employees.

Indian employment credit

The Joint Committee staff recommends that the Indian employment credit should be calculated without reference to amounts paid by the employer in 1993. Eliminating the incremental aspect of the credit would reduce the record retention burden on taxpayers in the event the credit is extended permanently.

Reduced emissions vehicles

The Joint Committee staff recommends that the tax benefit for reduced emissions vehicles should be a deduction of qualified expenses related to all such qualifying vehicles, provided that the Congress chooses to extend the tax benefits applicable to such vehicles. Fewer tax benefit options for a similar policy goal would simplify taxpayer decision making and promote a uniform incentive.

8. Accounting provisions

Cash method of accounting

The Joint Committee staff recommends that a taxpayer with less than $5 million of average annual gross receipts should be permitted to use the cash method of accounting and should not be required to use an accrual method of accounting for purchases and sales of merchandise under section 471. A taxpayer that elects not to account for inventory under section 471 would be required to treat inventory as a material or supply that is deductible only in the amount that it is actually consumed and used in operations during the tax year. The recommendation would not apply to tax shelters and would not alter the rules for family farm corporations. The recommendation would enlarge the class of businesses that can use the cash method of accounting, which is a simpler method of accounting. Such businesses would have reduced recordkeeping requirements and would not need to understand the requirements associated with an accrual method of accounting.

Organizational costs

The Joint Committee staff recommends that the rules and requirements to elect to amortize organizational costs should be codified in a single Code provision irrespective of the choice of entity chosen by the taxpayer. In addition, organizational costs incurred in the formation of entities that are, or are elected to be, disregarded for Federal income tax purposes would be eligible to recover organization costs over 60 months. The recommendation would consolidate the rules governing the treatment of organizational costs for all types of entities into one provision and would clarify the tax treatment of organizational costs incurred with respect to legal entities that are disregarded for Federal income tax purposes.

Mid-quarter convention for depreciation

The Joint Committee staff recommends that the mid-quarter convention for depreciable property should be eliminated. This calculation, which requires an analysis of property placed in service during the last three months of any taxable year, can be complex and burdensome because taxpayers must wait until after the end of the taxable year to determine the proper placed-in-service convention for calculating depreciation for its assets during the taxable year. The recommendation would simplify the rules for calculating depreciation, because an analysis of property would no longer need to be performed with respect to property placed in service during the last three months of a taxable year to determine application of the mid-quarter convention.

9. Financial products and institutions

Straddle rules

The Joint Committee staff recommends that the general loss deferral rule of the straddle rules should be modified to allow the identification of offsetting positions that are components of a straddle at the time the taxpayer enters into a transaction that creates a straddle, including an unbalanced straddle. Straddle period losses would be allocated to the identified offsetting positions in proportion to the offsetting straddle period gains and would be capitalized into the basis of the offsetting position.

The Joint Committee staff recommends that the exception for stock in the definition of personal property should be eliminated. Thus, offsetting positions involving actively traded stock generally would constitute a straddle.

Modifying the general loss deferral rule to permit identification of offsetting positions in a straddle would eliminate an additional level of complexity and uncertainty encountered by taxpayers in applying the loss deferral rules to straddles, particularly unbalanced straddles. Similarly, eliminating the stock exception would simplify the straddle rules by eliminating an exception that has become very complex in practice and only applies to a narrow class of transactions.

Interest computation

The Joint Committee staff recommends that the eight different regimes for imposing interest on deferred taxes should be consolidated into three separate regimes: (1) an annual interest charge rule; (2) a look-back rule in which estimates are used; and (3) a look-back rule in which the tax is allocated to prior years based on the applicable Federal rate. The interest rate that would be applied in connection with the three separate regimes would be a uniform rate. Consolidating the interest charge rules would reduce complexity by providing a more uniform application of rules that fulfill the same policy of imposing interest on the deferral of tax. Computing the interest charges at a uniform rate would further reduce the complexity of interest charges.

Taxation of annuities

The Joint Committee staff recommends that section 72, relating to taxation of annuities, should be redrafted to eliminate overly convoluted language and improve the readability of the statutory language. The Joint Committee staff provides a recommended redraft of a portion of section 72 for public review and comment.

In addition, the Joint Committee staff recommends that the provisions of section 72 that apply to qualified retirement plans should be separated from the other provisions of section 72 and combined with the other rules governing the taxation of distributions from such plans. The recommendations would provide simplification by improving the readability of the provisions and by grouping related provisions together so they can be more easily found and understood.

Insurance companies

The Joint Committee staff recommends that the special rules permitting a deduction for certain reserves for mortgage guaranty insurance, lease guaranty insurance, and insurance of State and local obligations should be eliminated. The recommendation would reduce complexity by eliminating tax rules that principally serve a financial accounting purpose.

The Joint Committee staff recommends that the special rules provided to Blue Cross and Blue Shield organizations in existence on August 16, 1986, should be eliminated. Appropriate rules would be provided for taking into account items arising from the resulting change in accounting method for tax purposes. Complexity would be reduced by eliminating special rules that are based on historical facts and that are of declining relevance to the tax treatment of health insurers.

The Joint Committee staff recommends that the two five-year rules relating to consolidated returns of affiliated groups including life insurance companies and nonlife insurance companies should be eliminated. Appropriate conforming rules should be provided. The complexity both to the acquired corporations and the existing members of the affiliated group in corporate acquisitions involving life insurance and nonlife insurance companies would be reduced, with respect to recordkeeping and with respect to calculation of tax liability.

10. International provisions

Foreign personal holding companies, personal holding companies, and foreign investment companies

The Joint Committee staff recommends that (1) the rules applicable to foreign personal holding companies and foreign investment companies should be eliminated,

(2) foreign corporations should be excluded from the application of the personal holding company rules, and (3) subpart F foreign personal holding company income should include certain personal services contract income targeted under the present-law foreign personal holding company rules. The recommendation would provide relief from the complex multiple sets of overlapping anti-deferral regimes that potentially apply to U.S. owners of stock in a foreign corporation.

Subpart F de minimis rule

The Joint Committee staff recommends that the subpart F de minimis rule should be modified to be the lesser of five percent of gross income or $5 million (increased from the present-law dollar threshold of $1 million). For taxpayers with relatively modest amounts of subpart F income, the recommendation would provide relief from the complexity and compliance burdens involved in separately accounting for income under the subpart F anti-deferral rules.

Look-through rule for 10/50 companies

The Joint Committee staff recommends that, for foreign tax credit limitation purposes, the look-through approach should be immediately applied to all dividends paid by a 10/50 company (regardless of the year in which the earnings and profits were accumulated). The recommendation would provide relief from recordkeeping burdens on U.S. corporations required to account for dividends paid by a 10/50 company under both the single basket limitation approach and the look-through approach.

Deemed-paid foreign tax credits

The Joint Committee staff recommends that a domestic corporation should be entitled to claim deemed-paid foreign tax credits with respect to a foreign corporation that is held indirectly through a foreign or U.S. partnership, provided that the domestic corporation owns (indirectly through the partnership) 10 percent or more of the foreign corporation's voting stock. The recommendation would clarify uncertainty in the law that may exist with respect to the application of the indirect foreign tax credit rules when a partner indirectly owns an interest in a foreign corporation through a partnership.

Section 30A and section 936

The Joint Committee staff recommends that, if the credits under section 30A and section 936 are extended (these provisions will expire after 2005), consideration should be given to conforming the application of the credit across all possessions and to combining the rules in one Code section. The recommendation would improve the readability of the rules for potential credit claimants with operations in Puerto Rico and other U.S. possessions by consolidating similar requirements for claiming such credits in one Code section.

Uniform capitalization rules

The Joint Committee staff recommends that in lieu of the uniform capitalization rules, costs incurred in producing property or acquiring property for resale should be capitalized using U.S. generally accepted accounting principles for purposes of determining a foreign person's earnings and profits and subpart F income. The uniform capitalization rules would continue to apply to foreign persons for purposes of determining income effectively connected with a U.S. trade or business. The recommendation would relieve taxpayers and the IRS from the compliance and enforcement burdens associated with applying the uniform capitalization adjustments in the context of certain foreign activities.

Secondary withholding tax

The Joint Committee staff recommends that the secondary withholding tax with respect to dividends paid by certain foreign corporations should be eliminated. The recommendation would spare taxpayers the burden of having to understand and comply with rules that have limited applicability, and relieve the IRS of the difficult task of trying to enforce the tax against a foreign corporation with little or no assets in the United States.

Tax on certain U.S.-source capital gains of nonresident individuals

The Joint Committee staff recommends that the 30-percent tax on certain U.S.-source capital gains of nonresident individuals should be eliminated. The recommendation would spare nonresident individuals with U.S. investments the burden of having to understand and comply with a rule that has limited applicability.

Treaties

The Joint Committee staff recommends that the Secretary of the Treasury should update and publish U.S. model tax treaties at least once each Congress. The recommendation would help inform potentially affected taxpayers of the Administration's current treaty policy goals, afford affected taxpayers the opportunity to offer more helpful commentary to treaty policy makers, and enable affected taxpayers to make more informed assessments regarding investments in countries in which treaty negotiations are being carried out.

The Joint Committee staff recommends that the Treasury should report to the Congress on the status of older U.S. tax treaties at least once each Congress. The recommendation would establish a process for renewing older U.S. tax treaties that may not reflect current policy and that provide different tax outcomes than do more recent U.S. tax treaties. Timely updates of U.S. tax treaties would reduce complexity that may arise for taxpayers and tax administrators as any one taxpayer may be subject to multiple different tax regimes on otherwise similar transactions by reason of the transactions involving different taxing jurisdictions with different treaties.

11. Tax-exempt organizations

Grass-roots lobbying

The Joint Committee staff recommends that the separate expenditure limitation on grass-roots lobbying by certain tax-exempt organizations should be eliminated. Eliminating this limitation would relieve charities making the section 501(h) election of the need to define and allocate expenses for grass-roots lobbying as a subset of total lobbying expenditures. This would simplify the Code and regulations by eliminating a largely unnecessary, but burdensome, process of definition and calculation.

Excise tax based on investment income

The Joint Committee staff recommends that the excise tax based on the investment income of private foundations should be eliminated. The recommendation would relieve private foundations of having to calculate net investment income, to make estimated tax payments, and to consider whether annual charitable distributions should be increased or decreased because of the two-tiered nature of the tax. In addition, taxable foundations would not be required to calculate the unrelated business income tax they would have been required to pay if they were a taxable organization. Short of elimination, the tax could be revised to generate less revenue and at the same time become less complex, for example, by basing the tax on a percentage of the value of a private foundation's assets at the end of a taxable year.

12. Farming, distressed communities, and energy provisions

Conservation payments

The Joint Committee staff recommends that the Code should be amended to reflect that the agricultural conservation program authorized by the Soil Conservation and Domestic Allotment Act has been replaced by the Environmental Quality Incentives Program. The recommendation would clarify that cost-sharing payments under the Environmental Quality Incentives Program are excludable from gross income.

Reforestation expenses

The Joint Committee staff recommends that the separate seven-year amortization and tax credit for $10,000 of reforestation expenses should be replaced with expensing of a specified amount of reforestation expenses. Expensing could provide approximately the same tax benefit for qualified reforestation expenditures without requiring two distinct calculations and without requiring the additional recordkeeping to carry forward the taxpayer's unamortized basis in the expenditures through eight taxable years.

Sales of timber qualifying for capital gains treatment

The Joint Committee staff recommends that (1) the sale of timber held more than one year by the owner of the land from which the timber is cut should be entitled to capital gain treatment and (2) the provision relating to a retained economic interest should be eliminated. The recommendation would eliminate the need to make subjective determinations of dealer status with respect to sales of timber and would eliminate a source of controversy and litigation.

District of Columbia ("D.C.") Enterprise Zone

The Joint Committee staff recommends that, if the D.C. Enterprise Zone is to be extended for a significant period of time, then the poverty rates and the gross in-

come thresholds applicable to the zero-percent capital gains rate should be conformed to the poverty rates and gross income thresholds that apply to the other tax incentives with respect to the D.C. Enterprise Zone. Thus, the Joint Committee staff recommends that a new business should qualify for the zero-percent capital gains rate if (1) more than 50 percent (rather than 80 percent) of its gross income is from the active conduct of a qualified business within the zone, and (2) the business is located in census tracts with at least a 20-percent (rather than 10 percent) poverty rate. The recommendations would eliminate much of the confusion, as well as traps for the unwary, for businesses that locate in the D.C. Enterprise Zone by providing a single gross income and single poverty test for determining whether a new business qualifies for the various tax incentives.

Tax incentives for business located in targeted geographic areas

The Joint Committee staff recommends that a uniform package of tax incentives for businesses that locate in targeted geographic areas should be adopted. In addition, the targeted geographic areas that would be eligible for the tax incentives would be determined based on the application of a consistent set of economic measurements. The recommendation would eliminate many of the complexities that exist under present law for businesses in determining where to locate its business facilities, and for the Treasury, the IRS, and State and local agencies in selecting the distressed areas complying with the tax laws and monitoring the effectiveness of the tax incentives.

Geological and geophysical costs

The Joint Committee staff recommends that taxpayers should be permitted immediate expensing of geological and geophysical costs. The recommendation would reduce complexity by eliminating the need to allocate such expenses to various properties and by eliminating the need to make factual determinations relating to the properties, such as what constitutes an area of interest and when a property is abandoned.

13. Excise taxes

Highway Trust Fund excise taxes

The Joint Committee staff recommends that the number of taxes imposed to finance Highway Trust Fund programs should be reduced by eliminating or consolidating the non-fuels taxes. The rates at which the fuels taxes or the restructured non-fuels taxes are imposed could be adjusted to ensure that future funding for Trust Fund programs is not affected. Adoption of this recommendation would reduce the number of taxpayers having direct involvement with the highway excise taxes. Further, the non-fuels taxes are heavily dependent on factual determinations; their elimination would end numerous audit issues between taxpayers and the IRS.

The Joint Committee staff recommends that the definition of highway vehicle should be clarified to eliminate taxpayer uncertainty about the taxability of motor fuels and retail sales (if the retail sales tax is retained). Enacting a single definition of highway vehicle would provide certainty to taxpayers.

The Joint Committee staff recommends that the option to pay the heavy vehicle annual use tax in quarterly installments should be eliminated (if that tax is retained). Elimination of this payment option would increase compliance with the highway excise taxes while eliminating the need for tracking relatively small amounts of tax due from numerous taxpayers.

The Joint Committee staff recommends that several technical modifications should be made to the present Code provisions governing motor fuels refund procedures and tax collection: (1) timing and threshold requirements for claiming quarterly refunds should be consolidated to allow a single claim to be filed on an aggregate basis for all fuels; (2) to the extent necessary to implement item (1), differing present-law exemptions should be conformed; (3) clarification of the party exclusively entitled to a refund should be provided in cases in which present law is unclear; (4) the regulatory definition of "position holder" (the party liable for payment of the gasoline, diesel fuel, and kerosene taxes) should be modified to recognize certain two-party terminal exchange agreements between registered parties; and (5) the condition of registration requiring terminals to offer for sale both undyed and dyed diesel fuel and kerosene should be eliminated. Consolidation and clarification of differing rules that affect similar transactions by taxpayers would provide certainty to taxpayers, as well as reducing needed IRS resources in administering these taxes.

Airport and Airway Trust Fund excise taxes

The Joint Committee staff recommends that liability for the commercial air transportation taxes should be imposed exclusively on transportation providers.

The Joint Committee staff recommends that the penalties for failure to disclose commercial air passenger tax on tickets and in advertising should be eliminated. Department of Transportation consumer protection disclosure requirements would remain in force for these as well as other currently regulated fees and charges.

The Joint Committee staff recommends that a uniform, statutory definition of the tax base for the commercial air freight tax should be enacted with any exclusion for accessorial ground services being specifically defined. This recommendation would provide a level playing field for all air freight carriers, and also would eliminate numerous audit disputes that occur under present law.

The Joint Committee staff recommends that the current definition of commercial air transportation, as applied to non-scheduled transportation, should be reviewed and, if appropriate, conformed to Federal Aviation Administration aircraft safety and pilot licensing regulations.

The Joint Committee staff recommends that the present-law Code provisions governing aviation fuel refund and tax collection procedures should be coordinated with comparable rules for Highway Trust Fund excise taxes, if possible.

Harbor Maintenance Trust Fund excise tax and tax on passenger transportation by water

The Joint Committee staff recommends that the Harbor Maintenance Trust Fund excise tax and the General Fund tax on passenger transportation by water should be eliminated. This recommendation would conform the Code to court decisions and U.S. international trade obligations.

Aquatic Resources Trust Fund excise taxes

The Joint Committee staff recommends that the sport fishing equipment excise tax should be eliminated. The current tax requires excessive factual determinations and disadvantages some industry participants relative to manufacturers of similar, untaxed articles that compete in the marketplace.

Federal Aid to Wildlife Fund and non-regular firearms excise taxes

The Joint Committee staff recommends that Federal Aid to Wildlife Fund and non-regular firearms excises taxes should be eliminated. If the taxes are retained, consideration should be given to (1) consolidating certain of the taxes and (2) changing the tax rates to fixed-amount-per-unit rates in lieu of the present ad valorem rate structure to reduce factual and tax-base issues arising under the current structure. Tax law simplification would be furthered if the dedicated taxes were repealed and the Wildlife Fund program financed with general revenue appropriations.

Black Lung Trust Fund excise tax

The Joint Committee staff recommends that the Code provisions on exported coal should be modified to eliminate the provisions imposing tax on coal mined for export in light of a recent court decision holding that portion of the tax to be unconstitutional.

Communications excise tax

The Joint Committee staff recommends that the present-law Federal communications excise tax should be eliminated. If the tax is not eliminated, the Joint Committee staff recommends that: (1) liability for the tax should be shifted to telecommunications service providers so that unpaid tax would be collected as part of regular bad debt collections; (2) the present Code provisions should be updated to reflect current technology; and (3) broad grants of regulatory authority should be provided to the Treasury to allow it continually to update the tax base to reflect future technological changes. Under present law, the communications tax does not reflect the state of technology in the industry, thereby giving rise to disparate treatment of different providers of similar services and requiring highly factual determinations as to when services are taxed.

Ozone-depleting chemicals excise tax

The Joint Committee staff recommends that the ozone-depleting chemicals excise tax should be eliminated as deadwood in light of provisions of the Montreal Protocol and the Clean Air Act that significantly restrict the use of the chemicals subject to tax.

Alcohol excise taxes

The Joint Committee staff recommends that the three separate excise taxes currently imposed on alcoholic beverages should be consolidated into a single tax, with the rate being based on alcohol content of the beverage. The Code provisions governing operation of alcohol production and distribution facilities similarly should be consolidated to the extent consistent with overall operation of Federal alcohol regulation laws.

The Joint Committee staff recommends that, if the current three-tax structure is retained, the reduced rates for production from certain small facilities and for distilled spirits beverages containing alcohol derived from fruit should be eliminated. This recommendation would result in identical beverages being subject to the same tax rate, thereby eliminating economic advantages that currently flow to some, but not all, producers of the same product as well as reducing recordkeeping requirements on taxpayers.

The Joint Committee staff recommends that the alcohol occupational taxes should be eliminated. These taxes are in the nature of business license fees and serve no tax policy purpose.

The Joint Committee staff recommends that the rules governing cover over of rum excise taxes to Puerto Rico and the U.S. Virgin Islands should be consolidated to reduce Federal administrative resources required for this revenue-sharing program.

Tobacco excise taxes

The Joint Committee staff recommends that the present excise taxes on pipe tobacco, roll-your-own tobacco, and cigarette papers and tubes should be consolidated into a single tax on pipe and roll-your-own tobacco.

The Joint Committee staff recommends that the tax rate imposed on cigars should be modified to eliminate the ad valorem component. Adoption of this recommendation would reduce audit issues as to the correct tax base in transactions where the products are sold between manufacturers and related parties in the distribution system.

The Joint Committee staff recommends that the tobacco occupational tax should be eliminated. This tax is in the nature of a business license fee and serves no tax policy purpose.

14. Tax-exempt bonds

Unrelated and disproportionate use limit

The Joint Committee staff recommends that the unrelated and disproportionate use limit under which no more than five percent of governmental bond proceeds may be used for a private purpose that is unrelated to the governmental activity also being financed should be eliminated. The general limits on private business use of governmental bond proceeds, combined with the requirement that certain larger issues receive an allocation of State private activity bond volume authority, adequately restrict issuance of tax-exempt governmental bonds to situations in which a private party does not receive excessive benefit.

Prohibition on use of private activity bond proceeds for certain business

The Joint Committee staff recommends that the prohibition on using private activity bond proceeds for certain business should be conformed for all such bonds and consolidated into one Code section. The multiple sets of rules for similar types of bonds create unnecessary complexity for taxpayers and the IRS.

Obsolete and near-obsolete provisions

The Joint Committee staff recommends that the special qualified mortgage bond rules for residences located in Federal disaster areas, which have expired, should be eliminated as deadwood.

The Joint Committee staff recommends that the temporary gubernatorial authority to allocate the private activity bond volume limits, which has expired, should be eliminated as deadwood.

The current qualified mortgage bond and qualified veterans' mortgage bond programs substantially overlap. The Joint Committee staff recommends that only one mortgage interest subsidy—qualified mortgage bonds—should be provided through the issuance of tax-exempt private activity bonds. Consolidation of two similar provisions would reduce the need for duplicate administrative agencies and eliminate potential confusion among potentially qualifying beneficiaries and among potential lenders in those States that issue both qualified mortgage bonds and qualified veterans' mortgage bonds.

The Joint Committee staff recommends that the $150 million limit for qualified section 501(c)(3) bonds should be eliminated as it relates to capital expenditures in-

curred before the date of enactment of the Taxpayer Relief Act of 1997. This limit was repealed in 1997 for capital expenditures incurred after enactment of the Taxpayer Relief Act.

The Joint Committee staff recommends that the qualified small-issuer exception for certain bank-qualified bonds should be eliminated in light of the development since 1986 (when the rule was enacted) of State bond banks and revolving pools that provide needed market access for smaller governmental units without the bank subsidy provided by the exception. In addition, provisions of the Community Reinvestment Act now require banks to invest in local projects without regard to subsidies such as that provided by this exception. The elimination of this exception would help streamline the arbitrage rebate rules without disadvantaging qualified small-issuers.

Public notice requirement

The Joint Committee staff recommends that the "public notice" requirement for a qualified private activity bond should be allowed to be satisfied by other media if the objective of reasonable coverage of the population can be met. For example, notice via the Internet in addition to radio and television would satisfy an expanded public notice requirement. The Joint Committee staff recommends that, in lieu of a public hearing, the public comment requirement should be satisfied by written response and Internet correspondence. The recommendation would reduce the compliance burden by offering issuers less costly ways to obtain public scrutiny of proposed bond issues.

Arbitrage rebate

The Joint Committee staff recommends that the present-law construction period spend down exception should be expanded to 36 months with prescribed intermediate targets. Expanding the present-law construction period spend down exception to somewhat longer construction projects would expand the number of issuers who are not required to track temporary investments and compute arbitrage without creating excessive incentives to issue bonds in larger amounts or earlier than needed for governmental purposes in order to invest proceeds for profit.

The Joint Committee staff recommends an increase to the basic amount of governmental bonds that small governmental units may issue without being subject to the arbitrage rebate requirement from $5 million to $10 million. Specifically, these governmental units would be allowed to issue up to $15 million of governmental bonds in a calendar year provided that at least $5 million of the bonds are used to finance public schools. This recommendation reflects the increased dollar costs of activities financed by smaller governments since the provision was enacted in 1986 without expanding the benefit beyond those smaller governments that often lack in-house accounting staff to perform needed investment tracking and arbitrage calculations.

15. Estate and gift tax

The Joint Committee staff recommends that the qualification and recapture rules contained in the special-use valuation and the qualified family owned business provisions be conformed to the extent practicable. Uniform rules to the extent practicable would make these related estate tax benefits easier to understand and administer.

16. Deadwood provisions

The Joint Committee staff recommends that out of date and obsolete provisions in the Code should be eliminated. The Joint Committee staff has identified more than 100 provisions that could be eliminated as deadwood.

PREPARED STATEMENT OF PAMELA J. PECARICH

Introductory Comments

Mr. Chairman, and members of this distinguished committee, my name is Pamela J. Pecarich, and I am the chair of the Tax Executive Committee of the American Institute of Certified Public Accountants (AICPA). The AICPA is the professional association of certified public accountants, with more than 330,000 members, many of whom provide comprehensive tax services to all types of taxpayers including businesses and individuals, in various financial situations. Our members work daily with the tax provisions you enact.

You have heard from the AICPA many times over the last decade about the growing need for tax law simplification. While some reductions in complexity have been accomplished, we believe that a lack of attention to simplification in the legislative process and frequent changes to the tax law over the years have combined to signifi-

cantly increase the size and complexity of the Internal Revenue Code. Few American taxpayers can understand and comply with the law without expending considerable resources. They have also lost respect for the tax system as it increasingly makes them victims of unintended consequences and outdated policies. The costly net result is eroded voluntary compliance. We continue to believe that citizens want to obey the tax law, but they can afford to spend only a limited amount of time and energy to understand and comply with the rules.

Fortunately, we face a unique opportunity. We are in a period of a budget surplus, and tax relief of some kind is imminent. We firmly believe that taxpayers are entitled to tax relief. But that tax relief can take many forms—a reduction in tax rates, additional incentives in the Code, or perhaps an overall reduction in the costs of compliance, both financial and psychological. In fact, the time is right for relief through tax simplification. Simplification has become an economic, political, and even moral imperative.

As Congress considers how to allocate the limited resources available for tax relief, we urge that priority attention be given to: fixing structural problems that have grown and existed in the tax system for too long; focusing resources on simplifying aspects of the tax law that trouble the largest number of taxpayers; and, avoiding further harm to the system through unnecessary complexity.

The time has past for merely applying "bandaids" as temporary fixes to structural problems. Although attempting comprehensive simplification of the entire Code may be unrealistic, focused simplification efforts on particular portions of the Code could rationalize existing law, as well as introduce new policy goals and initiatives in a manner consistent with an overall framework. A perfect example of an area that has become outdated and grown into a structural problem is the alternative minimum tax—a provision originally intended for a narrow group of the highest income taxpayers. The projected number of individual, middle income taxpayers who will be caught in the AMT trap over the next few years is staggering. The time to fix this problem is now, especially as Congress is considering an across-the-board tax cut which would compound the AMT problem exponentially.

Next, there are many complex areas of law affecting a large number of not particularly sophisticated taxpayers. A concerted simplification effort in any of these areas would go a long way toward easing compliance burdens. Areas that could benefit greatly from simplification include the earned income tax credit, education credits, the child credit, retirement savings provisions, and even expensing versus capitalization rules which affect a significant proportion of businesses.

Congress can avoid further harm by giving simplification a prominent position in the tax process on an on-going basis. The process of considering new tax legislation must include a complexity analysis of every proposal and a simplification review of existing law in the area under consideration. Although simplification should not take precedence over revenue and tax policy objectives, it must be an equal and integral part of the legislative, regulatory, and administrative process. Collectively, we must learn to accept "rough justice" in return for a more viable tax system.[BM1]

We recognize that a tax system that is "simple" for all taxpayers may never be achieved, but we do believe that a "simpler" system is attainable. Now is the time to move toward this simpler system.

THE LEGISLATIVE PROCESS AND TAX SIMPLIFICATION

The AICPA has long advocated tax simplification. We were greatly pleased when many of the concepts and factors identified in our Blueprint for Tax Simplification and Complexity Index were incorporated into the tax law complexity analysis mandated by the Internal Revenue Service Restructuring and Reform Act of 1998. We were also pleased that the independent role of the National Taxpayer Advocate was strengthened and enhanced.

In the Annual Report to Congress for fiscal year 2000, the Advocate confirmed that tax law complexity "remains the number one problem facing taxpayers, and is the root-cause of many of the other problems on the Top 20 list." The Advocate's concern about complexity has become so severe that complexity is now ranked number one and number two on the Taxpayer Advocate's list of the 20 most serious problems facing the U.S. tax system.

"Despite IRS restructuring to target services to taxpayer needs," the Advocate's report states, "the fact remains that the Internal Revenue Code is riddled with complexities that often defy explanation . . . . [therefore, the Advocate suggests that] Congress take actions to simplify the Internal Revenue Code and make it easier to understand and implement." As you review the AICPA's simplification recommendations, you will see many parallels to the recommendations of the Taxpayer Advocate.

The 1998 Act established a framework for analyzing complexity, and since enactment, much work has been done to develop the tools to measure a proposal's incremental complexity. In addition, we look forward to reviewing and commenting on the Joint Committee on Taxation's just-completed study on complexity.

The next step must be to use these tools to evaluate the proposals currently before Congress. Legislators and staff must commit to considering the relative complexity of competing proposals and to meeting policy goals in the "simplest" manner possible. This final element is critical to achieving the simplest tax system possible for the most taxpayers.

RECENT LEGISLATIVE PROPOSALS

In recent years, tax legislation has been enacted more frequently and has increasingly relied on thresholds, ceilings, income tests, eligibility rules, phase-ins, and phase-outs—all of which complicate compliance. In addition varying effective and sunset dates are used to target benefits to numerous specific taxpayer groups within set revenue constraints. Although well intentioned, these targeted benefits sacrifice simplification. Cumulatively, targeted provisions further weigh down our tax system with complexity and impose very real compliance costs.

The Administration's fiscal year 2002 tax relief proposals continue this trend through a five-year phase-in of many of the key provisions and the addition of new, targeted provisions—i.e., reducing tax rates, increasing the child tax credit, reducing the marriage penalty, and providing a charitable contribution deduction for non-itemizers. Simpler solutions are attainable in order to accomplish the desired policy goals. We firmly believe that the goal of reduced complexity must be balanced with the other policy goals underlying the provisions.

Providing some balance, the Administration's fiscal year 2002 tax relief proposals also contain provisions to permanently extend several tax credits, such as the research and experimentation tax credit and the adoption tax credit. Without taking a position on the underlying policies, we applaud the effort to bring the "expiration and extension cycle" for these provisions to an end. Unfortunately, the Administration's proposals also include only a one-year extension for multiple provisions that will expire in 2001, such as the exclusion of employer-provided educational assistance. Short-term extensions of broadly applicable provisions cause administrative difficulties for the IRS and taxpayers, making it impossible for taxpayers to plan with any degree of certainty.

Complexity is manifested in Code provisions that contain vague or highly technical requirements, often with exceptions, limitations, and other special rules that even the most sophisticated tax advisers can find difficult, if not impossible, to decipher. Add to this the many provisions—complex in their own right—that must be applied in tandem with other complex provisions. Even if a complex provision works appropriately standing alone, when coupled with another equally complex provision, the result may be simply incomprehensible. Constant changes and amendments to the tax laws, accompanied by effective date and transition rules, breed complexity as well as uncertainty, confusion, and frustration. Since 1995 there have been 2,116 tax law changes. Statutory change spawns a steady stream of new, and often voluminous, Treasury regulations, which require an enormous expenditure of IRS and Treasury intellectual capital[BM2]. This is clearly demonstrated by the explosion in the number of pages in the Code and regulations from 19,500 in 1984 to 45,662 in 2001.

We recognize that most complex Code provisions have laudable goals. In many cases, however, the burdens imposed on taxpayers and the Internal Revenue Service quite simply outweigh the benefits of attaining those underlying goals in that particular manner. Further, original, worthy goals are often superseded by changes in society or the economy, or by other changes in the law, resulting in complex provisions that no longer serve their intended purpose. Yet, these provisions remain in the law.

We encourage Congress to fundamentally change the way it considers tax legislation and the priority it gives to tax simplification.

ABA, AICPA AND TEI JOINT EFFORT TO SIMPLIFY EXISTING TAX LAW

The AICPA is not alone in its concerns about tax law complexity. Over the past several years, we have been pleased to join with the American Bar Association Section of Taxation and the Tax Executives Institute in working toward the common goal of simplifying and rationalizing our tax system. In collaboration with our professional colleagues, we developed a package of tax simplification recommendations that we first submitted to Congress on February 25, 2000. A copy of our proposals is attached as Appendix A. Please note that we are in the process of updating the

package and it will be resubmitted in several weeks. Many of our recommendations are in areas are also recommended for action in the Taxpayer Advocate reports to Congress over the last two years.

These recommendations are not exhaustive; rather, they are merely a starting point. Neither are the proposals are listed in priority order. Action in any of these areas will go a long way toward simplifying the tax system for many individual and business taxpayers. In my testimony today, there are several areas on which I would like to focus your attention.

Eliminate or Rationalize 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. Targeting is accomplished by phasing out benefits when individual or family income exceeds certain levels. As you will see from the chart included as Appendix B, phase-outs are used throughout the Code, without any consistency in the measure of income, the ranges of income over which they apply, or the method of application. In short, the Code lacks a coherent, consistent framework for defining, providing or denying tax benefits to low-, middle-, and upper-income taxpayers.

Phase-outs result in a significant number of problems, including:

- creating hidden tax increases and irrational marginal tax rates;
- adding significantly to the length of tax returns;
- increasing the potential for errors;
- being difficult to understand; and
- obscuring whether the promised benefit will ultimately be available.

CPAs regularly—and all too frequently—encounter taxpayers frustrated and angered by the loss of an anticipated benefit because some unforeseen factor or phase-out rule denies them eligibility. Often this discovery occurs only after the tax return is filed, and possibly not until the IRS proposes an adjustment or penalty.

Examples: Attached as Appendix D is an article from the March 2001 Journal of Accountancy titled “Stealth Taxes—The Real Cost of Hidden Tax Traps.” It contains examples demonstrating how various limitations and AGI tests interact to create virtually unpredictable tax consequences in a variety of common circumstances.

A recent example that came to our attention involved a contribution to an Individual Retirement Account by a taxpayer whose wife[BM3] was a participant in an employer pension plan. The couple filed an extension for their personal tax return on April 15th, but subsequently received a Form K–1 for the wife with a larger than expected amount of partnership income. This additional income unexpectedly put the couple over the phase-out level for a deductible IRA contribution.

Another member exclaimed after this filing season, “How could a typical taxpayer possibly remember or understand the rules about how much or whether contributions can be made to a traditional IRA, a Roth IRA, a nondeductible IRA, or an education IRA[BM4]?”

Recommendations: Simplification could be achieved by eliminating phase-outs altogether and standardizing income limits and eligibility rules. Alternately, substituting cliffs for phase-outs would reduce complexity, as would providing consistency in how income is measured and standardizing phase-out ranges and methods.

Harmonize and Simplify Education Incentives

Since 1997, Congress has provided numerous education incentives and tax benefits for students and parents. There are currently eight different “education incentive programs” in the tax law including tuition credits, education IRAs, deductible state tuition prepayment programs, income-limited deductions on student loan interest, and tax-favored employer-provided education assistance programs. Attached as Appendix C is a table highlighting the myriad of eligibility rules for these programs. The Administration has proposed expanding education savings accounts and increasing the annual contribution limit[BM5] over five years. Rather than adding more rules to an already overly complex area of tax law, Congress should consider a comprehensive overhaul of all these provisions to accomplish the desired policy goals and at the same time harmonize and simplify the tax system’s existing education incentives.

In our experience, education incentives are an area where the rules are so cumbersome in comparison with the benefits received that many taxpayers choose to forego the benefit. Other taxpayers, who struggle through the complicated rules to take advantage of the benefit, may ultimately find that some unforeseen factor makes them ineligible. The incentive goal of provisions enacted to spur education is lost due to the complexity.

Examples: Eligibility for one of the education [BM6]credits depends on the academic year in which the child is enrolled, the timing of tuition payments, the nature and timing of other eligible expenditures, and the adjusted gross income level of the parents or, possibly, the student. In any given year, parents may be entitled to different credits for different children. In other years, credits may be available for one child but not another. The education credits are dependent on the income levels of the parents or the child attempting to claim them. Further complicating the scheme, the Code precludes using the Lifetime or Hope Credit if the child also receives benefits [BM7]from an education IRA. Although a child can elect out of education IRA benefits, this decision entails additional analysis and complication.

A tax professor recently recounted his students' confusion over education credits. Particularly troubling for the students was that they attend school by an academic year, but the credits are calculated on a calendar year basis. For example, in the spring semester of the second year of college, a student is still in the first year of the two-year eligibility for the Hope Credit. But in the fall semester of that same calendar year, the student is in their third year of college for the Lifetime Learning Credit. Because both credits cannot [BM8]be used in the same calendar year, which should they use? The answer to this tax conundrum is definitely not clear and often a wrong decision is made.

Five of the eight educational provisions are complicated by eligibility phase-outs based on various AGI levels. Thus taxpayers must make numerous calculations to determine eligibility for each of the various incentives. By failing to satisfy all the many individual tests required for each benefit, taxpayers may inadvertently lose the benefits of a particular incentive because they either do not understand the provision or they pay tuition or other qualifying expenses during the wrong tax year.

Separately, college graduates are entitled to deduct a portion of interest paid on their student loans. However, this deduction is reduced or eliminated as AGI exceeds certain thresholds[BM9]. In turn, these phase-out thresholds differ from the education credit and education IRA thresholds.

With tax filing season fresh in our memories, our members recount stories of taxpayers who found themselves ineligible to use an education incentive because of an unanticipated factor. This tax season's major culprit has been the recognition of unanticipated capital gains at year-end, brought on by the stock market's sharp rise and steep fall. Many middle-income taxpayers who planned on help with their child's education costs are now finding out that their hard work to understand and comply with the rules was for naught because of this unexpected income recognition.

Recommendations: Simplification suggestions for higher education tax incentives include:

- combine both existing education credits into one;
- simplify the definition of "student;"
- establish a single amount eligible for the credit;
- eliminate or standardize the income ranges required for eligibility;
- in lieu of the credits, grant additional exemption amounts to taxpayers who qualify for the credit under current law;
- ease the interest deduction requirements and coordinate the phase-out amounts with other education incentives; and
- replace current tax benefits with a new universal education deduction or credit.

Repeal the Alternative Minimum Tax

The individual AMT no longer serves its intended purpose. Rather, it produces enormous complexity and has unintended consequences. Enacted in 1969 to address concerns that persons with significant economic income were paying little or no Federal tax, the AMT today has little effect on its original target and increasingly affects an unintended group of taxpayers—the middle class. These taxpayers generally find themselves unexpectedly subject to the AMT, not because they "overused" specialized tax preferences, but because of ordinary use of personal exemptions, the standard deduction, state and local taxes, or miscellaneous itemized deductions[BM10].

Examples: This problem is exemplified by stories from a CPA helping out at a volunteer tax clinic. A single mother of five who earned only $45,000 found herself subject to $1,850 of AMT because the number of personal exemptions triggered the AMT[BM11]. To further add to her tax woes, this struggling mother did not qualify for the child care credit. In another case, a combination of unusual events subjected a couple to AMT. An unexpected capital gain and a large emergency medical expense resulting from being medically evacuated from Africa combined to trigger the AMT. In these and in much less dramatic circumstances, the AMT continues to surprise taxpayers and their advisors by the unpredictability of its application.

Recommendations: Other changes to the Code since 1969 that limit tax shelter deductions and credits now achieve the result originally intended for the AMT. Repealing the individual AMT would accomplish significant simplification in one fell swoop[BM12]. The past and present Taxpayer Advocate strongly support AMT repeal[BM13]. Further, the corporate AMT suffers from the same infirmities as the individual AMT and should be repealed as well.

Simplify the Rules for Taxation of Capital Gains

The capital gains regime for individuals has become excessively complex as a result of numerous expansions and adjustments. Although each item of fine-tuning may be defensible in isolation, the cumulative effect has been to create a structure that is incomprehensible both to taxpayers and to the people who [BM14]prepare their returns.

The problem is exacerbated by the large number of taxpayers now affected; compliance with capital gains rules no longer concerns just the wealthy. Almost half of the American people now own stock, and due to the stock market's sharp rise and steep fall, the 2000 tax year will be the biggest capital-gains tax year in history. The Congressional Budget Office estimates that roughly 12 percent of all individual income tax receipts for the year will come from capital gains—double the percentage of a decade ago.

Further, the current system imposes significant record-keeping and reporting burdens on taxpayers. According to the IRS's own measure of this increased reporting burden, in 1990 the average taxpayer spent an estimated 3 hours and 18 minutes completing Schedule D to report capital gains. Just 10 years later that estimate has more than doubled to 6 hours and 58 minutes.

Examples: A CPA recently put this issue in perspective for me. A friend had prepared his own tax return by hand. He reported several stock and mutual fund transactions on the front page of Schedule D, with nothing novel like collectibles, small business stock, or recapture of real estate depreciation. The friend had not, however, completed the back of the form to compute the 20 percent tax on his long-term capital gain. When asked "why not," the friend acknowledged that, although he knew it would save him taxes, it was just too complicated to bother. Clearly here the burden of complexity outweighed the intended tax benefit. All too often CPAs are encountering taxpayers who choose to forgo a tax benefit because the compliance cost, both financial and psychological, is too high.

Despite the already excessive complexity associated with capital gains taxation, additional complexities continue to be added. For example, a special rule now 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 the special 18 percent rate if it is held for another five years. Additional confusion results because this special rule applies immediately for those in the 15 percent bracket, but can be elected by those above the 15 percent bracket. Determining whether to make this election will require taxpayers to make economic assumptions and do difficult present value calculations.

Recommendations: Capital gains taxation should be simplified by establishing a single preferential rate and a single long-term holding period for all types of capital assets.

Clarify Rules Governing Expensing, Capitalization and Recovery of Capitalized Costs

Another area in great need of simplification is the capitalization or expensing of costs. The tax treatment of some business expenditures depends on whether they are classified as "period" expenses, and therefore deductible in the current year, or expenses which must be capitalized. In which case, they are either deducted over time as the asset depreciates or when the asset is sold. This classification depends on whether the expenditure produces a "future benefit." But, that determination is rarely obvious or easy.

The enormous drain on both government and taxpayer resources [BM15]to make these determinations must be alleviated. The IRS and Treasury should be required to issue guidance setting forth objective, administrable tests on recurring and routine deductible business expenses and to create clearly defined categories of capital expenditures.

Additional Areas in Need of Simplification

As noted earlier, I have attached a full package of recommendations jointly developed with the ABA Tax Section and TEI as Appendix A to my written testimony. Additional areas in need of simplification covered in the package include:

Simplify and harmonize the definitions and qualification requirements associated with filing status, dependency exemptions, and credits—Family status affects various tax provisions designed to accomplish different ends. Family status issues are fur-

ther complicated by the increasing number of non-traditional families—a phenomenon that cuts across all income levels. Given the multiple policy considerations underlying the family status provisions, uniform definitions alone may not achieve optimum simplicity. It is possible, however, to simplify and harmonize the eligibility criteria for many of these provisions and establish safe harbors to provide taxpayers with more certainty and comfort.

Rationalize estimated tax safe harbors—The availability and computation of the prior-year safe harbor for estimated taxes has been adjusted repeatedly during the past decade. This has resulted in considerable confusion and complexity for a significant number of individual and small business taxpayers. An appropriate safe harbor percentage (perhaps 100%) should be determined and applied for all years. Enacting a meaningful safe harbor would also simplify estimated tax computation and compliance for all corporations.

Make expiring provisions permanent—The need to extend expiring provisions adds confusion and, in many cases, undermines the policy reasons for enacting the incentives in the first place. The on-again, off-again nature of these provisions, coupled in some cases with retroactive enactment, contributes significant complexity. Significant incentive provisions should be enacted on a permanent basis.

Change the half-year conventions for retirement plan distributions to full-years—The Code 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 age 70 1/2. It also provides that plan benefits may not be distributed before certain stated events occur, including attainment of age 59 1/2. 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.

Simplify the minimum distribution rules for retirement accounts—The tax rules concerning retirement plan distributions are among the most complex in the Code and present numerous traps for the unwary. Further, an ever-growing percentage of Americans are now in or approaching their retirement years. Untold millions of retirement accounts will soon become subject to these rules. Simplification is badly needed.

Replace the 20-factor common law worker classification test—Whether a worker is an employee or independent contractor is a particularly complex determination using a 20-factor common law test. Each of the factors is subject to interpretation, and there is precious little guidance on how or whether to weight them. In addition, the factors do not apply in all work situations and do not always result in a meaningful indication of whether the worker is an employee or independent contractor. This complex and highly uncertain determination should be eliminated and replaced with a more objective test applicable 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.

Harmonize attribution rules—The attribution rules throughout the Code contain a myriad of distinctions. While perhaps reasonably fashioned in light of the particular underlying concern at the time enacted, the attribution rules should be reexamined with the objective of harmonizing and standardizing them.

Simplify the foreign tax credit rules—The core purpose of the foreign tax credit (FTC) is to prevent double taxation of the same income by both the United States and a foreign country. Although these rules may never be truly simple, action can be taken to temper the extraordinary complexity of the current regime. At a minimum, Congress should act to: consolidate the separate baskets of income for businesses that are either starting up abroad or that constitute small investments; and, eliminate the alternative minimum tax credit limitations on using the FTC. Accelerating the effective date of the look-through rules for dividends from so-called 10/50 companies should also be considered.

Simplify application of Subpart F—In general, 10-percent or greater U.S. shareholders of a controlled foreign corporation (CFC) are required to include certain income of the CFC (Subpart F income) in current income. The Subpart F rules were created almost four decades ago, and sorely need updating to deal with today's global economy in which companies are centralizing their services, distribution, invoicing, and often manufacturing operations. Substantial simplification could be achieved through basic measures, including exempting smaller taxpayers or smaller foreign investments from the Subpart F rules; excluding foreign base company sales and services income from current taxation; and treating European Union member states as a single country for purposes of the same-country exception.

Limit application of the passive foreign investment company rules—In 1997, the passive foreign investment company (PFIC) rules were simplified by eliminating the CFC–PFIC overlap and allowing a mark-to-market election for marketable stock. However, a great deal of complication remains, 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.

Repeal the collapsible corporation provisions—The repeal of the General Utilities doctrine in 1986 rendered IRC section[BM16] 341 redundant. It is deadwood and should be repealed. As an additional incentive, its repeal would result in the interment [BM17]of the longest sentence in the Internal Revenue Code

The AICPA and our professional colleagues will continue to develop additional simplification recommendations and to refine the recommendations detailed above.

CONCLUSION

I would like to again stress that NOW is the time to enact meaningful tax simplification relief. Congress must take advantage of the unique opportunity presented by a budget surplus in a year when broad support exists for tax relief. In allocating the limited resources available for tax relief, Congress must give priority attention to fixing structural problems, focusing on areas troubling large numbers of taxpayers, and avoiding the further harm of adding complexity to the tax system.

I greatly appreciate this opportunity to share the AICPA's views and thoughts with you today. As always, the AICPA stands ready to provide whatever assistance and support this Committee may find helpful in its critical task of simplifying our tax laws.

APPENDIX A

February 12, 2001

Hon. PAUL H. O'NEILL,
Secretary,
Department of the Treasury,
1500 Pennsylvania Avenue, NW,
Washington, DC.

Dear Mr. Secretary:

The Tax Division of the American Institute of Certified Public Accountants, the American Bar Association Section of Taxation, and Tax Executives Institute joined forces several years ago to advance a goal that each organization had promoted separately for decades—tax simplification. Over time the need for tax simplification has become more pressing and, in our collective judgment, the income tax system has now reached a critical juncture.

American taxpayers have lost not only the ability to understand and comply with the law without expending considerable resources, but also respect for a tax system that increasingly makes them victims of its unintended consequences and outdated or ill-conceived policies. This cannot help but reduce compliance, increase the cost and complexity of administering the tax system, and undermine the public's general confidence in government. Simplification is not merely an ideal to be sought but never achieved; in our view, it is an economic, political, and even moral imperative.

The Bush Administration and Congress have an historic opportunity to reverse course—to move beyond paying lip service to tax simplification to making it a real part of each tax proposal that is enacted. Given the projected budget surplus, the growing consensus that major tax legislation will be enacted this year, and the Joint Committee on Taxation's forthcoming staff report on tax simplification, we believe the time is right for simplification. We urge this Administration and Congress to seize every possible opportunity to promote tax simplification and to begin to repair the problems that have developed in the tax law. Our organizations stand ready to assist in this endeavor.

Enclosed is our joint statement outlining our top recommendations for simplifying the tax law, including recommendations regarding the alternative minimum tax, phase-outs for deductions and credits, and capital gains, along with more detailed suggestions for legislative change. The list of recommendations certainly is not exhaustive. Action in these areas will, however, significantly reduce complexity for individual and business taxpayers alike, will make the system more responsive to taxpayer needs, and will streamline and improve administration of the income tax, al-

lowing some of the public and private sector resources currently devoted to tax matters to be redeployed.

We are directing this letter to you at this time because of your expressed interest in tax simplification. As the tax legislation moves forward this year, we also will be continuing our discussions with members of Congress and congressional committees interested in tax simplification and with your Office of Tax Policy. Please feel free to contact us if there are questions. Once again, we look forward to being of assistance in this process.

Sincerely,

PAMELA J. PECARICH, *Chair*
American Institute of Certified Public Accountants, Tax Executive Committee.

RICHARD M. LIPTON, *Chair*
American Bar Association, Section of Taxation.

BETTY M. WILSON, *President,*
Tax Executives Institute.

cc: Mark A. Weinberger, Department of the Treasury
Pamela F. Olson, Department of the Treasury

Enclosure: "10 Ways to Simplify the Tax Code, a Joint Initiative of the ABA Tax Section, TEI and AICPA," along with Tax Simplification Recommendations

APPENDIX A: ABA/AICPA/TEI TAX SIMPLIFICATION RECOMMENDATIONS (SUBMITTED FEBRUARY 25, 2000)

The American Bar Association Section of Taxation, the AICPA Tax Division, and the Tax Executives Institute believe that simplification of the tax laws should be a high priority for Congress. In an effort to assist in the process of simplifying the tax laws, we respectfully submit the following simplification recommendations.*

Alternative Minimum Tax (AMT)

Repeal the individual AMT. It no longer serves the purpose for which it was enacted, produces enormous complexity, and has unintended consequences. 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 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 95 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 ill consequences since 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.

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.

Phase-outs

Eliminate or rationalize 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.

There is no consistency among the phase-outs 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, 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. Affected taxpayers understandably react in anger upon discovering that they have lost either wholly or partially itemized deductions, personal exemptions, or credits. Simplicity would be achieved by (a) eliminating phase-outs altogether, (b) substituting cliffs for the phase-outs, or (c) providing consistency in the measure of income, the range of phase-out, and the method of phase-out.

Capital Gains Provisions

Simplify the taxation of capital gains. The capital gains regime applicable to individuals is excessively complex. The system imposes difficult record-keeping burdens on taxpayers. The significant differences in rates encourages taxpayers to engage in transactions such as investments in derivatives or short sales in order 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 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 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.

Family Status Issues, including the Earned Income Credit

Simplify and harmonize the definitions and qualification requirements associated with filing status, dependency exemptions, and credits. Complexity in family status issues arises because family status 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. The provisions 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. To that end, we recommend the following changes:

1. Create a safe harbor test for determining eligibility for the dependency exemption, head of household (HOH) status, earned income credit (EIC), child credit, and child and dependent care credit, permitting the custodial parent or guardian of a child to claim these tax benefits. This would lessen the intrusiveness of audits on eligible taxpayers while targeting cases of fraud or abuse. In most cases, custody can be demonstrated by court orders, separation agreements, or government or private agency placements. Retain the ability of the custodial parent or guardian to consent to transfer the dependency exemption to the noncustodial parent (or other third party).

2. Create a safe harbor test for the AGI tie-breaker rule under the EIC (IRC 32(c)(1)(C)). Absent fraud, the custodial parent or guardian of a qualifying child

would be deemed to maintain a separate principal place of abode with that child and would be eligible therefore to claim the EIC, regardless of what other adult also resides in that residence.

3. Modify the definition of foster child for five purposes: dependency exemption, HOH status, EIC, child credit, and child and dependent care credit. The revision would require foster children to live in the same principal place of abode with the taxpayer for more than one-half the year (as opposed to a full year under current law).

4. Define "earned income for EIC purposes as taxable wages (Form 1040, Line 7) and self-employment income (Form 1040, Line 12, less Form 1040, Line 27).

5. Deny the EIC to taxpayers whose foreign earned income exceeds $2,200 (adjusted for inflation) or whose AGI exceeds earned income by more than $2,200 (adjusted for inflation), excluding taxable social security, pensions, and unemployment compensation (items easily taken from the face of the tax return).

6. Apply one standard for qualification as a dependent child and head of household status that combines support with the cost of maintaining a taxpayer's household. Use the same terminology in each statute to refer to this expanded support concept.

7. Provide that certain government benefits (food stamps, Section VIII housing subsidy, payments under the Temporary Assistance to Needy Families program, child's social security benefits) do not count against the custodial parent in determining "expanded support for purposes of the dependency exemption, HOH, and the child and dependent care credit.

8. Repeal the Child Tax Credit (IRC §24); replace it by increasing the amount of the dependency exemption and expanding the child and dependent care credit.

9. Establish a uniform credit rate for the child and dependent care credit; remove or adjust for inflation the limitation of dependent care expenses eligible for the credit; and make the credit refundable. Remove (or increase) the $5,000 limit (whether joint, HOH, or single) on dependent care expenses eligible for exclusion (pre-tax treatment by the employer).

10. Extend HOH 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 will be targeted primarily to those taxpayers who do not itemize deductions. The proposal also encourages the payment of child support and removes the incentive for fraud or noncompliance under other family status provisions.

11. Conform the treatment of married filing separately taxpayers under family status provisions to the treatment of similarly situated joint/single/head of household taxpayers, unless a clear, overriding policy reason exists for the different treatment.

Estimated Tax Safe Harbors

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 (a) 90 percent of the tax actually due for the year or (b) 100 percent of the tax due for the immediately prior year. The availability and computation of the prior year safe harbor has been adjusted by Congress repeatedly during the past decade. Currently, for individuals with adjusted gross income exceeding $150,000, the prior year safe harbor percentage increases and decreases from year to year. The percentage was 105 last year, increases to 108.6 in this year, and will increase in the future to 112 percent. The purpose of these changes 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. An appropriate safe harbor percentage (perhaps 100%) should be determined and applied 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.

Extenders

Make the so-called extenders package permanent. 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 and, in many cases, undermines the policy reasons for enacting the incentives in the first place. This is so be-

cause 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.

Education Incentives

Harmonize and simplify education incentives. In today's tax structure, there are eight different education incentive provisions," including tuition credits, Education IRAs, state deductible tuition programs, limited interest deductions, and employer provided assistance programs. In addition, we note with dismay that a number of changes to and expansions of these programs, as well as the establishment of new education incentives, were recently proposed in the Administration's FY 2001 Budget. The various provisions contain numerous and differing eligibility rules. For many taxpayers, analysis and application of the intended incentives are too cumbersome to deal with compared with the benefits received.

For example, eligibility for one of the two education credits depends on numerous factors including the academic year in which the child is in school, the timing of tuition payments, the nature and timing of other eligible expenditures, and the adjusted gross income level of the parents (or possibly the student). Further, in a given year a parent may be entitled to different credits for different children, while in subsequent years credits may be available for one child but not another. Both types of credits are dependent on the income levels of the parents or the child attempting to claim them. Further complicating the statutory scheme, the Code precludes use of the Lifetime or Hope Credit if the child also receives tax benefits from an Education IRA. Although the child can elect out of such benefits, this decision also entails additional analysis.

An additional complicating factor is the phase-out of eligibility based on various AGI levels in five of the eight provisions. This requires taxpayers to make numerous calculations to determine eligibility for the various incentives. Since there are so many individual tests that must be satisfied for each benefit, taxpayers may inadvertently lose the benefits of a particular incentive because they either do not understand the provision or because they pay tuition or other qualifying expenses during the wrong tax year.

Separately, college graduates are entitled to deduct a portion of any interest paid on student loans. The amount deducted is limited or eliminated when AGI exceeds certain thresholds. These phase-out thresholds are different from the Credit and Education IRA thresholds.

Possible measures for simplifying the tax benefits for higher education include:

1. Combine both credits into one.
2. Simplify the definition of "student."
3. Establish a single amount eligible for the credit.
4. Eliminate or standardize the income ranges required for eligibility.
5. In lieu of the credits, grant additional exemption amounts to taxpayers who qualify for the credit under current law.
6. Ease the requirements for interest deduction and coordinate the phase-out amounts with other education incentives.
7. Replace current tax benefits with a new universal education deduction or credit, i.e., develop one or two education-related deductions or credits to replace the myriad current provisions.

Capitalization, Expensing, and Recovery of Capitalized Costs

Provide clear rules governing the expensing, capitalization, and recovery of capitalized costs. Since the Supreme Court's decision in INDOPCO v. Commissioner, 503 U.S. 79 (1992), whether a particular expense may be deducted or must be capitalized has become a particularly troublesome issue for businesses. The National Taxpayer Advocate has confirmed that capitalization issues are a major cause of controversy for business taxpayers, identifying them as the most litigated issue in his 1998 Report to Congress. The language of 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. The core inquiry is whether an expenditure produces a "future benefit." Expenditures producing "incidental future benefits" remain deductible, but determining whether there is a future benefit and, if so, whether it is incidental is rarely obvious or easy. It is imperative that this enormous drain on both Government and taxpayer time and resources be alleviated by developing objective, administrable tests governing the deduction of recurring or routine business expenses or the capitalization of clearly defined categories of expenditures.

Half-Year Age Conventions

Change the half-year age conventions for retirement plan distributions to full-years. The Code 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 age 701/2. It also provides that plan benefits may not be distributed before certain stated events occur, including attainment of age 591/2. Further, premature distributions from a qualified retirement plan, including most in-service distributions occurring before an employee's reaching age 591/2, are subject to an additional 10-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 701/2 and to 59 from 591/2 would have a significant simplifying effect.

Minimum Distribution Requirements

Modify the minimum distribution rules. The tax rules concerning retirement plan distributions (especially the minimum distribution requirements of IRC §401(a)(9)) are among the most complex in the Code and present numerous traps for the unwary. To avoid a possible 50-percent penalty where a distribution is less than the required minimum, all but the most sophisticated taxpayers must seek professional help to navigate the maze of complicated rules (involving, among other things, the potential for requiring an annual recalculation of the minimum distribution, based on a taxpayer's changing life expectancy from year to year). Further, an ever-growing percentage of Americans are now in or approaching their retirement years, and untold millions of IRA and 401(k) accounts (in addition to traditional pension accounts) will become subject to these rules. Simplification is badly needed.

Although the minimum distribution rules are intended to preclude the unreasonable deferral of benefits, they are not truly needed inasmuch as benefits deferred are subject to income taxation upon eventual distribution and may be subject to estate taxation on a participant's death. Thus, the provisions of IRC §401(a)(9), other than those dealing with the required start date for distributions, should be replaced with the incidental death benefit rule in effect prior to the enactment of ERISA.

Worker Classification

Replace the 20-factor common law test for determining 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, 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. Nor do the factors 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. The relief afforded by legislative safe harbors is limited to employment taxes. This complex and highly uncertain determination should be eliminated and replaced with a more objective test applicable 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.

Attribution Rules

Harmonize 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 those reasons justify the complexity they create. The attribution rules should be reexamined in light of their underlying concerns with the objective of harmonizing and standardizing them. Further reexamination may permit the development of a single, uniform set of rules. Even without reexamination, they could be simplified by standardizing throughout the Code how the ownership percentages apply, i.e., whether the percentage under a particular attribution rule is "equal to" or "greater than."

Foreign Tax Credit Rules

Simplify the foreign tax credit. The core purpose of the foreign tax credit (FTC), which has been part of the Code for more than 80 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 com-

plex. The nine separate baskets for allocating income and credits set forth in section 904(d)(1) are especially complicated to apply, particularly for small businesses. (The basket regime is intended to prevent inappropriate averaging of high- and low-tax earnings.)

These 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 act to (a) consolidate the separate baskets for businesses that are either starting up abroad or that constitute small investments; and (b) eliminate the alternative minimum tax credit limitations on the use of the FTC.

In addition, consideration should be given to 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 10 and 50 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, a separate "super" FTC basket is required to be maintained for dividends that are received after 2002 but 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. The "super" basket should be eliminated and the effective date of the look-through rule accelerated.

Subpart F

Simplify application of Subpart F. In general, 10-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 to tax passive income or income that is readily moveable from one taxing jurisdiction to another, for example, to take advantage of low rates of tax. Since the Subpart F rules were enacted in 1962, they have been amended several times to capture more and more categories of active operating income. Nevertheless, income of a CFC may be excepted from taxation under the Subpart F provisions under various "same-country" exceptions. 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 were created almost four decades ago. They 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, as well). 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 can 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.
3. Treat countries of the European Union as a single country for purposes of the same-country exception.

PFIC Rules

Limit application of the PFIC rules. In 1997, the passive foreign investment company ("PFIC") rules were simplified by the elimination of the controlled foreign corporation-PFIC overlap and by allowing 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.

Collapsible Corporation

Repeal the collapsible corporation provisions. The repeal of the General Utilities doctrine in 1986 rendered IRC §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 IRC §341, it is now deadwood and should be repealed. Its repeal would result in the interment of the longest sentence in the Code.

*These Recommendations are presented on behalf of the Section of Taxation. They have 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 policies of the Association.

APPENDIX B - Selected AGI Phaseout Amounts

IRC Section	Provision	Foot-note	Current - Joint	Current - Single & HOH	Current - Married/Sep.	*Proposed - Joint*	*Proposed - Single & HOH & MFS*
PHASEOUT LEVELS FOR *LOW-INCOME TAXPAYERS*							
21	30 Percent Dependent Care Credit	(3)	$10,000-$28,000	$10,000-$28,000	No credit	*$15,000-$37,500*	*$7,500-$18,750*
22	Elderly Credit	(4,10)	$10,000-$25,000 or $20,000	$7,500-$17,500	$5,000-$12,500	*$15,000-$37,500*	*$7,500-$18,750*
32	EITC (No Child)	(2,3, 4)	$5,800-$10,380	$5,800-$10,380	No credit	*$15,000-$37,500*	*$7,500-$18,750*
32	EITC (1 Child)	(2,3, 4)	$12,700-$27,413	$12,700-$27,413	No credit	*$15,000-$37,500*	*$7,500-$18,750*
32	EITC (2 or More Children)	(2,3, 4)	$12,700-$31,152	$12,700-$31,152	No credit	*$15,000-$37,500*	*$7,500-$18,750*
PHASEOUT LEVELS FOR *MIDDLE-INCOME TAXPAYERS*							
86	Social Security Benefits - 50% Taxed	(1)	$32,000-$44,000 (base amount)	$25,000-$34,000 (base amount)	$0 (base amount)	*$60,0000*	*$30,000*
86	Social Security Benefits 85% Taxed	(1)	$44,001- (base amount)	$34,001- (base amount)	$0 (base amount)	*$60,000*	*$30,000*
219	IRA Deduction with retirement plan	(1,9, 11)	$52,000-$62,000	$32,000-$42,000	$0-$10,000	*$60,000-$75,000*	*$30,000-$37,500*
221	Education Loan Interest Expense	(1,2,6)	$60,000-$75,000	$40,000-$55,000	No deduction	*$60,000-$75,000*	*$30,000-$37,500*
IRC Section	Provision	Foot-note	Current - Joint	Current - Single & HOH	Current - Married/Sep.	*Proposed - Joint*	*Proposed - Single & HOH & MFS*
PHASEOUT LEVELS FOR *HIGH-INCOME TAXPAYERS*							
24	Child Credit	(1,5,6)	$110,000-	$75,000-	$55,000-	*$225,000-$450,000*	*$112,500-$225,000*
25A	Hope Credit & Lifetime Learning Credit	(1,2,6)	$80,000-$100,000	$40,000-$50,000	No credit	*$225,000-$450,000*	*$112,500-$225,000*
23 & 137	Adoption Credit/ Exclusion	(1)	$75,000-$115,000	$75,000-$115,000	No benefit	*$225,000-$450,000*	*$112,500-$225,000*
55(d)	AMT Exemption	(1,8)	$150,000-	$112,500-	$75,000-	*$225,000-*	*$112,500-*

			$330,000	$247,500	$165,000	*$450,000*	*$225,000*
68	Itemized Deduction Level	(2)	$128,950-	$128,950-	$64,475-	*$225,000- $450,000*	*$112,500- $225,000*
135	EE Bond Interest Exclusion	(1,2)	$81,100- $111,100	$54,100- $69,100	No exclusion	*$225,000- $450,000*	*$112,500- $225,000*
151	Personal Exemption	(2)	$193,400- $315,900	$128,950- $251,450 HOH$161,150 -283,650	$96,700- $157,950	*$225,000- $450,000*	*$112,500- $225,000*
219(g) (7)	IRA w/spouse w/retirement plan	(1,6,11)	$150,000- $160,000	Not applicable	No deduction	*$225,000- $450,000*	*$112,500- $225,000*
408A	Roth IRA Deduction	(1,6)	$150,000- $160,000	$95,000- $110,000	$0-$10,000	*$225,000- $450,000*	*$112,500- $225,000*
408A	IRA to Roth IRA Rollover	(1,6)	$100,000	$100,000	No rollover	*$225,000*	*$112,500*
469(i)	$25,000 Rent Passive Loss	(1)	$100,000- $150,000	$100,000- $150,000	$50,000- $75,000	*$225,000- $450,000*	*$112,500- $225,000*
469(i)	Passive Rehabilitation Credit	(1)	$200,000- $250,000	$200,000- $250,000	$100,000- $125,000	*$225,000- $450,000*	*$112,500- $225,000*
530	Education IRA Deduction	(1,6)	$150,000- $160,000	$95,000- $110,000	No deduction	*$225,000- $450,000*	*$112,500- $225,000*

Footnotes: (1) Modifications to AGI apply; (2) Inflation indexed; (3) Earned income limitations; (4) Low income only; (5) Phaseout range depends on number of children; (6) Enacted in 1997; (7) Not Used; (8) Phaseout applies to alternative minimum taxable income rather than AGI; (9) Increases for future years are specifically provided in the statute; (10)Larger phaseout if both spouses eligible; (11)Depends on if spouses lived apart during entire year

APPENDIX B CONTINUED - Current Method of Phaseout

Code Section(s)	Tax Provision	Current Methodology for Phaseouts Application
21	Dependent Care Credit	Credit percent reduced from 30 percent to 20 percent in AGI range noted by 1 percent credit for each $2,000 in income
22	Elderly Credit	Credit amount reduced by amount of excess over AGI range
23 & 137	Adoption Credit & Exclusion	Benefit reduced by excess of modified AGI over lowest amount noted divided by $40,000
24	Child Credit	Credit reduced by $50 for each $1,000 in modified AGI over lowest amount noted
25A	Education Credits (Hope/Lifetime Lrng)	Credits reduced by excess of modified AGI over lowest amount divided by $10,000 (single) and $20,000 (joint)
32	Earned Income Credit	Credit determined by earned income and AGI levels
55	AMT Exemption	Exemption reduced by 1/4 of AGI in excess of lowest amount noted
68	Itemized Deductions	Itemized deductions reduced by 3 percent of excess AGI over amount noted
86	Social Security Benefits	Benefits taxed when modified AGI plus half social security benefits exceeds the base amount
135	Series EE Bonds	Excess of modified AGI over lowest amount divided by $15,000 (single), $30,000 (joint) reduces excludable amount
151	Personal Exemption	AGI in excess of lowest amount, divided by $2,500, rounded to nearest whole number, multiplied by 2, equals the percentage reduction in the exemption amounts
219	Traditional IRA w/ Retirement Plan	Individual retirement account (IRA) limitation ($2,000/$4,000) reduced by excess of AGI over lowest amount noted divided by $10,000
219(g)(7)	IRA w/Spouse w/ Retirement Plan	Deduction for not active spouse reduced by excess of modified AGI over lowest amount noted divided by $10,000
221	Education Loan Interest Expense Deduction	Deduction reduced by excess of modified AGI over lowest amount noted divided by $15,000
408A	Roth IRA	Contribution reduced by excess of modified AGI over lowest amount noted divided by $15,000 (single) and $10,000 (joint)
408A	IRA Rollover-Roth IRA	Rollover not permitted if AGI exceeds $100,000 or if MFS
469(i)	Passive Loss Rental $25,000 Rule	Benefit reduced by 50 percent of AGI over lowest amount noted
530	Education IRA Deduction	Contribution reduced by excess of modified AGI over lowest amount noted divided by $15,000 (single) and $10,000 (joint)

Appendix C **Highlights of Tax Benefits for Higher Education**

Do not rely on this chart alone. It provides only general highlights of some of the differences among the benefits covered in this publication. See the text for definitions of terms and for more complete explanations.

Caution: No double benefits are allowed. See the footnotes.

	Hope credit (Education credit)	Lifetime learning credit (Education credit)	Education IRA[1]	Traditional and Roth IRAs[1]	Interest Paid on Student Loans	Qualified State Tuition Programs	Qualified U.S. Savings Bonds[1]	Employer's Educational Assistance Program[1]
What is your benefit?[2]	Tax credit (nonrefundable)		Withdrawals are tax free	No 10% additional tax on early withdrawal	Deduction to arrive at adjusted gross income	Prepay future tuition expenses	Interest is excludable from income	Employer benefits are excludable from income
What is the annual limit?	Up to $1,500 per student	Up to $1,000 per family	$500 contribution per child under 18	Amount of qualifying expenses	1998: $1,000 1999: $1,500 2000: $2,000 2001: $2,500	None	Amount of qualifying expenses	$5,250
What expenses qualify besides tuition and required enrollment fees?[2]	N/A		Books, supplies, & equipment; Room and board if at least half-time attendance; Payments to qualified state tuition program	Books, supplies, & equipment; Room and board if at least half-time attendance	Books, supplies, & equipment; Room and board; Transportation; Other necessary expenses	Books, supplies, & equipment; Room and board if at least half-time attendance	Payments to qualified state tuition programs; Payments to education IRAs	Books, supplies, & equipment
What education qualifies?	1st 2 years of undergraduate	All undergraduate and graduate levels						Undergraduate level
What other conditions apply?	Can be claimed only for 2 years; Must be enrolled at least half-time in a degree program	Applies to expenses paid an for school attendance after June 20, 1998	Contributions not deductible; Cannot also contribute to qualified state tuition program or claim an education credit; Must withdraw assets at age 30	Must receive entire balance or begin receiving withdrawals by April 1 of year following year in which age 70½ is reached	Applies to the 1st 60 months' interest; Must be enrolled at least half-time in a degree program	Tax-deferred earnings are taxed to beneficiary when withdrawn	Applies only to qualified series EE bonds issued after 1989 or series I bonds	Cannot also claim an education credit; Expires for courses beginning after May 31, 2000
At what income range do benefits phase out?	$40,000-$50,000 $80,000-$100,000 for joint returns		$95,000-$110,000; $150,000-$160,000 for joint returns	N/A	$40,000-$55,000; $60,000-$75,000 for joint returns	N/A	1999: $53,100-$68,100; $79,650,-$109,650 for joint returns	N/A

[1] Any nontaxable withdrawal is limited to the amount that does not exceed qualifying educational expenses.

[2] You must generally reduce qualifying educational expenses by any tax-free income. You generally cannot use the same educational expense for figuring more than one benefit.

Appendix D

The real cost of hidden tax traps.

Stealth Taxes

BY RICHARD BOES AND GARY R. WELLS

Surprise!

- IRS statistics confirm that more people are falling victim to the alternative minimum tax and other unexpected taxes.
- Nearly 4.5 million upper-income taxpayers were hit by the itemized deduction limitation in 1997, up 10.5% from 1996.
- Itemized deductions lost to the phase-out rules amounted to $22.7 billion, up 20% from 1996.
- Another 590,649 individuals were subject to the alternative minimum tax for 1997, up sharply from only 132,103 in 1990.
- Source: IRS.

Tax planning is only as valuable as the quality of information used to make projections. When a CPA helps a client assess the tax cost or benefit of a proposed transaction, the client's marginal tax rate is generally considered the rate to apply. However, finding the correct marginal rate for tax planning purposes is not always easy.

CPAs frequently use the bracket rates of 15%, 28%, 31%, 36% and 39.6% as marginal rates. While they may be the right ones, incorrect use of these rates may lead CPAs to make erroneous conclusions because of increasingly common stealth or backdoor taxes—making the correct marginal tax rate difficult to find. At the same time, rising incomes subject more taxpayers to these hidden taxes, and the alternative minimum tax increases the challenge of finding the correct marginal rate.

The CPA's task is made doubly difficult because the provisions governing these hidden taxes are not uniform and taxpayers won't know their actual income until yearend. The more knowledgeable a CPA is about the nuances of the tax law, the greater the likelihood of using the correct marginal rate in tax planning and of being able to warn clients of the potential tax costs they face in advance.

BEWARE OF STEALTH TAXES

This article has four case studies to illustrate how improper reliance on the bracket rates can lead to incorrect conclusions. In some, the errors are small; in others, they are more dramatic. While all four

cases are based on year 2000 tax rates, taxpayers will experience nearly identical problems with 2001 rates. Unless otherwise indicated, the taxpayer is assumed to be filing a joint return using the standard deduction. About 70% of all individual taxpayers take the standard deduction, including a number of upper-income taxpayers.

Case 1. Brian wants to know the tax cost of selling an investment that will result in a $30,000 capital gain. Assume he will report the following income for the year if he does not sell the investment:

Adjusted gross income		$79,100
Standard deduction	$ 7,350	
Exemptions (4 @ $2,800)	11,200	(18,550)
Taxable income		$60,550
Total tax		$11,254

Brian cashed in $6,000 of series EE bonds to pay his dependent daughter's qualified higher education expenses in 2000. The $6,000 consists of $2,000 of interest and $4,000 of principal.

A simple analysis of these facts suggests Brian is in the 28% marginal tax bracket, since an additional $30,000 of gross income will not move him into a higher bracket. However, selling the investment will presumably result in $30,000 of capital gain income. Thus, a CPA's first question in determining Brian's correct marginal tax rate is whether the investment holding period is short-term or long-term. If it is short-term (one year or less), the marginal tax rate is 28%. However, if Brian has held the investment longer than one year, the situation is trickier. The tax rate on the gain could be either 28%, 25%, or 20% (and in a few years, possibly 18% on capital assets purchased after December 31, 2000 and held over five years) or a combination thereof.

Brian's minimum marginal tax rate on the gain is 20%—the normal rate on long-term capital gains. His maximum marginal rate is 28%. This rate will apply if the gain is either short-term or a long-term gain arising from the sale of a "collectible" or an IRC section 1202 gain, which results from sales of certain small business stock. A 25% rate will apply to any portion of the gain that represents IRC section 1250 unrecaptured income. The 28% rate will also apply to any ordinary income recapture. Hence, the marginal tax on the gain could range from 20% to 28%, resulting in an increase in tax from $6,000 to $8,400.

But there is another, hidden tax. Before the sale, the $2,000 of interest on the series EE bonds was fully excluded from Brian's income under IRC section 135 and thus not reflected in the above numbers. The gain from the sale of the investment will cause Brian to lose all of this exclusion due to phase-outs in section 135. The tax rate on the interest income will thus rise from 0 to 28%. Hence, there is a $560 hidden tax, making the final tax cost of selling the investment anywhere from $6,560 to $8,960.

Case 2. Jordan, who is married and has one dependent, wants to know the tax cost of selling a stock that will result in a $15,000 gain. If she does not sell the stock Jordan will report the following:

Adjusted gross income			$58,000
Itemized deductions			
Medical	$5,000		
Less: 71/2% of AGI	(4,350)	$ 650	
Taxes		2,600	
Mortgage interest		3,750	
Charitable contributions		1,000	
Miscellaneous	$1,500		
Less: 2% of AGI	(1,160)	340	(8,340)
Exemptions (3 @ $2,800)			(8,400)
Taxable income			$41,260
Total tax			$ 6,189

Jordan also incurred $2,000 of interest on a loan that she used to pay her spouse's qualifying educational expenses under IRC section 221. As in case 1 above, the sale of the stock will result in a capital gain. Since the asset is stock, CPAs can ignore the added complexity of the collectibles and unrecaptured section 1250 gain rules. For a short-term gain, on naive first glance one might conclude that $2,590 of the gain should be taxed at 15% ($43,850 tax bracket breakpoint less $41,260 of taxable income), with the $12,410 balance taxed at 28%. This will result in $3,863 of additional tax, with an effective or average rate of 25.8% on the gain. Similarly, if the gain is long term, one might conclude that $2,590 of it should be taxed at 10%, with $12,410 taxed at 20%. This will result in $2,741 of additional tax, with an effective rate of 18.3%.

But hidden taxes come into play once again. The $2,000 of interest on the education loan is initially fully deductible for or toward AGI under section 221. However, with an additional $15,000 of income, this deduction is completely phased out. This phase-out—in conjunction with the capital gain—increases Jordan's AGI by $17,000. As a result, she now loses the medical expense and miscellaneous itemized deductions. Thus, if Jordan sells the stock, she and her husband will report:

AGI (58,000 + 2,000 + 15,000)			$75,000
Itemized deductions			
Medical	$5,000		
Less: 71/2% of AGI	(5,625)	$ 0	
Taxes		2,600	
Mortgage interest		3,750	
Charitable contributions		1,000	
Miscellaneous	$1,500		
Less: 2% of AGI	(1,500)	0	(7,350)
Exemptions (3 @ 2,800)			(8,400)
Taxable income			$59,250
Total tax (Short-term gain)			$10,890
Total tax (Long-term gain)			$ 9,690

If the gain is short-term, the actual tax increase will be $4,701 ($10,890-- $6,189), which is $838 higher ($4,701-- $3,863) than the earlier analysis. This results in an effective or average rate of 31.3% on the capital gain. The total tax due on a long-term gain is computed by applying the regular rates to the $44,250 of ordinary income ($59,250 taxable income less the $15,000 capital gain) and then adding 20% of the $15,000 long-term gain. The $9,690 total tax is $3,501 higher ($9,690 -- $6,189) than the total tax before the $15,000 gain was recognized, for an effective rate of 23.3% on the capital gain. The actual tax is $760 higher ($3,501 -- $2,741) than the initial analysis suggested since the capital gain resulted in the loss of the medical expense, miscellaneous and interest deductions.

In both examples so far, the hidden taxes involve deductions. When the backdoor taxes involve credits, tax costs escalate quickly, as illustrated in case 3.

Case 3. Morty is facing large educational expenses for his children and himself. He wants to know the tax cost of selling some stock to help pay these expenses. Morty has held the stock for more than one year and will have a $20,000 gain. He and his wife have two children attending college, both of whom meet the requirements to qualify for the maximum Hope Scholarship Credit (100% of the first $1,000 of qualifying educational expenses plus 50% of the next $1,000 to a maximum of $1,500). Morty himself incurred $1,000 of educational costs that qualify for the Lifetime Learning Credit (20% of up to $5,000 in qualifying expenses, to a maximum credit of $1,000). If they do not sell the stock Morty and his wife will report the following:

Adjusted gross income		$80,000
Standard deduction	$ 7,350	
Exemptions (4 @ 2,800)	11,200	(18,550)
Taxable income		$61,450
Total tax before credits		$11,506

Hope Scholarship and Lifetime Learning Credits	(3,200)
Net tax	$ 8,306

Since Morty is already in the 28% tax bracket, a quick analysis might lead to the conclusion that the tax due on the long-term capital gain will be $4,000 (20,000 X 20%). However, the gain will totally phase out the education credits. Hence, the increase in tax will be $7,200 (4,000 + 3,200) for an effective rate of 36% on the capital gain—16 percentage points higher than usual. Morty might find that borrowing money to pay for the education costs is more prudent than selling his stock. Or he might examine his portfolio to see if he can sell stock with a smaller gain.

Morty and his family have another option. IRC section 25A suggests that if a student qualifies as another taxpayer's dependent, only the parents (or supporting taxpayer) can claim the Hope Scholarship credit, not the student. However, proposed regulation section 1.25A-1(g) says, "if the taxpayer is eligible to, but does not claim the student as a dependent, only the student may claim the education credit for the student's qualified tuition and related expenses."

Thus, if Morty is willing to forego the dependency exemptions, apparently his children can claim the Hope Scholarship credits on their own returns. Dropping the students as dependents will carry an additional tax cost of $1,568 ($5,600 X 28%), bringing the total cost of the capital gain to $8,768. But each child can then potentially claim a $1,500 credit for a net family cost of $5,768—better than the $7,200 above. Unfortunately, the students' tax liabilities may not be large enough to allow the full use of the credits, since they are not refundable.

Case 4. Gwen and Tom are married with six children. They are scheduled to report the following:

Adjusted gross income		$193,400
Standard deduction	$ 7,350	
Exemptions (8 @ $2,800)	22,400	(29,750)
Taxable income		$163,650
Gross tax liability		$ 41,963

Under these circumstances, any additional income will force the couple into the phase-out area for personal and dependency exemptions. Higher taxes would result. Suppose the couple unexpectedly receives a $1 dividend from a stock they own. Although the couple is in the 36% tax bracket, the dividend pushes them over the phase-out threshold, making the marginal tax rate on the dividend an astounding 16,100%, not 36%, as the following analysis shows.

Adjusted gross income		$193,401
Standard deduction	$ 7,350	
Exemptions	21,952	(29,302)
Taxable income		$164,099
Gross tax liability		$ 42,124
Increase in tax:		$ 161

The $1 dividend forces the couple into the phase-out area for exemptions. The amount of exemptions lost is computed as follows:

Adjusted gross income		$193,401
Threshold		(193,400)
Excess		1
Divide excess by 2,500 (1 / 2,500) =.0004		
Round up to next whole number = 1		
Times 2 = percent lost (1 X 2%)	2%	
Normal exemptions (8 X 2,800)		$ 22,400

Amount lost (22,400 X 2%)	(448)
Allowed exemptions	$ 21,952

There would have been both good and bad news if Gwen and Tom had one more dependent (nine in total). In that case, their income level would make them subject to the AMT. The bad news is that the AMT is higher than the regular tax. The good news is the couple would owe only another $.26 in tax on the $1 dividend (for a 26% marginal rate):

	Regular Tax	AMT
Adjusted gross income	$193,401	$193,401
Standard deduction	(7,350)	none
Modified exemptions	(24,696)	(34,150)
Taxable income	$161,355	$159,251
Gross tax liability	$ 41,141	$ 41,405

When clients are not subject to the AMT, it will clearly pay for them to come up with a small deduction for or toward AGI. CPAs should watch for tax planning strategies as taxpayers approach various phase-out areas that will trigger hidden taxes. (Note: See Appendix B of the earlier testimony for some important phase-outs CPAs should keep an eye on.)

STEER CLEAR OF PHASE-OUTS

As these cases illustrate, hidden taxes and the AMT can wreak havoc on the expected tax cost of a transaction vs. the actual or true cost. CPAs should check to see if phase-outs apply to a taxpayer's situation and suggest appropriate tax planning strategies. These could include postponing planned transactions that will trigger phase-outs, qualifying the transaction for installment reporting or nontaxable exchange treatment or finding transactions that will generate deductions for or toward AGI to lower income levels below the phase-out thresholds.

A congressional committee says more than 9 million people will be hit by the AMT in 2009 unless Congress makes major changes. Although Congress may enact legislation to scale back or eliminate the AMT, it appears likely the hidden tax problem will continue to plague taxpayers in the future. CPAs should remain aware of the hazards and costs stealth taxes impose on unsuspecting taxpayers.

EXECUTIVE SUMMARY

- HIDDEN TAXES CAN MAKE IT DIFFICULT FOR CPAs to do accurate tax planning. Sometimes, a client's marginal tax rate is not what it might appear to be because of the alternative minimum tax, tax credits and other provisions that come into play in determining the correct tax liability.

- THE TAX RATE ON A CAPITAL GAIN COULD BE 28%, 25% or 20%, depending on the holding period and the type of asset the taxpayer sells. In some cases, however, increased income from the gain can cause a taxpayer to pay tax on income that had previously been excluded or to lose a deduction. These "hidden" taxes sharply increase the actual tax resulting from the capital gain.

- IN OTHER INSTANCES, THE EXTRA INCOME FROM a capital gain could cause a taxpayer to lose the benefits of certain tax credits, such as the Hope Scholarship Credit or the Lifetime Learning Credit. This phase-out could increase the effective tax rate on the capital gain. Under other circumstances, the AMT could cause a taxpayer to lose certain deductions, increasing his or tax liability and changing the effective tax rate on additional income.

- AS TAXPAYERS APPROACH VARIOUS PHASE-OUTS that will trigger hidden taxes, CPAs should be aware of tax planning strategies, such as postponing planned transactions, that can minimize or eliminate the impact of these taxes.

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PREPARED STATEMENT OF BETTY M. WILSON

Mr. Chairman and Members of the Committee: Good morning. I am Betty Wilson, Vice President of Taxes for MGM MIRAGE in Las Vegas. I appear today as President of Tax Executives Institute, whose 5,300 members represent the 2,800 largest companies in the United States, Canada, and Europe. I am accompanied by the Institute's General Counsel and Director of Tax Affairs, Timothy McCormally.

Mr. Chairman, thank you very much for scheduling this hearing on simplifying the Internal Revenue Code. The IRS National Taxpayer Advocate has identified the complexity of the tax laws as the number one problem facing taxpayers. As you learned earlier this month when you addressed TEI's 51st Midyear Conference, our members agree, and we applaud your efforts to give fresh impetus to the subject

of tax simplification. Thanks are also due the Majority and Democratic staffs of the Finance Committee, as well as the staff of the Joint Committee on Taxation, for their dedication and commitment to establishing an open process for identifying and addressing areas of tax law complexity.[1] I also want to acknowledge the efforts of the other organizations who are represented here today and to associate myself and TEI generally with their testimony. TEI is quite pleased to have worked closely with the American Bar Association's Section of Taxation and the American Institute of Certified Public Accountants' Tax Division to develop joint recommendations for simplifying the tax code. We firmly believe that our best chance for real simplification lies in collective, coordinated action. Finally, I want to note that, although TEI has not formally collaborated with the National Association of Enrolled Agents on tax simplification, the Institute is pleased that very important organization is also represented here today. The subject of tax simplification is too important to be considered the province of a single organization or even a group of organizations.

BACKGROUND

Tax Executives Institute was established in 1944 to serve the professional needs of in-house tax practitioners. Today, the Institute has 53 chapters in the United States, Canada, and Europe. Our more than 5,300 members are accountants, attorneys, and other business professionals who work for the largest 2,800 companies in North America and their European affiliates; they are responsible for conducting the tax affairs of their companies and ensuring their compliance with the tax laws. TEI represents a cross-section of the business community, and is dedicated to the development and effective implementation of sound tax policy, to promoting the uniform and equitable enforcement of the tax laws, and to reducing the cost and burden of administration and compliance to the benefit of taxpayers and government alike. TEI members deal with the tax code in all its complexity, as well as with the Internal Revenue Service, on almost a daily basis.

Mr. Chairman, the organizations appearing before you today are uniquely qualified to comment on the costs, burdens, and headaches of tax complexity. Our members have the expertise and experience to identify not only the problems but the possible solutions. I would note, however, that unlike the other three organizations, TEI is not an organization of tax practitioners who represent taxpayers. Rather, we are an organization of taxpayers themselves. It is our costs, our burdens, our headaches and loss of productivity that we are talking about.

THE CASE FOR TAX SIMPLIFICATION

Two years ago, Tax Executives Institute joined with the AICPA Tax Division and ABA Tax Section to draw attention to the pressing need for tax simplification. Our action was met with skepticism in some quarters because the members of our three organizations (plus the NAEA) are sometimes seen as the beneficiaries of tax complexity. "Isn't it true," we were asked, "that the more complicated the laws are, the more business you will get?" "Isn't it true that most tax laws could be subtitled 'The Tax Lawyers and Accountants Full Employment Act'?" Mr. Chairman, I assure you that I would not be here today if TEI subscribed to these views. To say that tax professionals oppose simplification because they benefit from complexity is akin to saying that doctors oppose flu shots and inoculations and the promotion of hygiene because the absence of these would be "good for business." It may be good for a laugh, but it misses the fundamental point.

The fundamental point is that tax law complexity adversely affects us all. Society as a whole is harmed by tax complexity, which can operate as a pernicious, hidden tax and as a drag on the economy. Although quantifying and measuring its precise toll is difficult, complexity exacts a very real price. Complexity not only makes it more difficult to comply, but it can regrettably widen the divide between taxpayers and their government. So, too, it can undermine the basic confidence of the public in the tax system and frustrate the congressional policies underlying particular provisions of the Code. If people cannot compute their earned income credit, if they cannot figure out whether they are eligible for one or more of the Code's myriad educational benefits, if they throw up their hands at the calculation of the alternative minimum tax or the phase out of personal exemptions, then, the system has failed

[1] This testimony was prepared without the benefit of reviewing the staff of the Joint Committee's report on tax simplification, which TEI understands will be released in conjunction with the Senate Finance Committee's April 26, 2001, hearing. TEI is committed to analyzing the Joint Committee's recommendations and submitting follow-up comments to both the staff and to the Finance Committee.

them. This is also the case in respect of corporations where the efficacy of particular incentives and the tax system itself is diminished by mind-boggling complexity.

Why simplification? Because if we do not act, the tax system may collapse of its own weight. This may sound like hyperbole, but we sincerely believe it to be true. What you cannot understand you are bound to distrust, and distrust can breed more than cynicism: It can breed a culture of noncompliance.

Why us? Because as tax professionals, TEI members and our colleagues in other organizations are well positioned to document the problems and to identify the means of dealing with them. To be sure, the companies that our members work for will strive to comply. That, after all, is our job: to deal with the Code in all its complexity. TEI recognizes that the laws governing the taxation of complex, multi-faceted, multinational business enterprises will never be simple. But they can be made a lot simpler. More to the point, the inevitable complexity of some provisions should not deter efforts to do as much as we can as quickly as we can. The groups testifying before you have identified several good targets for action that pertain to both individuals and businesses. Additionally, even though large corporations will not benefit directly from many of the recommendations contained in the joint AICPA–ABA–TEI submission, TEI supports them all. Everyone Congress, the Treasury Department and the IRS, tax professionals, and taxpayers bears responsibility for the current state of the law. Everyone has an obligation to work to make it better. TEI pledges its support for changes that will make the tax law simpler for all of us.

Why now? Because if we do not start the journey, we will never arrive at our destination. Because projected budget surpluses afford Congress greater flexibility to cut the Gordian knot of complexity than anytime in the past two decades. Because Congress and the Administration have signaled their desire to address questions of fundamental tax reform and because the opportunity is ripe for revisiting core decisions about the tax system that, despite their policy basis, have spawned bewildering and unwieldy complexities.

Mr. Chairman, TEI has no illusions that we will ever have a perfect, simple tax system, but as one of your predecessors, Russell Long, often remarked, the perfect should not be the enemy of the good. The Institute thus agrees that incremental simplification is better than no simplification. The time to begin is now.

DISCUSSION OF SPECIFIC PROPOSALS

Other witnesses on this panel have addressed some of the more vexing provisions affecting individuals, which are detailed in the joint TEI–ABA–AICPA submission. As already noted, TEI supports these recommendations. I wish now to focus on several areas where the tax law could be simplified for business taxpayers.

First, Congress can effect meaningful simplification by repealing the **corporate alternative minimum tax.** The corporate AMT suffers from the same deficiencies and structural flaws as the individual AMT. It requires taxpayers to operate in, and comply with the myriad requirements of, two separate tax systems. It creates enormous administrative burden and, through its depreciation component, discriminates against capital-intensive companies. TEI strongly believes that taxpayers should not be required to compute their taxes twice and to keep two sets of books. Equally important from a policy perspective, taxpayers should not be subject to an additional levy at the very time they can least afford it, but that is precisely what the AMT does: It kicks in when companies are increasingly challenged to compete in an economic downturn. Even assuming that the AMT served a valid purpose when enacted, the burdens it imposes which grow every day cannot be justified in today's highly competitive global economy. It should be repealed for all taxpayers, individuals and corporations.

Next, it is time to reform and simplify the **depreciation** rules. The tax code now provides a modified Accelerated Cost Recovery System (MACRS) for determining depreciation deductions for most tangible property. There are also special recovery periods and methods that apply in certain situations. The law assigns tangible property to one of seven recovery periods that range from three to twenty-five years; real property has its own recovery periods. In 1998, Congress directed the Treasury Department to conduct a comprehensive study of recovery periods and depreciation methods. The study released last summer disappointed many observers because it did not include concrete recommendations for modernizing current law. The study did confirm one very important fact: *The current system is hopelessly outdated and needlessly complex*. For example, is there really a need to depreciate foreign assets at a different rate from that used in respect of domestic property? Asset class lives have been largely unchanged since 1981 and most date back to at least 1962. New industries, new technologies, and new manufacturing processes have been developed in the intervening years.

Mr. Chairman, when you addressed TEI earlier this month, you stated that this was one area that the Finance Committee will focus on this year. TEI applauds that decision, and we pledge our support to your efforts in replacing the current system with a simpler, more flexible model.

Uncertainty in the tax law also breeds complexity, and not knowing from one year to another what rules govern is the ultimate in uncertainty. Several temporary provisions of the tax code have been extended with such regularity that they have become a recurring component of the annual legislative agenda. Most notable among **"the extenders"** are the research credit in section 41 and the educational assistance exclusion in section 127. TEI has long contended that these provisions cannot effectively serve their legislative purpose if taxpayers are unable to know whether they will remain in effect from year to year. Moreover, the retroactive extensions and gaps in coverage not only impair the incentive effect, but also impose significant administrative burdens. For example, the last time the section 127 exclusion expired, several TEI members instructed their Human Resources departments to issue Forms W–2 that included the amounts spent on educational assistance. When the provision was re-enacted retroactively several months later, the companies were forced to re-issue the W–2s, incurring additional costs and causing confusion among their employees.

The on-again, off-again nature of these provisions creates wholly unwarranted complexity. TEI thus endorses the Bush Administration's proposal to make the R&D credit permanent, and we urge Congress to act in this area sooner, rather than later. Hence, although the credit is not due to expire until 2003, the planning horizon for research projects is routinely more than three or four years; in other words, some may argue that there is no urgency in renewing the research tax credit, but we respectfully disagree. In addition, we recommend that permanency be extended to other provisions such as section 127 and the work opportunity credit.

Finally, Mr. Chairman, we second your call to take a serious look at the **Code's foreign provisions.** The foreign tax credit and Subpart F rules may never be truly simple for multinational corporations, but they can be simpler. For example, Subpart F was initially enacted as an exception to the deferral principle in order to tax the types of income considered relatively "movable" from one taxing jurisdiction to another and therefore able to take advantage of low rates of tax. In the nearly four decades since its enactment, however, Subpart F has been distended to capture active operating income. One solution to removing Subpart F's artificial barrier to competitiveness would be to exclude foreign base sales and services income from current taxation. Consider the case of a U.S. company wanting to sell in China. Setting up a subsidiary in that country would expose the corporation to currency controls and customs problems. The better business decision is to establish a Hong Kong subsidiary, but doing so would subject the corporation to current taxation of sales income because of the Subpart F rules. U.S. companies face similar challenges in attempting to penetrate European markets.

Other international areas that should be considered for simplification include the translation of the deemed paid tax credit under section 986 and the interest allocation rules. under section 861 We understand that Senators Hatch and Baucus are working together on an international tax simplification bill. We look forward to reviewing the proposals and working with this Committee to achieve meaningful reform.

CONCLUSION

Tax Executives Institute commends the Senate Committee on Finance for holding this hearing and reaffirming its commitment to addressing the need for tax simplification. We all must resist the temptation, however, to think that this hearing is anything more than the beginning. We cannot simply pat one another on the back for being concerned, and then put the Joint Committee's report and our own testimony on the shelf. We must work together to make the quest for simplification real. Simplification must become more than an afterthought. It must permeate all decisions made about tax legislation. Please be assured that TEI fully supports your leadership in the area and pledges its own continuing efforts to simplify and improve the tax laws.

COMMUNICATIONS

STATEMENT OF THE AD HOC LIFE-NONLIFE CONSOLIDATED RETURN GROUP [1]

This Statement is submitted in support of the recommendations of the staff of the Joint Committee on Taxation to simplify the consolidated return rules for corporate groups with life insurance company affiliates by repealing two of the three restrictions on the ability of such groups to file a consolidated return and to urge that the third restriction also be repealed. These restrictions were enacted as part of the Tax Reform Act of 1976. Remnants of another era, these restrictions, without justification in tax or economic policy, serve only to create artificial barriers and needless complexity in the tax law.

Changes in the marketplace, as well as the enactment of the Gramm Leach Bliley financial services modernization legislation, make repeal of these restrictions on the ability of a group of corporations to file a consolidated return particularly critical as an economic matter. Repeal would represent sound tax policy, both from the perspective of simplifying our tax laws and from the perspective of treating affiliated groups of corporations with life insurance affiliates the same as all other affiliated groups of corporations.

DISCUSSION

It has long been a basic tenet of tax accounting that consolidated reporting is the most appropriate method of reflecting the income of an economic group. Congress has repeatedly expressed the view that consolidation is not a special privilege but merely a recognition of reality. As stated by the House in connection with the Revenue Act of 1964:

> [T]he return of commonly controlled corporations *as a single economic unit for tax purposes is in accord with the reality of the situation*. Moreover, there appears to be no reason why, where a group of commonly controlled corporations are willing to have their operations consolidated for tax purposes, the mere presence of more than one corporate organization in the group should result in any penalty tax. No such penalty, for example, is exacted in the case of other corporate organizations operating through divisions rather than separate corporations.[2]

The Tax Reform Act of 1976 allowed life insurance companies to file consolidated returns with other companies. It provided, however, three distinct restrictions where a life insurance company is affiliated with companies other than life insurance companies. These restrictions are still part of current law and are as follows:

- Section 1504(c)(2) [3] provides that a life insurance company will not be treated as an includible corporation in the affiliated group unless it has been a member of the affiliated group for the five taxable years immediately preceding the taxable year for which the consolidated return is filed.
- Section 1503(c)(2) provides that any net operating loss of a non-life insurance member of the group may not offset the taxable income of a life insurance member for any of the first five years the life and non-life insurance corporations have been members of the same affiliated group.
- Section 1503(c)(1) provides that even when the requirements of the two "five year" rules are met, the amounts of losses attributable to corporations other than life insurance companies that may offset life insurance company taxable

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[1] A list of member companies is attached at the end of this statement.
[2] H.R. Rep. No. 749, 88th Cong., 1st Sess. 116 (1963) (emphasis added).
[3] Unless otherwise indicated, all references and citations to sections are to sections of the Internal Revenue Code of 1986, as amended.

income are restricted to the lesser of 35 percent of life insurance company taxable income or 35 percent of the non-life insurance company losses.

These three limitations pose serious and complex obstacles to full consolidation. For example, if a member of the life/non-life affiliated group acquires a life insurance company from outside the group, the latter company may not be included in the consolidated return for five years. It must file a separate return. If a non-life company has losses but has not been a member of the life/non-life group for five years, its losses may not offset life company income. Finally, even if the five-year rules are met, the maximum amount of non-life losses that may ever be offset in any one year against life company income is limited to the lesser of 35 percent of life insurance company income or 35 percent of the non-life insurance company losses.

The legislative history of the Tax Reform Act of 1976 does not provide particularly clear statements of the justifications for the limitations contained in the consolidation provisions. The Treasury Department had no tax policy objection to full consolidation of returns for affiliated groups containing life insurance companies.[4] The life/non-life consolidation provision which originated in the Senate Finance Committee, originally allowed full consolidation, subject to a 50 percent limitation (later reduced in conference to 35 percent). The only reason given for the percentage limitation on the use of non-life losses was to preserve the notion that life insurance companies pay some tax on their investment income, evidently an early "minimum tax" concept.[5]

The five-year rules were a product of the Conference Committee and the reasons for them do not appear in the Conference Report. On a political level, some major life insurance companies were at the time expanding into the property and casualty insurance business. Some smaller property and casualty companies may have been concerned that giving larger life insurers the ability to fully consolidate with property and casualty affiliates experiencing tax losses could give them a competitive advantage.[6] In addition, unrelated political issues may have contributed to the number and severity of the limitations.[7]

Despite the Treasury Department support for full consolidation on tax policy grounds, it would have been possible to have argued, in 1976, that the tax bases for both life insurance companies and property/casualty insurance companies were substantially different from those of general business corporations and those differences justified some limitation on the ability to consolidate. However, the tax base of life insurance companies was substantially revised in 1982, 1984, 1986, 1987, and 1990. These changes put life insurance companies on a "total income" tax base and substantially increased their income tax liability.

However, it is clear from the 1976 legislative history that Congress was more concerned about tax losses generated by property and casualty insurance being offset against life insurance company income. This concern can be seen in the structure of the 35 percent limitation, for example, where the losses that are limited are those of an other than life insurance company which, absent the limitations, would be offset by life insurance company income.

If this concern had a basis in the laws in existence in 1976, it no longer has any justification today since the tax provisions relating to property and casualty insurance companies were substantially reformed and their tax base dramatically changed as part of the Tax Reform Act of 1986.

Thus, at this juncture, there is no reasonable basis for continuing the three restrictions on life insurance company consolidation with other corporations. No other corporations are subject to these restrictions. Even a property and casualty insurance company is free to consolidate fully with other corporations so long as a life insurance company is not involved.

These restrictions are now causing significant economic losses and disruptions. The ability to file consolidated returns is particularly important for life insurance companies. Some corporations in other industries may establish divisions within one corporation to conduct different businesses. State laws and other non-tax business considerations, generally require a life insurance company to conduct its non-life insurance business through subsidiaries. In response to changes in the marketplace in recent years, both domestically and globally, life insurance companies have diver-

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[4] Letter from Assistant Treasury Secretary (Tax Policy) Charles M. Walker to the Honorable Russell B. Long, dated May 25, 1976.

[5] *See* Staff of the Jt. Comm. On Tax'n, 94th Cong. 2nd Sess. 435–436 (1976).

[6] *See* 122 Cong. Rec. 24690 (July 30, 1976).

[7] *See, e.g.*, Peter Carlson, Dan Rostenkowski Goes Down in History, *Wash. Post*, Oct. 17, 1993 (Magazine) at W35; Curt Suplee, The Ways & Means Broker: Dan Rostenkowski, *Wash. Post*, July 23, 1981, at C1.

sified into other insurance lines and related fields. This diversification is not limited to a life insurance company affiliating with a property and casualty insurance company.

As insurance companies have evolved into fields such as health care delivery, equity products, investment advisory services to mutual funds and pension plans, data processing and computer services, these activities have become increasingly important to affiliated groups that include life insurance companies. Further, the enactment of the landmark Gramm Leach Bliley Act has now opened the way to financial services modernization and affiliations between banks and life insurance companies. All of these affiliations with life insurance companies, however, remain inhibited by obsolete and cumbersome restrictions on full tax consolidation enacted in another era with no relevance to the tax and economic environment of today.

The burdens and economic inefficiencies of these restrictions have been particularly evident in light of the consolidations, mergers, acquisitions and divestitures that have been taking place in the financial services industry. Here are some examples:

For the five-year period following a life/non-life group's acquisition of a life insurance company, the latter may not be included in the group's life/non-life consolidated return. It must file a separate return and its gains and losses may not be offset against those of members of the group. If the acquired life company transfers assets to a member of the group during the five-year period, any gain is subject to immediate tax. (This contrasts with gains in other groups not involving life insurance companies which are treated as deferred inter-company transactions and are deferred.) On the other hand, if the life company realizes a loss on the transfer of the asset, tax recognition is deferred under section 267(f)—the worst of both worlds. Although the acquired life company is 100 percent owned by a member of the life/non-life group, some distributions to its parent, *e.g.*, dividends paid out of pre-affiliation earnings, may still be subject to partial tax. This would not be so if as with other corporations, the acquired life company could be immediately included in the consolidated return.

If a life/non-life group that files a consolidated return acquires another life/non-life group of companies, the life members of the acquired group (and their lower-tier subsidiaries) are immediately deconsolidated from the acquiring company's consolidated return. This means that separate returns must be filed for each of the deconsolidated life companies. In some instances, to the extent the acquired companies have been together for five years, they may file their own life/life consolidated returns. Again, to the extent there are asset transfers between the acquired life companies and members of the acquiring life/non-life group, gain must be recognized immediately (the deferred inter-company transaction rule will not apply to these gains) and losses must be deferred.

Once an acquired life company has been a member of the group for five years, it may be included on the life/non-life return, but even then losses incurred in the life/non-life group during the five years may not be carried forward and offset against the life company's income after the five-year period.

The restrictions cause further complications with other Code sections. For example, section 355 spin-off transactions raise questions concerning the five-year ineligibility period for the spun-off company. Pursuant to Reg. 1.1502–80(b), section 304 (which provides rules for distributions in redemption of stock) does not apply to stock acquisitions in inter-company transactions. Since the consolidated return regulations will not apply during the five-year period that a life company is unconsolidated, section 304 will apply to stock transfers between the unconsolidated life company and other related corporations.

Satisfaction of the two five-year rules does not end the complexity. Cumbersome and complex regulations govern the determination of the amounts which may be offset subject to the 35 percent limitation. For example, life/non-life consolidated income must be determined on a subgroup basis where the life companies are viewed as one subgroup and the non-life companies as another. Operating and capital loss carry backs of one subgroup may not be carried back to offset prior year income of another subgroup. Loss carry backs of one subgroup will "bump" any loss of the other subgroup used in the carry back year. (*See* Regs. §§1.1502–47 (h) and (k)). A maze of regulations govern all of these determinations.

In sum, the two five-year rules coupled with the 35 percent limitation hugely inhibit life company consolidation, posing heavy costs, economic inefficiency and myriad administrative complexities. These restrictions should be eliminated and life insurance companies should be entitled to the full consolidation afforded other companies.

The staff of the Joint Committee on Taxation's recently issued *Study of the Overall State of the Federal Tax System and Recommendations for Simplification* (April

2001) addresses the two five-year restrictions. The Report (Vol. II, pp. 381–383) refers to the "complexity both to the acquired corporations and the existing members of the affiliated group in corporate acquisitions involving life insurance and non-life insurance companies . . ." and recommends that the two five-year rules, relating to consolidated returns of affiliated groups including life insurance companies and non-life insurance companies, be eliminated.

We are pleased that Joint Committee staff has devoted time and effort to this issue and has recommended that the two five-year rules should be eliminated. On the other hand, the recommendations do not go far enough. The third restriction—the 35 percent limitation on loss utilization—should also be eliminated. The considerations that require elimination of the two "five-year rules" apply as well to the "35 percent rule." Indeed the latter stands for no more than needless complexity and economic inefficiency.

As noted earlier, the only reason given for the percentage limitation on the use of non-life losses in 1976 was to preserve the notion that life insurance companies pay some tax on their investment income, evidently an early "minimum tax" concept. If there was any concern about preserving the investment income tax base of life insurance companies, it is no longer relevant. Life insurance companies are now clearly taxed on their total income under federally prescribed rules.

If there is any concern about eliminating a "minimum tax" on life insurance companies, that concern runs counter to other Joint Committee staff recommendations. The staff has reviewed the corporate alternative minimum tax (AMT) and has concluded that, while the corporate AMT may once have been appropriate, it does not necessarily produce a more accurate measurement of income after the depreciation, inventory and accounting provisions of the Tax Reform Act of 1986 have become fully effective. The Report (Vol. II, pp. 14–16), emphasizing the needless complexity and inefficiency of the corporate alternative minimum tax (AMT), recommends that it be eliminated. Certainly, if the AMT should be repealed, the 35 percent limitation which was enacted for much the same reasons as the AMT, should also be repealed. In fact, the 35 percent limitation should have been repealed, as redundant, at the time the AMT was first enacted.

CONCLUSION

The tax policy goal of equity of treatment of corporate taxpayers leads to the obvious conclusion that life insurance companies should be treated the same as other corporations and be permitted to file full consolidated returns with non-life insurance affiliates. This is especially important in today's financial services environment. The provisions contained in the Tax Reform Act of 1976 that allowed limited consolidation of these companies were an important acknowledgment that enterprises including life insurance companies should not be denied the benefits of consolidation. The Treasury Department's position in 1976 that there was no principle on which to base denial of such consolidation is even more supportable in 2001 than it was in 1976.

In addition to the fairness issue, it is also clear that the limitations on consolidation imposed on corporate groups with life insurance company affiliates have resulted in complex regulations which have, in turn, created numerous compliance problems and costs, both for taxpayers and for the Internal Revenue Service. These resources certainly could be put to better use than to attempt to comply with restrictions that are antiquated at best and probably not justified at the time they were enacted.

Amendment of the consolidated return rules to allow full consolidation of life insurance companies with non-life affiliates is not merely a matter of conceptually sound and appropriate tax policy. The limitations contained in present law are a substantial economic burden borne by affiliated groups containing a life insurance company but not borne by other affiliated groups of corporations, many of which compete directly with groups containing life insurance affiliates.

Life Insurance companies should be allowed to consolidate with other affiliated corporations without the restrictions enacted in 1976.

Ad Hoc Life-Nonlife Consolidated Return Group Members

AEGON USA, Inc.

Allstate Insurance Company

American Financial Group

American General Corporation

The Amerus Group

CIGNA Corporation

Conseco, Inc.

General Electric Capital Corporation

The Hartford

Lincoln National Life Insurance Company

Metropolitan Life Insurance Company

The Travelers Group

UnumProvident Corporation

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Air Transport Association

Carol B. Hallett
President & Chief Executive Officer

May 11, 2001

The Honorable Charles E. Grassley
Chairman
Senate Finance Committee
219 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

On behalf of the Air Transport Association member airlines*, I would like the comments below included in the record of the April 26, 2001, hearing held by the Senate Finance Committee to discuss the tax simplification recommendations prepared by the Joint Committee on Taxation. The Air Transport Association is the United States' oldest and largest airline trade association. Our members include 22 U.S. and four associate (non-U.S.) airlines that carry over 600 million passengers and more than 25 billion ton miles of cargo each year. U.S. members account for more than 95 percent of the passenger and cargo traffic carried by scheduled U.S. airlines.

The Joint Committee's report (in Part Three, Section XII.B.) addresses Airport and Airways Trust Fund Excise Taxes, and recommends changes to several provisions of the current law regarding these taxes. While ATA's members have not currently been able to fully analyze the proposals, the recommendations could significantly change the application of these taxes. Therefore, we respectfully request that if the Senate plans further action on these recommendations we have the opportunity to meet with those involved to discuss the proposals in greater detail.

Sincerely,

Carol Hallett

Carol B. Hallett
Chairman & Chief Executive Officer

*Airborne Express, Alaska Airlines, Aloha Airlines, America West Airlines, American Airlines, American Trans Air, Atlas Air, Continental Airlines, Delta Air Lines, DHL Airways, Emery Worldwide, Evergreen International Airlines, FedEx, Hawaiian Airlines, Midwest Express Airlines, Northwest Airlines, Polar Air Cargo, Southwest Airlines, Trans World Airlines LLC, United Airlines, United Parcel Service, and US Airways. Associate members are Aeromexico, Air Canada, KLM Royal Dutch Airlines, and Mexicana.

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STATEMENT OF THE AMERICAN BANKERS ASSOCIATION

The American Bankers Association (ABA) is pleased to have an opportunity to submit this statement for the record on "Tax Code Complexity: New Hope for Fresh Solutions."

The American Bankers Association brings together all categories of banking institutions to best represent the interests of the rapidly changing industry. Its membership—which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks—makes ABA the largest banking trade association in the country.

The federal tax system is greatly in need of simplification and reform. Many of the current rules have not kept pace with technological advances and changes in the global economy. Others have been in place for a number of years and do not adjust for inflation or no longer serve their original purpose. As a result, they have become increasingly restrictive on a broader base of taxpayers than originally intended when enacted by Congress or are so overly complex that they are rarely used.

In view of the focus of this hearing on the complexity of existing federal tax law, we have limited our comments and recommendations to areas in need of simplification. However, we must point out that the ABA believes that the current federal tax system is also in need of immediate modification and reform in a number of areas, such as the need for improvement of the tax laws with respect to the tax treatment of Subchapter S banking institutions, which issue has been the subject of an earlier hearing.

SIMPLIFY AND EXPAND RETIREMENT SAVINGS

ABA supports the enactment of additional tax incentives to encourage household savings. Congress has addressed these issues by expanding IRA eligibility, establishing Roth IRAs and enhanced spousal IRAs. Further expansion and simplification of the current IRA, 401(k) and retirement savings regime is sorely needed, including raising contribution limits, eliminating income caps and permitting "catch-up" contributions to IRAs.

We commend Senate Finance Committee Chairman Charles Grassley (R–IA) and Senator Max Baucus (D–MT) for introducing the "Retirement Security and Savings Act of 2001" (S. 742), which would allow Americans to set more aside in an IRA or 401(k) plan. The proposed legislation would increase the IRA contribution limit to $5,000 and the 401(k) plan contribution limit to $15,000. In addition, the bill raises adjusted gross income phase-out limits and includes a special catch-up contribution for Americans age 50 or older. Further, the proposed legislation increases pension portability, provides for faster vesting, and makes various other changes, which will increase savings and streamline pension rules. We note that the House of Representatives has recently approved similar legislation (H.R. 10) by a vote of 407–24. The ABA strongly supports this proposed legislation.

We also commend Senators Phil Gramm (R–TX) and Jon Kyl (R–AZ) for having introduced the "Tax Cut with a Purpose Act" (S. 35), and Senators Robert Torricelli (D–NJ), John Breaux (D–LA), Fred Thompson (R–TN) and Kyl for having introduced the "Coverdell Education Savings Accounts Act of 2001" (S. 306). Both proposals would expand and simplify education Individual Retirement Accounts (education IRAs). Expanding education IRAs would do much to encourage household savings for education.

Since the 1970s, the U.S. personal savings rate has declined steadily—recently hitting its lowest level since the Great Depression of the 1930s. Although there are many variables that affect the savings rate over the short-term, the long-range trend of American savings is clearly going in the wrong direction and needs to be reversed. In particular, baby boomers are not increasing their level of retirement savings as they move into their mid-to-late 40s. According to Stanford economist Douglas Bernheim, boomers on average have less than 40 percent of the amount needed to avoid a decline in their standard of living in retirement.

Significantly, this low savings rate threatens not only the retirement security of millions of Americans, but also could curb our continued economic growth by limiting investment capital and keeping an upward pressure on interest rates. Increasing retirement savings must be a critical component of any strategy to increase national savings and spur long-term economic growth.

Under the current system, a person can only set aside $2,000 in an IRA. This will not be enough money for retiring at age 65, or even older. Contribution limits on pensions and IRAs have remained virtually unchanged since 1981. Moreover, the current income limits also impose a severe marriage penalty, phasing out contribution amounts at moderate income levels. Accordingly, we are in agreement with the

recommendation of the Joint Committee on Taxation that income limits on eligibility to contribute to IRAs should be eliminated.

SIMPLIFY THE INTERNATIONAL TAX REGIME

As technology and expanding trade opportunities change the global market place, financial institutions have had to make rapid adjustments in order to remain competitive with foreign financial entities. With respect to the international operations of U.S.-based financial institutions, the tax law has not kept pace with technological advances and changes in the global economy.

The ABA supports the enactment of legislation that would simplify the international tax law and that would assist, rather than hinder, U.S. financial institutions' global competitiveness. We agree with the observation that we cannot afford a tax system that fails to keep pace with fundamental changes in the global economy or that creates barriers that place U.S. financial services companies at a competitive disadvantage. In that regard, the ABA would like to commend Senator Orrin Hatch (R–UT) for having introduced the "International Tax Simplification for American Competitiveness Act" (S. 1164) in the 106th Congress. We understand that similar legislation is expected to be introduced in this Congress.

Permanent enactment of the Subpart F "active finance" provision

ABA urges permanent enactment of the active finance exception to Subpart F. Under general income tax principles, the foreign income of a foreign corporation is generally not subject to tax even if it has been organized by a U.S. taxpayer. The U.S. taxpayer would not pay tax until the income is repatriated to the U.S. (e.g., as a dividend). We commend Senators Orrin Hatch (R–UT) and Max Baucus (D–MT) for introducing S. 676 to permanently enact the subpart F active finance provision. We also commend Representatives Jim McCrery (R–LA) and Richard Neal (D–MA), for introducing similar legislation (H.R. 1357) in the House of Representatives.

Subpart F was enacted to prevent passive foreign income (dividends, rents, interest, etc.) from escaping taxation through use of the deferral principle. As a result, it provides that passive income items are not eligible for deferral. However, Congress enacted an exception for such income if derived in the active conduct of a banking, financing or similar financial services business. This financial services exception was enacted in the Taxpayer Relief Act of 1997 as a temporary measure. It was later extended and modified by the Tax and Trade Relief Extension Act of 1998. The financial services exception reflects Congress' belief that financial services businesses are "active" and should have appropriate deferral benefits. This temporary provision is scheduled to expire December 31, 2001.

Permanent enactment of the active financing provision is sorely needed to level the international business playing field and increase the competitiveness of U.S. financial services companies.

Simplify the foreign tax credit limitation for dividends from 10/50 companies

The foreign tax credit rules impose a separate foreign tax credit limitation (separate baskets) for companies in which U.S. shareholders own at least 10 but no more than 50 percent of the foreign corporation. The old law 10/50 rule imposed an unreasonable level of complexity, which Congress sought to correct in the 1997 Tax Relief Act by eliminating the separate baskets for 10/50 companies using a "look through" rule. However, the 1997 Act change is not effective until after year 2002, and it imposes an additional set of complex rules.

The ABA supports the Joint Committee's recommendation to immediately apply the look-through approach to all dividends paid by a 10/50 company irrespective of when the earnings constituting the makeup of the dividend were accumulated. Such change would dramatically reduce tax credit complexity and the administrative burdens on financial institutions doing business internationally. It would also help level the playing field with respect to global competitors.

S CORPORATION SIMPLIFICATION

The ABA supports the Joint Committee's recommendation that the special termination rule for certain S corporations with excess passive investment income should be eliminated. Eliminating the passive investment rules would encourage the growth of small businesses and alleviate unnecessary investment costs, especially for regulated Subchapter S banks.

EXCLUSION FOR EMPLOYER-PROVIDED EDUCATIONAL ASSISTANCE

We commend Chairman Grassley (R–IA) and Ranking Member Baucus (D–MT) for having introduced the "Employee Educational Assistance Act" (S. 133), which

would permanently enact Internal Revenue Code Section 127 for both graduate and undergraduate study. That legislation would encourage the retraining of employees to reflect the changing needs of the workplace.

Section 127 provides an exclusion of up to $5,250 per year of employer-provided educational assistance from an employee's gross income and wages, irrespective of whether the education is job-related. In the absence of this exclusion, educational assistance is excludable from income only if it is related to the employee's current job. The current law Section 127 exclusion expires December 31, 2001. Educational assistance for graduate-level courses expired July 1, 1996.

The ABA supports the Joint Committee's recommendation for permanent enactment of the exclusion for employer-provided education and its expansion to include graduate education. The banking and financial services industries are experiencing dramatic technological changes. Well-educated workers are essential. This provision will expand educational opportunity and increase productivity. It will also assist in the training of employees to better face global competition. Moreover, employer provided educational assistance is a central component of the modern compensation package and is used to recruit and retain vital employees. We support the permanent enactment of this provision.

REPEAL OF THE ALTERNATIVE MINIMUM TAX

The ABA supports the Joint Committee's recommendation to repeal the Alternative Minimum Tax (AMT). We agree that the AMT no longer serves the original purposes for which it was intended and adds unnecessary complexity, time and expense to compliance with the federal tax laws.

ELIMINATE THE QUALIFIED SMALL-ISSUER EXCEPTION FOR CERTAIN BANK-QUALIFIED TAX EXEMPT BONDS

The Joint Committee report recommends that the small-issuer exception for bank-qualified bonds be eliminated and states that it is largely irrelevant given the availability of State bond pools. The ABA strongly disagrees with that recommendation.

Internal Revenue Code section 265(b) generally disallows the interest expense allocable to tax-exempt obligations acquired by a bank. However, the Code provides an exception for certain small issuers, allowing them to issue $10 million per year of "qualified tax-exempt obligations" (QTEOs), and allows banks to deduct the interest expense.

Elimination of the qualified small-issuer exception would greatly impede the quality of services small municipalities could provide to their citizens. Community banks rely upon QTEOs to provide finance services to small municipalities, many of which do not have access to State bond pools. The 1999 ABA Bank Portfolio Managers Survey Report results shows that tax-free municipal securities were ranked among the most common type of security in banks' investment portfolios, comprising an average of 16 percent of the total portfolio. (The most common security was callable agency securities, which comprised an average of 22 percent of a bank's portfolio.) Generally, smaller banks tend to hold larger investment portfolios than larger institutions, relative to their total assets. Accordingly, the QTEO portfolio composition of smaller banks would be larger than the survey indicates.

Indeed, the ABA Community Bankers Council's Special Report of January, 2000, *Compliance, Competition and the Community Bank Tax Burden: Blueprint for Reform*, urges further expansion of QTEOs and points out that the 15 year old volume cap should be raised and indexed for inflation.

SIMPLIFY ESTATE AND TRUST TAXATION

The ABA supports the Joint Committee's recommendation that the qualification and recapture rules contained in the special-use valuation and family-owned business deduction provisions should be conformed and believes it would greatly improve these rules. However, without further simplification, the qualified family owned business provisions will continue to be overly complex and burdensome and will continue to be rarely used.

The Joint Committee recommended the elimination of the two-percent floor on miscellaneous itemized deductions. We agree that this provision has proven to be particularly troublesome to bank trust departments and is in need of immediate resolution.

CONCLUSION

The ABA appreciates having this opportunity to present our views on simplification of the federal tax system. We look forward to continuing to work with you on these most important matters.

STATEMENT OF THE AMERICAN COUNCIL OF LIFE INSURERS

I. INTRODUCTION

The American Council of Life Insurers (ACLI) welcomes the opportunity to place this statement into the record of the Finance Committee's hearing on tax simplification. The 426 member companies of the ACLI account for 80% of all life insurance premiums and 81% of all annuity considerations and have assets representing 80% of all U.S. legal reserve life insurance companies. The 106th Congress took major steps forward in rewriting the regulatory structure of the financial services industry in the United States [1]. This realignment is already having a positive impact on the way life insurance companies serve their customers, conduct their operations and merge their businesses. Unfortunately, there remain three specific, complex, outdated provisions in the tax code that present barriers to the life insurance industry's integration with other sectors of the fast moving global financial services marketplace.[2] These provisions, presented in the numerical order in which they appear in the Internal Revenue Code are:

- **Section 809**—the mutual company "add-on" tax that is complex as well as theoretically and mechanically flawed;
- **Section 815**—the stock company Policyholders Surplus Account (PSA) from pre-1984 tax rules that existed to provide a balance in the revenue burden within the life insurance industry under the 1959 Act [3];
- **The Life/Non-life Consolidated Return Restrictions (Sections 1503(c) and 1504(c))** that do not apply to any other financial or non-financial companies and were only appropriate, if ever, under an old tax regime and an old financial services regulatory structure.

In the past, life insurance companies were subject to a federal tax regime that differed significantly from other corporations. As will be detailed below, this has not been the case since 1984. In addition, arcane, complicated rules for life insurance taxation have been justified on the basis that life insurers are under-taxed or not taxed on their full income. Today and for many years, life insurance companies have been paying very significant federal income taxes at a rate that far exceeds that for all U.S. corporations. A Coopers & Lybrand study shows that life insurers paid $57.6 billion in federal corporate income taxes from 1991–1997. In the last year of that period, 1997, the life insurance industry paid over $9 billion in federal taxes. The average effective tax rate for U.S. life insurers over that seven-year period was 35.4%, significantly higher than the 28.3% average effective rate for all U.S. corporations.

For the reasons detailed below, the ACLI advocates the repeal of these three provisions of current tax law as part of any effort to simplify the tax code.

II. SECTION 809

Background

In 1984 Congress enacted Section 809, which imposed an additional tax on mutual life insurers to guarantee that stock life insurers would not be competitively disadvantaged by what was then thought to be the dominant mutual segment of the industry. When Section 809 was enacted, mutual life insurers held more than half the assets of U.S. life insurance companies. Section 809 operates by taxing some of the dividends that mutual life insurers pay to their policyholders. Section 809 has not been a significant component of the substantial taxes paid by the life insurance industry, including mutual companies. It has been extremely burdensome because of its unpredictable nature, and has been criticized by the Treasury Department and others as fundamentally flawed in concept.

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[1] Gramm-Leach-Bliley Act of 1999 ("1999 Act"), Pub. L. No. 106–102, 113 Stat. 1341.

[2] An informative article on this topic can be found in a January 2001 Special Report in *The Insurance Tax Review, at p.31*, by William B. Harman Jr., John T. Adney, and Bryan W. Keene entitled "The Taxes on Starlight: A Case for the Repeal of Sections 809, 815, and 1503(c) of the Internal Revenue Code".

[3] Life Insurance Company Tax Act of 1959 ("1959 Act"), Pub. L. No. 86–69, 73 Stat. 112.

Section 809 employs complex formulas that impute the earnings of the 50 largest stock life insurance companies to reduce the deduction of mutual life insurers for policyholder dividends. The effect of Section 809 is to require mutual life insurers to reduce amounts paid to policyholders as dividends or benefits, thereby increasing the cost of insurance. Section 809 is a tax on the dividends mutual insurance companies pay their policyholders, but it is based on neither the amount of policyholder dividends a mutual company pays nor the actual income of the mutual insurer. Instead, the tax is based on a bizarre formula under which the tax of each mutual life insurer increases if the earnings of its large stock company competitors rise—even when a mutual company's earnings fall. It is like basing part of Ford's taxes on how much GM earns.

Section 809 Adds Unnecessary Complexity for Life Insurers and for the IRS

Aside from the conceptual flaws in section 809, from a tax policy standpoint, the mechanical operation of the section creates administrative burdens for the Internal Revenue Service, all mutual life insurance companies, and the 50 largest stock life insurance companies. The way section 809 attempts to determine how much additional tax mutual insurers must pay is by calculating a "differential earnings amount." Practically all of the factors that go into the formula are created solely to administer section 809 and would not otherwise be tracked. There are numerous anomalies in the formula, such as the comparison of weighted one-year actual mutual company earnings rates with three-year arithmetic "imputed average" rates of the 50 largest stock life insurers utilizing a factor created in 1984 expressly to obtain a 55%–45% split in the tax burdens of mutual and stock life insurers for that year.

Briefly stated, the differential earnings amount is defined as the product of the mutual company's "average equity base" and a "differential earnings rate." The differential earnings rate has to be calculated each year by the IRS using aggregate industry data that it must assemble and is the difference between the average earnings rates of the stock and mutual segments of the life insurance industry, after deducting all policyholder dividends. The earnings differential is obtained by comparing the arithmetic average earnings rates of the 50 largest stock company groups for the three years preceding the taxable year with the weighted average earnings rates of all mutual companies for the immediately prior year. This is subsequently "trued up" when mutual company earnings for the actual taxable year become available. As if the formula is not bizarre enough, in calculating the differential earnings rate, actual mutual company rates are used, but an "imputed earnings rate" is used for the stock segment.

The Theoretical Basis for Section 809 was Flawed

When Congress enacted section 809 in 1984, it recognized that despite its best efforts to establish an appropriate mechanism for taxing mutual life insurance companies, further examination would be necessary. In studies mandated by Congress, both the Treasury Department and the General Accounting Office concluded that the theoretical basis for section 809 was mistaken.[4] The basic flaw was revealed in what is identified as the "prepayment analysis." The current model for taxing corporate income calls for taxing corporate returns on invested capital only once, either when returns on capital are paid to the owners or when the capital is received. Stock companies do not pay any tax on the receipt of capital, so it is appropriate that returns on stock company capital should not be deductible. Conversely, mutual companies' sole source of capital is fully taxed premium income, therefore, the tax on capital is "prepaid" when received and any justification to disallowing deductions for capital returns disappears.[5] The prepayment analysis has even been endorsed by Henry Aaron, who acknowledged that his initial analysis (upon which Congress relied in establishing section 809 in 1984) was incorrect and who characterized section 809 as a "legislative atrocity."[6] The prepayment analysis was also endorsed by

[4] See Department of the Treasury, *Final Report to Congress on Life Insurance Company Taxation* (August 1989) and U.S. General Accounting Office, *Tax Policy: Allocation of Taxes within the Life Insurance Industry* (October 1989).

[5] The prepayment analysis adopted by Treasury and GAO is based upon the analysis of Yale Law Professor Michael Graetz who subsequently served in the Treasury Department. See his article *Life Insurance Company Taxation: An Overview of the Mutual Stock Differential*, Proceedings of the Yale Conference (1986).

[6] Statement of Henry Aaron before the Committee on Ways and Means, U.S. House of Representatives (October 19, 1989).

other renowned economists, including Michael Boskin and John Shoven of Stanford University and Robert Shapiro of the Progressive Policy Institute.[7]

Both tax simplification and fairness demand the repeal of Section 809. Since 1984, the life insurance industry has changed radically. Within a few years, life insurers operating as mutual companies are expected to constitute less than ten percent of the industry. Importantly, the remaining mutual insurers should not be forced out of mutual form by the unpredictable nature of this tax. The original rationale behind the enactment of Section 809 no longer exists, and mutual life insurers should not pay taxes based on the earnings of their competitors or solely because they exist in the mutual form. In addition, the administrative burden placed on mutual companies, stock companies and the IRS to gather the required information to calculate the add-on tax is enormous. As the number of mutual companies continues to shrink, spurred on in no small part by the cost and uncertainties of section 809, any rationale for continuing to compute an add-on tax for mutuals has disappeared. The ACLI urges repeal of section 809.

III. SECTION 815—TAX ON POLICYHOLDERS SURPLUS ACCOUNTS

Background

Prior to 1959, life insurance companies were taxed only on that portion of their investment income that was in excess of the funds reserved to satisfy their obligations to policyholders. The Life Insurance Company Income Tax Act of 1959 introduced a three-phase procedure for taxing life insurance companies which provided that companies would be taxed on the lesser of their taxable investment income or their gain from operations. If a company's gain from operations exceeded its taxable investment income, the company would be taxed on 50 percent of such excess. Tax on the other 50 percent would be deferred in the Policyholders Surplus Account. The PSA would be taxed only if an extraordinarily large distribution to shareholders occurred or if the PSA exceeded certain thresholds relative to the company's income or other reserves. The PSAs at no time contained actual funds.

The Deficit Reduction Act of 1984 made several changes to the life insurance provisions of the tax code in an attempt to simplify the code and eliminate the complex three-phase tax structure created by the 1959 Act. As part of those changes, the 1984 Act provided that no further additions could be made to PSAs. However, the legislation also provided that amounts recorded in PSAs would not be taxed unless an extraordinarily large distribution was made to shareholders. Significantly, Congress contemplated at that time that, in practice, the PSAs would never be taxed. In fact, the Joint Committee on Taxation summary of the provision which was prepared for, and relied upon by, the House and Senate conferees who prepared the final text of the 1984 Act describes the provision subsequently enacted into law as "Forgiveness of Phase III Tax," (JCX1684; p.4). Congress's decision not to tax PSAs was part of a much broader set of insurance provisions in the 1984 Act which collectively sought to revise the tax treatment of insurance companies to eliminate as much as possible unjustified tax advantages among competing companies. Accordingly, the tax treatment of PSAs provided by the 1984 Act was a part of numerous provisions that sought to establish a competitive balance within the industry.

PSAs Add Unnecessary Complexity for Stock Life Insurers

It is important to understand that the PSA is merely a memo account kept in a company's tax department and has no meaning for any other purpose. Life insurance companies do not carry the PSA on any books and records other than those required for the federal income tax return, and there is no fund or segregated group of assets supporting the PSA. In fact, the only financial reporting of the PSA under generally accepted accounting principles ("GAAP") would be a note to the consolidated financial statements that the insurance companies have not accrued for any taxes associated with the PSA. In other words, the only evidence of the PSA in either GAAP or insurance regulatory financials is a note in the GAAP financials that the PSA exists for tax purposes but that the tax liability is never expected to become due.

This GAAP treatment originated in 1972, when the predecessor of the Financial Accounting Standards Board issued an opinion, APB 23, on the appropriate accounting treatment of amounts deferred under section 815 which stated, in part, as follows:

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[7] Boskin, Shoven, Smart, *Economic Issues in the Taxation of Mutual and Stock Life Insurance Companies*, Stanford Center for Economic Policy Research, discussion Paper Series No. 126 (1988); Shapiro, *Neutrality in the Taxation of the Life Insurance Industry*, Insurance Tax Review 2607 (1996).

> The Board concludes that a difference between taxable income and pretax accounting income attributable to amounts designated as policyholders' surplus of a stock life insurance company may not reverse until indefinite future periods or may never reverse. The insurance company controls the events that create the tax consequences and the company is generally required to take specific action before the initial difference reverses. Therefore, a stock life insurance company should not accrue income taxes on the difference between taxable income and pre-tax accounting income attributable to amounts designated as policyholders' surplus.

The conclusion of APB 23, as it concerns policyholders surplus accounts, was carried over in FAS 60, and, most importantly, the treatment was preserved in FAS 109 which currently governs financial accounting presentation of income taxes. Adopted in 1992, FAS 109 repudiated the APB 23 premise that taxes did not have to be accrued if they would be paid only in the indefinite future, but retained nonaccrual for only four items covered under APB 23, one of which was the PSA, and stated that a tax accrual would be required only if it became apparent that the tax would become payable in the foreseeable future. Thus, the accounting community recognized that neither the companies nor the government expected that the tax on the PSA would become due or payable.

Similarly, for state regulatory purposes, there has never been a requirement for the establishment of a liability, or an apportionment of surplus, for potential tax liability in connection with PSAs. In fact, there is no requirement that any potential liability be disclosed. State insurance departments would not regulate an insurance company any differently if it had no potential PSA tax liability or a billion dollar potential PSA tax liability. This is simply because there is no expectation that this tax will ever be due.

Thus, there is no "fund," "reserve," 'provision" or any other type of liability or allocation of assets on a life insurance company's statutory or GAAP financial statements to pay this proposed tax. Any additional tax imposed will reduce a company's current earnings in the year in which the legislation is enacted and ultimately will reduce the company's capital and surplus.

Segment Balance is no Longer Meaningful

Section 815, like section 809, was enacted as a means of balancing the portion of the life insurance industry's tax bill between its stock and mutual company segments. Under the 1959 Act, Congress used the then dominant mutual company segment as the model for taxation and utilized section 815 to assure that the change from an investment income to underwriting income based tax system for life insurers did not place an inappropriate proportion of taxes on the stock segment of the industry. In 1984, the stock life insurance company was used as the model and segment balance was achieved through section 809. As indicated above, there is no longer any practical need to balance the life insurance industry's tax burden between the segments, and furthermore, no reason to believe that taxing life insurers like all other business corporations will result in a revenue shortfall to the Treasury.

When Congress enacted the 1984 Act, no attempt was made to trigger tax on the existing PSAs. It has been suggested that PSA balances were not forgiven in 1984 because of a desire to maintain a safety net in case the sweeping changes from the 1959 Act did not produce sufficient revenue.[8] This has not been the case. With the imposition of additional taxes on the life insurance industry in 1987[9] and 1990[10], today, life insurers are as fully taxed on their total income as are other corporations.

Section 815 Impedes Financial Services Reform

When Congress enacted the Gramm-Leach-Bliley Act of 1999, it removed historic restrictions on affiliations between insurance companies and banks, allowing the creation of full-service financial institutions. While life insurers are now permitted to affiliate with banks and brokers, they cannot own such firms directly as subsidiaries. The continued existence of section 815 prevents life insurers from taking full advantage of the new law, by requiring corporate groups to retain capital in their life insurance company affiliates that could be better used elsewhere, solely because

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[8] See January 2001 Special Report in *The Insurance Tax Review, at p.31*, by William B. Harman Jr., John T. Adney, and Bryan W. Keene entitled "The Taxes on Starlight: A Case for the Repeal of Sections 809, 815, and 1503(c) of the Internal Revenue Code", *supra* fn.2.

[9] See The Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100–203, 101 Stat. (imposing further limitations on reserve deductions by revising interest rates used to calculate life insurance reserves under section 807(d)).

[10] See The Omnibus Budget Reconciliation Act of 1990, Pub. L. 101–508, 104 Stat. 1338 (imposing the "DAC" tax under section 848).

withdrawal could trigger tax. Thus, groups which include a life insurance company face unnecessary restrictions on their ability to use capital residing in a life insurance company affiliate to purchase another entity. This uncertainty over possible phase III taxation is at odds with the intended purposes of the 1999 Act to promote the ability of U.S. financial services companies to fully compete in the global marketplace.

For these reasons, section 815 should be repealed.

IV. LIFE/NON-LIFE CONSOLIDATED RETURN PENALTIES—SECTIONS 1503(C) AND 1504(C)

Background

In general, tax law permits members of an affiliated group of corporations to file consolidated tax returns so that the entire economic income of the group may be taxed as a whole (as if the included corporations were divisions of a single company). There are some exceptions to this treatment to account for non-taxed corporations and pass-through entities (such as IRC §501 entities, regulated investment companies, and real estate investment trusts), as well as foreign corporations. In addition, current tax law includes a number of restrictions on the ability of a group of affiliated companies to file a consolidated federal income tax return if the group includes a company that is taxed as a life insurance company under IRC § 801. The consolidation rules applicable to other corporations, including other financial intermediaries, contain no such restrictions. While such restrictions may have had justification at a time when life insurance companies were subject to a tax regime that differed from other corporations, this is no longer the case.

From 1918 to 1927, insurance companies were permitted to file consolidated returns on the same basis as other companies. This continued even after 1921 tax law changes made life insurers taxable only on their investment income. Starting in 1928, life companies were not permitted to file consolidated returns with non-life affiliates because of this different tax base. With passage of the Tax Reform Act of 1976 (the "1976 Act")[11], beginning in 1981, life companies were able again to consolidate with non-life companies, but they faced severe tax restrictions. These limits were intended to ensure that life companies that owned or purchased property and casualty companies still paid taxes despite potential large losses in the property and casualty company. These rules still exist today even though in 1984, the tax treatment of life insurance companies and property and casualty companies were brought more closely in line with that of other corporate taxpayers. Today, insurance companies (life and property and casualty) are taxed on a level equal to that of other corporate taxpayers.

Nature of the Restrictions

Five Year Rules

Under Section 1504(c), a life insurance company cannot be included in a consolidated tax return with other, non-life companies until the life company has been part of the affiliated group for five years. Moreover, net operating losses of a non-life member cannot be used to offset life subgroup income if the non-life member has not been part of the affiliated group for five years. Losses of non-life subgroup members that have been part of the affiliated group for less than five years are considered "ineligible losses" and can only be used to offset non-life subgroup taxable income.[12]

35% Loss Limitation Rules

Under Section 1503(c) and the regulations thereunder, if a life company is part of the consolidated group, the consolidated group is divided into a life subgroup and a non-life subgroup. Each subgroup must separately compute and keep track of its taxable income as well as its capital and ordinary losses. The losses of the non-life subgroup may be used to reduce life subgroup income, but only to the extent of the lesser of (i) 35% of the non-life subgroup losses or (ii) 35% of the life subgroup taxable income.

[11] Pub. L. No. 94–455 (1976).

[12] To guard against "incubating" a shell company for five years, Treas. Reg. Sec. 1.1502–47(d)(12) has rules such as requiring the conduct of an active trade or business, prohibiting a change in tax character and not allowing disproportionate asset acquisitions.

Restrictions are based on a tax regime for life insurers that no longer exists and serve no justifiable purpose

The prohibition on life insurance companies joining in a consolidated return dates back to 1928 [13]. From 1921 through 1957, life insurance companies were taxed only on their "free" investment income: the amount of investment income not considered necessary to fund current and projected policyholder liabilities as required by state law. Various adjustments were made to the formula for determining the portion of investment income that was "free" between 1921 and 1957, but during this period, neither underwriting income, nor capital gains from life insurance business were taxed [14].

The Life Insurance Company Income Tax Act of 1959 (the "1959 Act")[15] expanded the calculation of a life insurance company's taxes to include underwriting income in a complex "three phase" formula that remained in effect until 1984. With the passage of the 1959 Act, the tax base of life insurers began to resemble more closely that of other corporate taxpayers. The Deficit Reduction Act of 1984 [16] sought to tax life insurance companies on gross income from all sources (investment and underwriting), reduced by ordinary and necessary business expenses plus reserve deductions for amounts put aside to fund current and projected liabilities to policyholders. Therefore, from 1984 forward, life insurance companies, like other taxpayers, have been subject to tax on all income: investment, operating, and capital gains. Passage of the Tax Reform Act of 1986 [17], while not directed specifically at insurance companies, lowered corporate tax rates generally and eliminated the special 20 percent deduction that life insurance companies had received in the 1984 Act. So, from 1987 through the present, insurers have been taxed at the same rate as other corporations (currently 35%).

Nonetheless, the limitations of Sections 1503(c) and 1504(c) remain in the tax code and continue to unfairly penalize any group containing a life insurance company member. Corporations in other industries can consolidate the income from various businesses into a single tax return by operating them as divisions of a single corporation. This avenue is generally not available to insurance companies because of both state insurance law and other non-tax business considerations that mandate operating through separate corporate entities.

Restrictions cause enormous administrative complexities

Consolidated return rules for all corporations (general business as well as insurance) are a complicated area without adding the limitations of Sections 1504(c), 1503(c) and Treas. Reg. §1.1502–47. Together these provisions create a level of complexity that makes little sense given the current system of taxing life insurance companies. The staff of the Joint Committee on Taxation in its recently released study on tax simplification [18] noted:

> The treatment of affiliated groups of corporations that include both life insurance companies and other types of companies is more complicated than other types of affiliated groups that wish to file consolidated returns. The two five-year rules require substantial additional record-keeping and calculations by taxpayers, as well as creating complexity in structuring business transactions.[19]

Joint Committee staff recommended that the two five-year rules relating to consolidated returns of affiliated groups including life insurance and non-life insurance companies should be eliminated. They pointed to reductions in complexity associated with filing consolidated returns for affiliated groups including both life and non-life companies and also to reduction in complexity for both acquired corporations and existing members of affiliated groups in corporate acquisitions involving life and non-life companies with respect to record-keeping and calculation of tax liability.[20]

The complications caused by the five-year rules pale in comparison to the 35% limitation rules. To comply with the 35% rules, each year, two separate "subgroups" must be created and maintained for tax accounting purposes—a life subgroup, and a non-life subgroup. The sole reason for establishing these subgroups is to keep the

[13] Revenue Act of 1928, Pub. L. No. 562, sec. 141(e), Conference Committee Report Amendment No. 91, H.R. Rep. No 1882, 70th Cong., 1st Sess. 17 (1928).

[14] An extensive summary of the tax laws applicable to life insurance companies can be found in "AICPA Communication on Consolidate Returns and Life Insurance Companies", in *Insurance Tax Review* (March 1993), at 344 *et seq*.

[15] Pub. L. No. 86–69, sec. 4 (1959).

[16] Pub. L. No. 98–369, 98 Stat. 434 (1984).

[17] Pub. L. No. 99–514 (1986).

[18] *Study of the Overall State of the Federal Tax System and Recommendations for Simplification Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986*, JCS–3–01 April 2001.

[19] *Id*., Vol. II at 382.

[20] *Id*.

income and losses of each subgroup separate for purposes of applying the 35% limitations on loss utilization. Complex ordering rules are required that mandate loss carrybacks and carryforwards being applied within each subgroup before the net result can be combined with the other subgroup if eligible. Losses carried back to any year can necessitate the filing of an amended return for the carryback year as well as amended returns for subsequent years according to a set of complex "bumping" rules that determine from which subgroup losses are deemed to be utilized. While carrybacks and carryovers can always cause complications, the level of difficulty increases exponentially when the subgroup and ordering rules of the regulations are layered in [21].

Restrictions discriminate against life insurers

The life/non-life consolidated return penalties come into play only when a life insurance company enters the equation. If a general business corporation (or another financial services company), with no life insurance members in its consolidated group acquires an unprofitable property/casualty insurance company, there are no prohibitions or limitations on immediate utilization of the insurer's post-acquisition losses by the new consolidated return group. At a time when legislative initiatives have been taken to modernize financial services regulation and make it easier for banks, insurance companies and securities firms to combine to provide better services to customers and compete in the global marketplace, this puts life insurance companies at a particular and unjustifiable disadvantage. For these competitive reasons in addition to providing a great reduction in the complexity of this portion of the Tax Code, sections 1503(c) and 1504(c) should be repealed.

IV. CONCLUSION

Sections 809, 815, and the consolidated return restrictions are all remnants of past eras in the taxation of life insurance companies that are no longer relevant under current law. In today's world, life insurers are fully taxed on their total income and eager to fully benefit from modernization of financial services laws intended to allow them to compete equally in the new global market with other financial institutions. As has been shown, the justifications for these life insurance only tax provisions no longer exist and each creates enormous administrative burdens for the companies and the IRS. They also hinder the ability of life insurance companies to plan for the future both in their core businesses and in any attempts to expand to other areas. For these reasons, ACLI urges the repeal of sections 809, 815, 1503(c) and 1504(c).

STATEMENT BY THE ASSOCIATION OF FINANCIAL GUARANTY INSURORS

Mr. Chairman, the Association of Financial Guaranty Insurors (AFGI), a trade association of financial guaranty insurors [1], appreciates the opportunity to submit testimony to the Committee as it examines the complexity of the Internal Revenue Code of 1986, as amended, (the "Code"). In 1998 Congress amended the Code to add Section 8022(3)(b), to require the Joint Committee on Taxation (the "Joint Committee") to report to the Senate Finance Committee at least once during each Congressional session on the overall state of the Federal tax system, including recommendations with respect to the possible simplification of the Code. On April 26th of this year, Joint Tax submitted to the Committee its *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986*. Volume II of the three-volume study, titled *Recommendations of the Staff of the Joint Committee on Taxation to Simplify the Federal Tax System* (the "Joint Committee Recommendations") was discussed at the Committee's hearing of April 26, 2001.

[21] Treas. Reg. Sec. 1.1502–47 sets out a four-step computation of income for each subgroup. First, separate consolidated life insurance company taxable income (LICTI) and non-life consolidated income are computed. Second, the subgroup results are carried back to prior years in each subgroup with the possibility of "bumping" a prior consolidated calculation. Third, after the carryback computation, a "bottom line" offset is calculated for the current year. Ordinary losses of one subgroup may offset ordinary income of the other subgroup (limited by the 35% restriction on non-life losses). Fourth, unused ordinary and capital losses carried forward from the current year must first offset the income of the subgroup that created the carryforward.

[1] The members of AFGI are ACA Financial Guaranty Corporation, Ace Guaranty Re. Inc., AMBAC Assurance Corporation, AXA Re Finance S.A., Enhance Reinsurance Company, Financial Guaranty Insurance Company, Financial Security Assurance, Inc., MBIA Insurance Corporation, RAM Reinsurance Company, and XL Capital Assurance, Inc.

The Joint Committee at Part VIII.E of its Recommendations (pages 377–78), proposes the elimination of Section 832(e) of the Code which it criticizes "as giving rise to complexity that achieves no Federal income tax goal, but rather, only a particular accounting result." The purpose of this testimony, Mr. Chairman, is to express AFGI's concern, for the reasons set out below, with Joint Committee's recommendation to eliminate Section 832(e) of the Code.

BACKGROUND

Section 832(e) of the Code is a provision that addresses a serious financial problem faced by certain insurance companies in a manner that is revenue neutral to the United States Treasury. The financial problem was caused by material reserve requirements for losses not yet incurred (so-called "contingency reserves") established by state insurance regulators. These contingency reserve requirements had the unintended impact of diminishing the statutory capital of the subject insurance companies. It was not practicable to change the statutory accounting rules in various states in order to address this impairment of capital. Instead, Section 832(e) was crafted with the support of the state insurance regulators to create a statutory asset equal to the tax benefits that would be realized by insurance companies if and when actual losses occurred.

More specifically, and as described in more detail below, Section 832(e) allowed the insurance company to deduct its contingency reserves for Federal income tax purposes, provided that the insurance company "invests" the tax savings from such deduction in non-interest bearing treasury notes called "tax and loss bonds" which, in turn, are treated as assets of the insurance company for statutory accounting purposes. Since the tax savings from the deduction are loaned to the Treasury on an interest-free basis, this arrangement is revenue-neutral to the Treasury. It remains impractical to change the statutory accounting rules in various states in order to address the concern currently addressed by Section 832(e). Section 832(e) of the Code remains the simplest answer to a complex problem, without cost to Treasury. Accordingly, AFGI respectfully submits that this provision remain in place.

DESCRIPTION OF SECTION 832(E)

Pursuant to section 832(e) of the Code, insurance companies writing mortgage guaranty, lease guaranty, and tax-exempt bond guaranty insurance may, subject to certain conditions, take a deduction for federal income purposes for their contingency reserves representing amounts required by state law to be set aside in a reserve for losses resulting from adverse economic cycles. The deduction cannot exceed the lesser of (i) the insurance company's taxable income or (ii) 50 percent of the premiums earned on such guaranty contracts during the year. Such a deduction represents advantageous treatment for such companies because, under the general tax principles otherwise applicable, the companies would not be able to deduct such reserved amounts until the losses actually arose. The companies may take such a deduction, however, only to the extent that they purchase so-called "tax and loss bonds" in an amount equal to the income tax savings attributable to it.

The Internal Revenue Code does not specify the terms of the tax and loss bonds. Per the legislative history underlying section 832(e), they are non-interest bearing obligations issued by the U.S. Government. An insurance company may present the bonds for redemption only as and when it restores to income the associated deduction for contingency reserves. Reserves are restored to income as and when they are applied, per state regulations, to cover loss or to the extent the company has a net operating loss in a subsequent year. See Code sections 832(e)(5)(B) and 832(e)(5)(C). Further, the reserve deduction taken in any particular year with respect to mortgage and lease guaranty insurance must be fully restored to income in 10 years. The reserve deduction taken in a particular year with respect to tax-exempt bond insurance must be fully restored in 20 years. See Code sections 832(e)(5)(A) and 832(e)(6).

LEGISLATIVE ORIGINS OF SECTION 832(E)

Section 832(e) of the Code was originally enacted in January 1968, effective January 1, 1967.[2] At that time it applied only to mortgage guaranty insurance. It was

[2] Before Section 832(e) was enacted in 1968, mortgage guaranty insurers relied upon a number of private letter rulings allowing them to deduct their contingency reserves as if they were unearned premium reserves (with respect to which a deduction was already allowed). Upon revocation of these rulings in 1967, Section 832(e) was enacted as a result of the express concern of Congress that the inability to deduct contingency reserves could impair an insurer's capital. *See*

Continued

then amended in 1974 to include lease guaranty and tax-exempt bond insurance after state insurance regulators imposed contingency reserves on those lines of insurance. According to the legislative history, it was adopted in response to high contingency reserve requirements imposed by state regulatory authorities. These reserve requirements ranged up to as high as 50% of earned premiums and were often required to remain in reserve for as long as 15 years. According to the legislative history, imposition of a current federal income tax on the reserved amounts, when combined with the effect of operating expenses and a loss experience of approximately 30% of non-reserved premium, could impose a serious burden on the insurance company's working capital. In such circumstances, the company's federal income tax obligation could easily exceed the cash remaining from available—*i.e.*, unreserved—funds after payment of expenses and loss.

In response to this problem, Congress decided to allow such insurers to take a deduction for these contingency reserves. However, because the reserve requirements imposed by the state regulatory authorities were substantially in excess of that suggested by experience, deferral of tax on such reserves could result in an unwarranted windfall for the companies. As a result, Congress permitted the deduction only to the extent the insurance companies invested the tax benefit there from in non-interest bearing tax and loss bonds. Because the bonds were expected to qualify as assets for state financial regulatory purposes, this would relieve the cash flow problems the companies could experience. At the same time, because the bonds did not bear interest, it was believed that the U.S. Treasury would also be unaffected. Indeed, at the time of the 1974 amendment, the U.S. Department of the Treasury stated with respect to the legislation that:

> "[f]rom the Treasury's standpoint, the deduction for additions to the special contingency reserve is only temporary, and the non-interest-bearing obligations give the Treasury at all times the unrestricted use of the deferred tax dollars as if there were no deduction and as if taxes were in fact paid." (Emphasis added)

From an economic perspective with regard to the regular income tax, the U.S. Treasury remains in essentially the same position after the application of Section 832(e) as it would have been had that provision not been enacted. Although its nominal tax revenue is reduced at the time the deduction for reserves is claimed, it receives, on an interest-free basis, an amount equal to foregone taxes through the purchase of the tax and loss bonds. So, its economic position at the time the contingency reserve deduction is taken (and the bonds purchased) is no different from what would otherwise have been the case. Similarly, although it will have to redeem those bonds at some later time when the reserve is restored to income, that also will not adversely affect its economic position from what it otherwise would have been. If the reserve was restored because of a loss, the amount paid to redeem the bonds will exactly equal the amount by which its tax revenues would otherwise decline had a net deduction for that loss been permitted.[3] If, on the other hand, the reserves are restored to income at the end of the 10- or 20-year time limitation because they had not been fully absorbed by the losses experienced up until then, the amount paid to redeem the bonds will simply offset the increased taxes attributable to the restoration of the reserve to income.

CONCLUSION

The interaction between the Code and the state insurance regulators in the treatment of contingency reserves is a long and intricate one, beginning with the issuance of private letter rulings by the Internal Revenue Service when state insurance laws first imposed contingency reserves on mortgage guaranty insurance, and continuing with implementation of Section 832(e) in 1968 when those rulings were revoked and a revision to Section 832(e) in1974 when state insurance laws imposed contingency reserve requirements on lease guaranty insurance and tax-exempt bond insurance. In fact, the relationship has become so well established that the State

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S. Rep. No 918, 90th Cong. 1st Sess. (1967), reprinted in 1967 U.S. Code Cong. & Admin. News, 2698–99. The provision was designed to "solve this unique problem created by unusual State requirements."

[3] Ordinarily, if a taxpayer has a loss, it will be able to claim a deduction and, as a result, will experience a reduction in what its income taxes otherwise would have been. Under section 832(e), however, a loss does not lead to such a decline in income tax revenue. Although the insurance company will claim a deduction for the amount of such loss, this deduction will be offset by the amount of the reserve restored to income. As a result, there will be no net change in taxable income, or tax revenue, at that time. Instead, the government will redeem an amount of tax and loss bonds equal to the tax savings the company experienced when it claimed the reserve deduction in an earlier year.

of New York, when it enacted legislation in 1989 providing that financial guaranty insurance was subject to contingency reserves, specifically authorized the insurers to invest in "tax and loss bonds (or similar securities) purchased pursuant to Section 832(e) of the Internal Revenue Code (or any successor provisions)."

Even if one concedes that the Joint Committee's assertion that Section 832(e) of the Code and related use of tax and loss bonds does "give rise to complexity," it is a long-established complexity that permits financial guaranty insurers to comply with state-imposed contingency reserve requirements without impairing their capital—a result that benefits the insurance companies, the parties whose obligations are insured, and the investing public that owns those obligations.

Elimination of Section 832(e) will greatly increase the complexities faced by the insurers who would be forced to attempt to change the statutory accounting rules in various states and should they fail to do so, which is likely, would face the possibility of impairment of their capital, a detrimental result for the insurers, the insureds and the beneficiaries.

AFGI respectfully submits that Section 821(e) not be eliminated.

Assuming tax rates have not changed in the interim, the amount paid to redeem the bonds will equal the amount by which taxes would (as a result of the loss) have declined had section 832(e) not been involved.

STATEMENT OF THE INVESTMENT COMPANY INSTITUTE

The Investment Company Institute (the "Institute")[1] is pleased to submit this statement to the Senate Finance Committee regarding the Joint Committee on Taxation's study of the overall state of the Federal tax system. In the report summarizing the results of its study, the Joint Committee has recommended a number of simplifications that would affect retirement savings vehicles and other long-term savings vehicles, including education savings vehicles. The Institute strongly supports efforts by the Joint Committee to simplify the rules applicable to retirement and other long-term saving incentives, thereby increasing opportunities for Americans to save for their retirement and other long-term goals, including saving for their children's education.

Millions of Americans use mutual funds to save for retirement and other long-term financial needs. Mutual funds are a significant investment medium for employer-sponsored retirement programs, including section 401(k) plans, 403(b) arrangements and the Savings Incentive Match Plan for Employees ("SIMPLE") used by small employers, as well as for individual savings vehicles such as the traditional and Roth IRAs. As of December 31, 1999, mutual funds held about $2.4 trillion in retirement assets, including $1.2 trillion in Individual Retirement Accounts ("IRAs") and $777 billion in 401(k)s. We estimate that about 49% of all IRA assets and 45% of all 401(k) assets are invested in mutual funds.[2]

The Institute has long supported efforts to enhance retirement savings and other long-term savings for Americans, including efforts that would expand savings opportunities, simplify the rules applicable to IRAs and qualified plans and enable individuals to better understand and manage their retirement assets. We support the Joint Committee's efforts in recommending simplification of various retirement and education savings vehicles. While the Joint Committee has made numerous recommendations worthy of consideration, we focus our testimony on four basic areas: (1) IRA eligibility rules; (2) individual account plan rules; (3) required minimum distribution rules ("RMDs"); and (4) education savings vehicles.

I. IRA ELIGIBILITY RULES

The Joint Committee recommends eliminating phase-outs relating to IRAs and eliminating the income limits on the eligibility to make deductible IRA contributions, Roth IRA contributions and conversions of traditional IRAs to Roth IRAs. The Joint Committee also recommends that the age restrictions on eligibility to make IRA contributions should be the same for all IRAs. Further, the Joint Committee recommends eliminating the nondeductible IRA. The Joint Committee's report states that the IRA recommendations would reduce the number of IRA options and

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[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,444 open-end investment companies ("mutual funds"), 490 closed-end investment companies and 8 sponsors of unit investment trusts. Its mutual fund members have assets of about $6.868 trillion, accounting for approximately 95% of total industry assets, and over 83.5 million individual shareholders.

[2] *"Mutual Funds and the Retirement Market," Fundamentals*, Vol. 9, No. 2 (Investment Company Institute, May 2000).

conform the eligibility criteria for remaining IRAs, thus simplifying taxpayers' savings decisions. We strongly support these changes. We wish to emphasize, however, that the nondeductible IRA should only be eliminated if the other recommended changes are made.

The Committee's recommended simplification of the IRA rules responds to an urgent need. Current IRA eligibility rules are so complicated that even individuals eligible to make a deductible IRA contribution are often deterred from doing so. When Congress imposed the current income-based eligibility criteria in 1986, IRA participation declined dramatically—even among those who remained eligible for the program. At the IRA's peak in 1986, contributions totaled approximately $38 billion and about 29% of all families with a household under age 65 had IRA accounts. Moreover, 75% of all IRA contributions were from families with annual incomes of less than $50,000.[3] However, when Congress restricted the deductibility of IRA contributions in the Tax Reform Act of 1986, the level of IRA contributions fell sharply and never recovered—to $15 billion in 1987 and $8.4 billion in 1995.[4] *Even among families retaining eligibility to fully deduct IRA contributions, IRA participation declined on average by 40% between 1986 and 1987, despite the fact that the change in law did not affect them.*[5] The number of IRA contributors with income of less than $25,000 dropped by 30% in that one year.[6]

Indeed, fund group surveys show that almost fifteen years later, many individuals continue to be confused by the IRA eligibility rules. American Century Investments surveyed 753 self-described retirement savers with respect to the rules governing IRAs. The survey results found that changes in eligibility, contribution levels and tax deductibility have left a majority of retirement investors confused.[7] This confusion is an important reason behind the decline in contributions to IRAs from its peak in 1986.

For these reasons, the Institute strongly supports the Joint Committee's recommendation to repeal the IRA's complex eligibility rules, which primarily serve to deter lower and moderate income individuals from participating in the program. A return to the "universal" IRA would result in increased savings by middle and lower-income Americans.

The Committee's report correctly recognizes that the return of the "universal IRA" together with the availability of the Roth IRA would eliminate the need for the nondeductible IRA. However, it is important to note that, in the absence of the Committee's other changes, the nondeductible IRA serves an important purpose—enabling those individuals not eligible for a deductible or Roth IRA to save for retirement. Consequently, the nondeductible IRA should only be eliminated if Congress repeals the income limits for traditional and Roth IRAs.

II. INDIVIDUAL ACCOUNT PLAN RULES

Employer-sponsored retirement plans are a key part of the system of incentives and opportunities we provide for American workers. However, as is the case with IRAs discussed above, the complexity of the rules applied to employer-sponsored plans frequently deters employers from establishing plans and workers from using them. Congress should reduce the complexity that discourages workplace retirement savings by simplifying the rules governing retirement plans.

The Joint Committee's recommendations, in part, focus on the rules applicable to various individual account type programs. This is a good place to start, as many Americans are confused by the various plan types, each with its own set of rules. Specifically, the Joint Committee recommends conforming the contribution limits of tax-sheltered annuities to the contribution limits of comparable qualified retirement plans. The Joint Committee notes that conforming the limits would reduce the recordkeeping and computational burdens related to tax-sheltered annuities and eliminate confusing differences between tax-sheltered annuities and qualified retirement plans. The Joint Committee also recommends allowing all State and local governments to maintain 401(k) plans. This, according to the Joint Committee's report,

[3] Venti, Stephen F. "Promoting Savings for Retirement Security," Testimony prepared for the Senate Finance Subcommittee on Deficits, Debt Management and Long-Term Growth (December 7, 1994).
[4] Internal Revenue Service, Statistics of Income.
[5] Venti, supra at note 3.
[6] Internal Revenue Service, Statistics of Income.
[7] American Century Investments, as part of its "1999 IRA Test," asked 753 self-described retirement "savers" ten general questions regarding IRAs. Only 30% of the respondents correctly answered six or more of the test's ten questions. Not a single test participant was able to answer all ten questions correctly.

would eliminate distinctions between the types of plans that may be offered by different types of employers and simplify planning decisions.

The Institute supports these efforts to reduce the complexity associated with retirement plans—especially for workers trying to understand the differences between 401(k), 403(b) and 457 plans. The ability of workers to understand the differences among plan types becomes even more important as Congress considers enacting portability provisions.[8] These provisions would enhance the ability of American workers to take their retirement plan assets to their new employer when they change jobs by facilitating the portability of benefits among 401(k) plans, 403(b) arrangements and 457 state and local government plans and IRAs. The Institute strongly supports portability and other efforts by Congress to simplify and conform rules that apply to different plan types in order to assist workers in understanding their retirement plans.

III. REQUIRED MINIMUM DISTRIBUTION RULES

The Joint Committee suggests various significant changes to the RMD rules applicable to tax-qualified retirement plans and IRAs. Specifically, the Committee recommends that the RMD rules should be modified so that: (1) no distributions are required during the life of a participant; (2) if distributions commence during the participant's lifetime under an annuity form of distribution, the terms of the annuity will govern distributions after the participant's death; and (3) if distributions either do not commence during the participant's lifetime or commence during the participant's lifetime under a nonannuity form of distribution, the undistributed accrued benefit must be distributed to the participant's beneficiary or beneficiaries within five years of the participant's death. The Joint Committee states that the elimination of RMDs during the life of the participant and the establishment of a uniform rule for post-death distributions would significantly simplify compliance by plan participants and their beneficiaries, as well as plan sponsors and administrators.

While we support the Joint Committee's efforts toward simplification of the RMD rules, we believe that the specific recommendation must be further considered to assure that there are no unintended consequences. For example, we are concerned that a rule that would require distribution of the entire account balance subject to the RMD rules within five years of the death of the participant could result in harmful consequences for the participant's beneficiary or beneficiaries. We note that the Internal Revenue Service recently released proposed regulations that significantly simplify the rules applicable to RMDs. Under the proposed regulations, in general, a beneficiary would be permitted to take RMDs over his or her lifetime. In cases where a participant names a spouse or child as beneficiary, the ability of that beneficiary to take RMDs over his or her life expectancy would generally be preferable to a requirement that the entire account be distributed within five years of the death of the participant. Notwithstanding our concern with the specific recommendation of the Joint Committee, however, we wholeheartedly support efforts to simplify the RMD rules and would be happy to work with the Joint Committee staff to develop proposals to do so.

IV. EDUCATION SAVINGS VEHICLES

The Joint Committee recommends several simplifications related to education savings vehicles. First, the Committee recommends eliminating the income-based eligibility phase-out ranges for the HOPE and Lifetime Learning credits. As with IRAs, we believe the phase-outs unnecessarily complicate these programs and deter participation among those eligible.

Second, the Committee recommends that a uniform definition of qualifying higher education expenses should be adopted. A uniform definition would eliminate the need to taxpayers to understand multiple definitions if they use more than one education tax incentive and reduce inadvertent taxpayer errors resulting from confusion with respect to the different definitions.

Third, the Committee supports combining the HOPE and Lifetime Learning credits into a single credit. As the Joint Committee states, combining the two credits would reduce complexity and confusion by eliminating the need to determine which credit provides the greatest benefit with respect to one individual and to determine if a taxpayer can qualify for both credits with respect to different individuals.

Finally, the Committee recommends eliminating the restrictions on the use of education tax incentives based on the use of other education tax incentives and re-

[8] H.R. 10, the "Comprehensive Retirement Security and Pension Reform Act of 2001" and S. 742, the "Retirement Security and Savings Act of 2001."

placing them with a limitation that the same expenses could not qualify under more than one provision. The Joint Committee states in its study that this recommendation would eliminate the complicated planning required in order to obtain full benefit of the education tax incentives and reduce "traps for the unwary."

We support the Joint Committee's efforts to simplify the rules applicable to various education savings vehicles. Savings for their children's education is a top priority for many working Americans. We applaud the Joint Committee's efforts to streamline the rules relating to education tax incentives. By reducing the complexity surrounding these various tax incentives and education savings vehicles, Congress will enable more Americans to take advantage of opportunities to save for their children's education.

V. CONCLUSION

Today's individual and employer-sponsored retirement system has evolved into a complex array of burdensome requirements and restrictive limitations that can serve as barriers to retirement savings. The same holds true for education tax incentives. Simplifying the rules relating to retirement and education savings vehicles would encourage greater savings by American workers.

STATEMENT OF THE MORTGAGE INSURANCE COMPANIES OF AMERICA

INTRODUCTION AND OVERVIEW

This testimony outlines the comments of the Mortgage Insurance Companies of America on the Joint Committee on Taxation's proposal to eliminate Internal Revenue Code ("IRC" or "Code") section 832(e).[1] Without impacting the Federal Treasury, IRC section 832(e) embodies a series of special deduction rules that apply specifically to mortgage and lease guaranty insurance and to insurance of state and local obligations.

The Mortgage Insurance Companies of America (MICA) is a national trade association of the private mortgage insurance industry. The organization's members help loan originators and investors make funds available to home buyers with as little as 3-to-5 percent down—and even less for qualified borrowers—by protecting these institutions from a major portion of the financial risk of default. The private mortgage insurance industry's mission is to help put as many people as possible into homes sooner for less money down, and to ensure that they stay in those homes. By insuring conventional low down payment mortgages, MICA members have made homeownership a reality for more than 20 million families.

MICA strongly urges Congress to reject the Joint Committee on Taxation's ("JCT" or "Committee") suggestion that Congress eliminate IRC section 832(e). Further, MICA believes that several of the premises upon which JCT bases its suggestion are inaccurate or fail to adequately reflect the true value of IRC section 832(e) for the mortgage insurance industry and its customers.

DESCRIPTION OF CURRENT LAW AND JOINT COMMITTEE ON TAXATION'S PROPOSAL

Current Law

Congress enacted IRC section 832(e) in 1967 to address financial pressures on the mortgage guaranty insurance industry and related insurers resulting from States mandating the creation of contingency reserves for extraordinary losses arising during adverse economic periods. In many States, up to 50 percent of premiums received in any one year have had to be set aside for these contingency reserves. The size of these reserves created a substantial drain on the working capital of these insurers. Prior to enactment of IRC section 832(e), it was unclear whether the Code permitted companies to take a tax deduction to offset the cost of additions to these reserves. Without a tax deduction for these reserves, the companies were required not only to set aside massive funds for the reserves, but also to pay taxes on such reserved funds. Accordingly, since the portion of annual earned premiums required to be set aside in the reserves could not be used to pay current losses and other expenses, a current tax on premiums thus set aside further depleted the companies' assets and created a drain on working capital. A drain on working capital means

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[1] Staff of the Joint Comm. on Taxation, 107th Cong., Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986, Volume II: Recommendations of the Staff of the Joint Committee on Taxation to Simplify the Federal Tax System 377 (Comm. Print 2001).

that a mortgage insurer's ability to continue to insure more loans and thus expand homeownership opportunities for lower income families would be limited.

The Code addresses the strain these State rules place on a mortgage guaranty insurer's working capital through a unique statutory provision that was carefully drafted to meet the concerns of both the federal government and the insurance industry. Specifically, IRC section 832(e) allows companies to deduct payments made to such reserves, subject to the following limitation: the deduction can be no greater than the lesser of (i) the company's taxable income or (ii) 50 percent of the premiums the company earned on guaranty contracts for the same taxable year. Deductible amounts added to the reserve must be restored to income no later than the close of 10 years, regardless of loss experience or a State's funding requirements.

Congress determined, however, that insurers should not realize an economic benefit from this deduction, in large part because the State reserve requirements were so substantial. Further, Congress wanted to accomplish this requirement in a way to minimize the financial hardship on insurers. Accordingly, IRC section 832(e) requires insurers who take the deduction to purchase non-interest-bearing tax and loss bonds equal to the amount of tax savings attributable to the related deductions. The bonds cannot be redeemed without the amounts in the reserve fund being restored to income (and therefore made subject to the federal income tax), either because of heavy, catastrophic losses or through operation of the 10-year rule mentioned above. Amounts received in redemption of the bonds are typically used to pay income taxes resulting from inclusion in income of the previously deducted amount Congress knew that the economic impact of purchasing the tax and loss bonds would be ameliorated since the bonds qualified as assets for State financial regulatory purposes. In summary, IRC section 832(e) denies mortgage guaranty insurance companies the benefit of tax deferral with respect to amounts deducted, but does not create a drain on the company's assets since the bonds are recognized as assets for relevant state regulatory and accounting purposes and, therefore, mortgage insurers can continue to expand homeownership opportunities for families who do not have sufficient resources to save for a large down payment.

Joint Committee on Taxation Proposal

Description of Proposal

The Joint Committee on Taxation has suggested that IRC section 832(e) be eliminated. The Committee believes the section provides "no Federal income tax goal, but rather, only a particular financial accounting result." Contrary to the Committee's belief, however, IRC section 832(e) does in fact address the primary policy goal recognized by Congress in 1967, by helping to alleviate the burdens placed on the mortgage guaranty insurance industry through compliance with State and local reserve requirements. This in turn promotes home ownership. Any reduction or elimination of this important section of the Code would significantly impair the industry's ability to provide mortgage guaranty insurance.

Reasons for Maintaining Current Law

Although IRC section 832(e) could be viewed as adding some complexity to the Code, the few companies that actually utilize and depend on the section [2] believe it is a fair, workable and necessary provision. Unlike Code provisions for many other industries, the current tax system for the insurance industry takes into account how State-mandated statutory accounting principles impact the industry's ability to operate and compete effectively. In particular, IRC section 832(e) reflects Congress' full appreciation of the burdens such State requirements place on the mortgage guaranty insurance industry, while also recognizing the economic realities of this business. Congress' original rationale for enacting Code IRC section 832(e) remains valid, and the same conditions, i.e., adverse economic cycles and the State regulatory system for the mortgage guaranty industry, continue to exist.

IRC section 832(e) also strikes a delicate balance between the business realities of the industry and the revenue needs of the Federal government. The deduction makes it easier for companies to fund their State-mandated reserves, thereby setting aside funds in good years that can be used to pay claims for losses that may arise many years later. U.S. property and casualty insurers are currently seeking a similar addition to the Code (H.R. 785), which would allow property and casualty insurers a deduction to set aside similar reserves for future catastrophic losses. The property and casualty insurers believe this addition to the Code would help them develop a domestic market capable of assuming long-term risks. Their losses are not

[2] Approximately two dozen companies, including mortgage and lease guaranty and municipal bond insurance companies, can and do utilize IRC section 832(e).

unlike the losses born by the mortgage guaranty industry, as both are the result of periodic adverse cycles and State regulatory requirements.

The balanced compromise in IRC section 832(e) should not be disturbed. The industries' need for funded loss reserves has been addressed under a compromise that requires companies to purchase non-interest-bearing tax and loss bonds in an amount equal to their tax savings attributable to the deduction. Purchase of the bonds provides the Federal government with an immediate receipt of funds, while companies are permitted to use the bonds to offset the high costs of funding the reserves required by their long-term economic risks. The tax and loss bonds qualify as assets for State financial regulatory purposes and offset working capital problems insurance companies would otherwise experience.

Importantly, the private mortgage guaranty insurance industry's main competitor is a tax-exempt agency of the federal government, the Federal Housing Administration ("FHA"). Any elimination of IRC section 832(e) would reduce the private mortgage guaranty insurance industry's ability to compete fairly with the FHA.

CONCLUSION

An elegant solution for a unique situation, IRC section 832(e) has worked well for more than 30 years. IRC section 832(e) continues to help stabilize the mortgage guaranty insurance industry through periods of economic instability. It recognizes the conservative capital requirements imposed on the industry through State-required contingency reserves. Its intent is to provide a methodology to ameliorate the effects of these reserves on the working capital of the insurers. It achieves this at no cost to the Federal Treasury. Thusly, mortgage insurance companies are able to continue to expand homeownership opportunities by helping millions of American families afford homeownership. For these reasons, MICA urges Congress to reject any proposal that would limit or eliminate IRC section 832(e).

STATEMENT OF THE MUTUAL TAX COMMITTEE

This is a statement by the Mutual Tax Committee in Support of H.R. 661.

The Mutual Tax Committee is an organization of current and former mutual life insurance companies that addresses issues relating to section 809 of the Internal Revenue Code of 1986, as amended. H.R. 661, introduced by Congressman Houghton and Neal on behalf of themselves and other members on February 14, 2001, would enact the Life Insurance Tax Simplification Act of 2001. This Act would repeal two sections of the Code, section 809, relating to mutual life insurance companies, and section 815, relating to stock life insurance companies. While the primary focus of this statement is on reasons why section 809 should be repealed, the Mutual Tax Committee also supports repeal of section 815.

SUMMARY

Section 809 was based on competitive industry circumstances that no longer exist, and on a tax theory that has been determined to be invalid. Additionally, the formulaic approach embodied in the statute has numerous design flaws that distort the measurement of the tax. While section 809 has become an erratic and insignificant revenue source for the Treasury, it poses a significant and unpredictable burden for companies continuing to operate in mutual form. Because section 809 taxes the policyholder dividends of mutual life insurance companies, it increases the cost of insurance to consumers of financial products issues by mutual life insurers. Repeal of section 809 is supported by the Consumer Federation of America, the National Cooperative Business Association, and the American Council of Life Insurers.

Section 809 is perhaps the single most flawed tax provision applicable to corporate enterprises in the United States and should be repealed.

BACKGROUND

Section 809 was enacted in 1984 when more than 100 mutual life insurance companies comprised about one-half of the life insurance industry, and held over one-half of industry assets. The purpose of section 809 was to provide for neutral taxation between mutual and stock life insurance companies with respect to the taxation of equity returns. Stock companies pay shareholder dividends which are not deductible. It was thought by some that mutual companies included equity returns in their "dividends" to policyholders that were like shareholder dividends. There is no way of identifying mutual company equity returns, if any, however, since policyholder dividends are wholly or primarily price rebates to customers, and such price adjustments are deductible by all corporations.

Section 809 represented an attempt to define and measure the portion of policyholder dividends (and other price adjustments) that constitute equity returns based on a theory initially developed by Henry Aaron of the Brookings Institution. The theory was that the mutual company earnings rate after the payment of policyholder dividends would generally be lower than the stock company earnings rate before shareholder dividends, and that non-deductible mutual company equity returns could be measured by applying a formula that compares these earning rates. In 1984, Congress established an elaborate process for measuring so-called differential earnings rates that requires annual filings of information returns by all mutual life insurance companies and by the 50 largest stock life insurance companies, and annual calculation of earnings rates by the Internal Revenue Service. Each mutual life insurance company multiplies the differential earnings rates announced annually by the Internal Revenue Service by its tax equity (as defined by section 809) to determine a differential earnings amount and a recomputed differential earnings amount. These amounts are then used to impute income to each mutual company in years in which the amounts thus calculated are positive.[1]

H.R. 661

Section 2 of H.R. 661 would repeal section 809 for taxable years beginning after December 31, 2000. Substantially identical legislation was adopted by the House of Representatives and was under consideration by the Senate at the conclusion of the 106th Congress. On March 29, 2001, staff of the Joint Committee on Taxation estimated the five-year cost of repealing section 809 to be $210 million.[2]

REASONS SUPPORTING REPEAL OF SECTION 809

The issue of competitive balance between stock and mutual life insurers no longer exists

When section 809 was enacted, there was a distinct life insurance industry, and there were over 100 mutual life insurers that by some measures of business activity accounted for more than one-half of the industry. Today's life insurance industry is increasingly becoming assimilated within the financial services industry, and the mutual life insurance sector has declined significantly. There are now only about 25 remaining mutual life insurance companies. Indeed, of the 25 largest mutual life insurers that conducted business in 1984, by the end of 2001, only four will remain. Companies continuing as mutual life insurers will soon account for less than 10 percent of the life insurance business. This remaining sliver of the life insurance industry will compete with a stock segment that is now largely composed of former mutual organizations and with other providers of financial services that have never been subject to a tax like section 809, regardless of organizational form.

Many mutual life insurers have concluded that to remain competitive in today's financial service marketplace, it is necessary to convert to investor-owned stock corporations through a process known as demutualization. Other mutual life insurance companies have adopted the mutual holding company form of organization under which the membership interest is transferred to a mutual holding company ("MHC") and the contractual interest is maintained by a stock life insurance company owned by the MHC. Once these demutualizations or conversions occur, the company is no longer subject to section 809.

Thus, the original perceived need for section 809—to maintain competitive balance with a life insurance industry composed of mutual and stock organizations—has disappeared.

The experts agree that the theoretical basis for Section 809 was flawed

When Congress enacted section 809 in 1984, it made a conscientious and good faith effort to determine appropriate taxation of mutual life insurers, but it also recognized that the implementation and administration of section 809 might reveal theoretical or operational flaws in section 809 that needed reexamination. Accordingly, Congress mandated studies of section 809 and reports to Congress on these issues. As a result, the Treasury Department issued two reports, an interim report

[1] The statute is susceptible of an interpretation, in certain years, that produces negative differential and recomputed differential earnings amounts. However, the Treasury Department and IRS have determined that negative amounts are to be ignored, and the courts have confirmed these determinations. In many recent tax years, section 809 has neither increased nor decreased the tax liabilities of mutual companies.

[2] The ten-year cost was estimated to be $416 million.

in 1988 and a final report in August, 1989.[3] The Government Accounting Office also issued a report to the Congress in these years.[4] Both the Treasury Department and the GAO concluded that the theoretical basis for section 809 was mistaken. The basic flaw was revealed in what became the taxation of capital upon receipt and the allowance of deductions for returns on capital. Under the current model for taxing corporate income, capital returns should be taxed only once, either when returns on capital are paid to owners or when the capital is received. Stock companies do not pay any tax on the receipt of capital so that it is appropriate that returns on stock company capital should not be deductible. On the other hand, mutual companies' sole source of capital is in premiums received from policyholders. Since such premiums are fully taxed when received, the tax on capital is "prepaid", and the justification for disallowing deductions for capital returns in policy dividends and other benefits disappears.[5]

The prepayment analysis that Treasury and GAO adopted was based on a study by Yale Law Professor Michael Graetz,[6] who subsequently served in the Treasury Department. Remarkably, the prepayment analysis was subsequently endorsed by Henry Aaron, who acknowledged that his initial analysis of this issue (upon which Congress relied in 1984) was mistaken and who subsequently characterized section 809 as a "legislative atrocity."[7] The prepayment analysis was also endorsed by other renowned economists, including Michael Boskin and John Shoven of Stanford University and Robert Shapiro of the Progressive Policy Institute.[8]

When Congress addressed the taxation of mutual property and casualty companies in 1987, it considered whether to apply a differential tax based on the mutual life insurance model contained in section 809 to mutual property and casualty companies. By this time, however, the flaws of section 809 were beginning to be recognized, and this precedent was not extended to the property and casualty industry. Also, the Treasury Department and Internal Revenue Service has correctly declined to apply section 809 to life insurance companies that are owned by other mutual organizations, such as life insurance subsidiaries of mutual property and casualty companies, foreign mutual life insurance companies, mutual holding companies or exempt organizations.

Thus, under a correct policy analysis, U.S. mutual life insurers are overtaxed, not only in comparison to traditional stock companies, but also in comparison to other forms of mutual enterprise.

Section 809 contains numerous design flaws

What initially strikes most observers as the most bizarre feature of section 809 is that it taxes mutual life insurance companies on the basis of the earnings of its stock company competitors. That is like taxing Ford on the income of GM, it has been noted. Thus, if the income of large stock companies increases, the tax liabilities of mutual life insurance companies increase. The absurdity does not stop there, however. If the income of mutual life insurance companies decreases because the companies have experienced a bad year of operations, section 809 taxes increase. Under the tortuous structure of section 809, this flaw is exacerbated because the section 809 formula compares the mutual earnings of the current year to stock earnings of previous years. As a consequence, section 809 has tended to impose the largest taxes on mutual life insurers in years when industry earnings decline. This is because a comparison based on the difference between the current year's low mutual company earnings and prior years' high stock company earnings produces a large differential earnings amount. The section 809 formula will soon reach the summit of the absurd. Unless repealed, in 2001, differential earnings of mutual companies

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[3] Department of the Treasury, *Interim Report to the Congress on Life Insurance Company Taxation* (June 1988); and Department of the Treasury, *Final Report to the Congress on Life Insurance Company Taxation* (August 1989).

[4] U.S. General Accounting Office, *Tax Policy: Allocation of Taxes within the Life Insurance Industry* (October 1989).

[5] Quite similar concepts have been applied to IRAs by the Congress, which concluded that there is a general equivalence between traditional IRAs and Roth IRAs. A taxpayer who contributes to a traditional IRA is able to deduct the contribution, but is fully taxable on returns from the IRA. In contrast, under the Roth IRA, contributions are not deductible, but returns are not taxable.

[6] Graetz, *Life Insurance Company Taxation: An Overview of the Mutual Stock Differential*, Proceedings of the Yale Conference (1986).

[7] Statement of Henry Aaron before the Committee on Ways and Means, U.S. House of Representatives (October 19, 1989).

[8] Boskin, Shoven, Smart, *Economic Issues in the Taxation of Mutual and Stock Life Insurance Companies*, Stanford Center for Economic Policy Research, discussion Paper Series No. 126 (1988), Shapiro, *Neutrality in the Taxation of the Life Insurance Industry*, Insurance Tax Review 2607 (1996).

will be based on the earnings rates of large stock companies, most of which are former mutual companies or have some mutual or foreign company affiliation. Additionally, 50 large stock companies will be required to file information returns to determine the tax liability of about four or five large, and perhaps 20 small, mutual companies.

The section 809 tax imposed on mutual companies is dependent not only on the earnings of their stock company competitors, but on the earnings of other mutual companies as well. Under the quirky mechanics of the statute, if the earnings of another mutual company change either upward or downward, the section 809 tax imposed on all other mutual companies also changes.

Revenues from Section 809 are insignificant from Treasury's perspective, but extremely burdensome from the standpoint of remaining mutual life insurers

As stated above, the cost of repealing section 809 averages only about $40 million a year. It may be noted that section 809 has produced virtually no revenue in the past five years, and the most likely expectation in any single year is that it will produce no revenue. Still, from the standpoint of remaining mutual life insurers, the section 809 tax is an ever present and totally unpredictable threat. Moreover, since the amount of the tax varies with a company's capital, it impedes normal corporate transactions, such as mergers. Finally, while most remaining mutual life insurers would like to stay in mutual form, the structure of the tax provides an incentive to change form of organization, precisely the type of incentive that policymakers generally seek to avoid.

To maintain efficient and competitive markets for consumers of life insurance company products, it is important to provide tax neutral rules for mutual life insurance companies

At the beginning of the 20th century, New York's Armstrong Commission concluded that the business of insurance is inherently mutual since much of the capital life insurance companies work with is provided by policyholders. Because life insurance company products involve long term commitments by customers, the cost of providing insurance can only be determined over long periods. The Armstrong Commission concluded that the mutual form was an ideal organization for satisfying customer needs over the long term because it did not need to reconcile the separate goals of customers and investors. The companies that continue as mutual companies still believe that mutual organizations perform a unique service in delivering and maintaining products in the marketplace. While stock companies have different perspectives and needs, all parties agree that tax laws should not dictate the form of organization of the carrier.

This year, the Consumer Federation of America and the National Cooperative Business Association adopted resolutions calling for the repeal of section 809. Section 809 is one of the few business tax provisions directly of concern to consumers and consumer organizations. From the perspective of consumers, it is important to permit continued competition by mutual life insurance companies and to eliminate an inappropriate tax on policyholder dividends. Repeal of section 809 is supported also by the American Council of Life Insurers (ACLI), the industry trade organization for both stock and mutual life insurers.

A Taxing Trend:
The Rise in Complexity, Forms and Paperwork Burdens

Statement of
David L. Keating*

Submitted to the
Committee on Finance
United States Senate

April 26, 2001

Summary:

- **Taxpayers Must Cope with Longer Forms and Instructions.** Even when the income tax became a mass tax during WWII, instructions to Form 1040 were 4 pages long. Now taxpayers wade through 117 pages of instructions, more than double the number in 1985, the year before taxes were "simplified."

- **Paid Professionals Now Prepare Most Returns, and Charge More.** The number of taxpayers relying on paid professionals for help has soared by 48% since 1980. When accounting for paid preparers *and* computer tax software programs, more than 4 out of 5 returns are prepared with such assistance today. Since 1985 the average fee at H&R Block rose 136% overall, or 42% after accounting for inflation.

- **It's Taking Longer to Prepare Returns.** The 1040 form is often filed with Schedules A, B, and D to report deductions and investment income. From 1990 to 2000, the burden for a taxpayer to learn about, prepare, and assemble these forms rose by 47%, to more than 27 hours. Even the 1040 "EZ" form requires 96% more time to complete than it did 10 years ago.

- **IRS Paperwork Swamps Attempts to Simplify.** In 1995 Congress mandated that all federal agencies reduce paperwork burdens by 30% by the year 1999. The law has been a failure, largely because of taxes. In FY 2000, total federal paperwork burdens for all agencies are estimated at 7.45 billion hours, 6.13 billion of which come from the Treasury.

***About the Author**

David L. Keating is Senior Counselor to the National Taxpayers Union and served on the National Commission on Restructuring the IRS.

Mr. Chairman, and members of the Committee, thank you for holding this much needed hearing on tax simplification. Like old age, tax complexity has been creeping up on us. We may not notice it one year at a time, but a review of older tax instructions reveals just how shockingly complicated taxes have become today.

Sixty-five years ago the Form 1040 instructions were just two pages long. Even when the income tax became a mass tax during World War II, the instructions took just four pages. Today taxpayers must wade through 117 pages of instructions, triple the number in 1975 and more than double the number in 1985, the year before taxes were "simplified."

Form 1040 -- Form and Instructions

Tax Year	Lines 1040	Form Pages 1040	Instruction Booklet Pages 1040
2000	70	2	117
1995	66	2	84
1985	68	2	52
1975	67	2	39
1965	54	2	17
1955	28	2	16
1945	24	2	4
1935	34	1	2

If you need help with something more complicated, the IRS prints at least 943 forms and instructions. UncleFed.com added up the length of these publications at our request and found a total of 12,933 pages for this tax-filing year alone.

Even the IRS is complaining about the burden. The new annual report of the IRS National Taxpayer Advocate identifies tax complexity for individuals and businesses as the number one and two most "serious problems encountered by taxpayers," and the "root cause" of the top twenty.

Paid Professionals Now Prepare Most Tax Returns

As the tax system's complexity has grown, more taxpayers are running to tax professionals to prepare their returns. While it is still too early to come to a final conclusion, it appears that more taxpayers will have used a tax pro this year. Through March 17, 56.3% of taxpayers used a pro, up from 53.8% at the same time last year. The more complex tax returns, which require professional assistance, tend to be filed later in the season.

The number of taxpayers using paid professionals has soared by 48% since 1980 and by 17% during the past decade. While some of this increase can be attributed to rising incomes, the growing use of home computers and tax preparation software has likely curtailed the rush to paid professionals.

The growth in the use of paid preparers can be accurately tracked because beginning in 1977 tax professionals have been required to sign returns they have been paid to prepare.

Tax Returns Signed by Paid Preparers

Tax Year	Paid Preparer Returns (percent)
1980	38.0%
1985	45.9%
1990	47.9%
1995	49.9%
1999	56.2%
2000*	58.0%

*NTU estimate

Between 1966 and 1977, anyone who prepared a return was required to sign it in addition to the taxpayer, meaning many unpaid relatives or friends signed the returns. Therefore, the data for the first few years probably overstates paid-preparer participation, because undoubtedly many unpaid people who had signed returns for years kept doing so even after the law had changed.

Tax preparation software has grown in sophistication as Windows software has come to dominate the PC market, enabling more taxpayers to sit in front of a computer and answer a seemingly endless stream of questions while the computer figures out how to prepare the return.

In 1980 no individual taxpayers used computers to prepare their taxes. Yet today, when accounting for paid preparers *and* computer returns combined, about 80% of all returns are prepared with such assistance.

Use of Paid Preparers and Computers

Tax Year	Paid Preparer plus Computer Prepared Returns (percent)
1980	38.0%
1996	66.4%
1997	70.5%
1999	76.3%
2000*	80.2%

* Through Mar. 17

Tax Preparation Fees are Rising Too

Tax preparation fees have increased substantially, largely due to increased complexity of the average tax return. One way of tracking the trend in fees is to examine the average fees charged by H&R Block, a publicly-traded company.

This rise in complexity has boosted profits at H&R Block, the nation's largest tax preparation firm. Its average $107 fee has increased 136% since 1980, or 42% after accounting for inflation. The sharp rise in fees is even more remarkable considering the huge increase in the capability of computers, tax return software and printer speed. The efficiency gain of computers and printers has likely been overwhelmed by the increases in complexity.

Average Fee Charged by H&R Block

Calendar Year	Nominal Dollars	Adjusted for Inflation
1985	$45.39	$75.33
1988	$49.21	$74.47
1998*	$84.39	$91.44
1999*	$92.57	$98.65
2000**	$97.13	$100.76
2001**	$107.26	$107.26

* Through April 15
** Through March 15

Tax Complexity Will Probably Get Worse

Tax complexity probably will get worse before it gets better. Although the tax relief legislation proposed by President George W. Bush would cut tax rates, it increases complexity. Married couples and donors to charities could claim new deductions, and the long phase-in of the tax cut and long phase-out of the death tax would cause new tax planning headaches.

Income taxpayers will consider timing their incomes to take advantage of latter-year tax rate cuts, while those concerned about the death tax must revise their estate plan to account for the gradual phase-out of the tax.

Because the tax cut would sharply reduce middle-class taxes, over 25 million more taxpayers would be forced to complete a second tax return for the Alternative Minimum Tax (AMT), a parallel and complex tax system once aimed at ensuring the rich paid a substantial tax bill. As if one tax return wasn't difficult enough already.

Worse, more complexity will grease the tax cut deal eventually struck by the President, House and Senate. Some of the tax code's most complex provisions have been created by political compromises that involve splitting differences or adding obscure tax breaks, which too often creates senseless complications. With control of Congress

teetering between the two parties, we can expect more compromises and more complexity.

Federal Law Orders Cut in Paperwork, but Tax Paperwork Burden Rises

In an attempt to bring the paperwork burden under control, Congress passed the Paperwork Reduction Act of 1995, which set annual goals for Federal agencies to meet. According to the Office of Management and Budget, the new law "set an annual government-wide goal for the reduction of the total information collection burden of 10% during each of Fiscal Years 1996 and 1997 and 5% during each of Fiscal Years 1998 through 2001. The baseline is the total burden of information collections as of the end of FY 1995."

By that measurement, the law has been a failure, largely due to the increasing burdens at the IRS. Burden hours at all agencies are expected to increase from 6,901 million hours in 1995 to 7,435 million hours in 2000.

Instead of declining by double-digit rates, tax paperwork burdens will soar by about 15% during the five years ending in 2000.

An earlier Paperwork Reduction Act passed in 1980 required federal agencies to track the paperwork burden imposed on citizens and business by their forms and recordkeeping requirements. In order to comply with the law, the IRS commissioned Arthur D. Little to undertake a comprehensive estimate of tax compliance costs for the tax year 1983, and this survey served as the basis for the methodology used to track tax paperwork burdens that the IRS finalized with the 1988 tax year.

While the Little study is by far the most comprehensive available, James Payne estimated in his 1993 book *Costly Returns* that even it may understate the real burden "perhaps by about 20-30 percent."

While no figures are separately published for the IRS, tax form paperwork burdens alone account for roughly 80% of the total paperwork burden hours of the United States Government. The IRS is part of the Department of the Treasury and very nearly accounts for the Department's entire paperwork burden.

In Fiscal Year 2000, total paperwork burdens for all agencies were estimated at 7,447.20 million hours, and the Treasury Department accounts for 6,131.85 million of these hours, or 82%.

Paperwork Burden Hours
Department of the Treasury

Fiscal Year	Burden Hours (in millions)	Paperwork Reduction Act of 1995 Target	Cumulative Increase Since 1995	Compared to Target
1995	5,331.30			
1996	5,352.85	4,798.17	0.4%	554.68
1997	5,582.12	4,318.35	4.7%	1,263.77
1998	5,702.24	4,102.44	7.0%	1,599.80
1999	5,909.07	3,897.31	10.8%	2,011.76
2000	6,131.85	3,702.45	15.0%	2,429.40

From the Information Collection Budget, Office of Management and Budget.
Target hours assume Treasury Department reductions meet the law's
overall average reduction for all Federal paperwork.

If the Treasury Department were to reduce its burden by the average amount mandated by the 1995 Paperwork Reduction Act, the burden would decline to 3,702 million hours in 2000. Instead, the Treasury has overshot that target by 2,429 million hours.

Paperwork burdens aren't the result of IRS bureaucrats mindlessly dreaming up new forms and regulations. Much of the burden increase is due to a flood of new tax laws, including the Taxpayer Relief Act of 1997. That law did reduce tax bills for middle class taxpayers, but significantly increased their paperwork burdens. The 1997 Taxpayer Relief Act alone added an estimated 92 million hours to the paperwork burden.

These figures apparently only account for the time spent in keeping the necessary records and learning about and complying with the law. Yet a significant additional but uncounted burden comes from trying to exploit the law's loopholes to the maximum extent. For example, millions of citizens subscribe to personal finance publications and much of the advice offered deals with taxes. Taxpayers are often advised to consider the tax consequences of any major financial transaction, and this form of tax planning undoubtedly adds many millions of hours to the time spent coping with the tax system.

It's Taking Longer to Prepare and File Tax Returns

Despite the passage of the 1995 Paperwork Reduction Act, the time it takes to file commonly-used individual income tax forms has increased.

The 1040 form is often filed with Schedules A, B and D where taxpayers report itemized deductions, interest and dividend income, and capital gains, respectively. From 1988, when the IRS started tracking this information, to 2000, the average paperwork burden hours climbed from 17 hours and 7 minutes to 27 hours and 2 minutes, an increase of 58%. The time burden has increased by 28% since 1995.

History of Estimated Preparation Time, 1040 Form and Common Schedules

Year	Recordkeeping	Learning about the law or the form	Preparing the form	Copying, assembling, and sending the form to the IRS	Total
Form 1040 and Schedules A, B, & D					
2000	7:52	7:16	10:05	1:49	27:02
1999	7:57	5:43	9:59	1:50	25:29
1995	7:04	4:36	7:11	2:21	21:12
1990	7:04	4:04	5:26	1:50	18:24
1988	6:56	3:39	5:02	1:30	17:07
Form 1040 only					
2000	2:45	3:25	6:16	0:35	13:01
1999	3:15	2:39	6:22	0:35	12:51
1995	3:08	2:54	4:43	0:53	11:38
1990	3:08	2:33	3:17	0:35	9:33
1988	3:07	2:28	3:07	0:35	9:17

Even the short forms are becoming more complicated. The 1040EZ form, the simplest in the IRS inventory, now requires 3 hours and 53 minutes, up from 1 hour and 31 minutes in 1988, a jump of 156%. The 1040A and Schedule 1 (interest and dividend income) has seen a paperwork burden increase of 35% since 1995.

History of Estimated Preparation Time, 1040A Forms

Year	Recordkeeping	Learning about the law or the form	Preparing the form	Copying, assembling, and sending the form to the IRS	Total
Form 1040A and Schedule EIC					
2000	1:10	3:05	5:11	0:54	10:20
1999	1:11	2:44	4:45	0:55	9:35
1995	1:04	2:25	3:02	0:40	7:11
1992	1:42	2:24	3:20	1:22	8:48
Form 1040A and Schedule 1					
2000	1:29	3:08	5:11	0:54	10:42
1999	1:31	2:46	4:45	0:55	9:57
1995	1:24	2:27	3:08	0:55	7:54
1990	1:42	2:35	3:26	0:55	8:38
1988	1:53	2:16	3:12	1:10	8:31
Form 1040A only					
2000	1:10	3:04	4:58	0:34	9:46
1999	1:11	2:42	4:31	0:35	8:59
1995	1:04	2:23	2:58	0:35	7:00
1990	1:22	2:31	3:16	0:35	7:44
1988	1:20	2:11	2:52	0:35	6:58

The tax code is so convoluted that no one inside or outside the IRS understands it. For many years *Money* magazine's annual test of tax preparers proved that paid professionals often make huge mistakes. In 1998, the last year *Money* administered the test, all forty-six tested tax professionals got a different answer, and not one got it right. The pro who directed the test admitted "that his computation is not the only possible correct answer" since the tax law is so murky. The tax computed by these pros "ranged from $34,240 to $68,912." The closest answer still erred in the government's favor by $610.

History of Estimated Preparation Time, 1040EZ Form

Year	Recordkeeping	Learning about the law or the form	Preparing the form	Copying, assembling, and sending the form to the IRS	Total
2000	0:05	1:38	1:50	0:20	3:53
1999	0:05	1:34	1:47	0:20	3:46
1995	0:05	0:55	1:22	0:20	2:42
1990	0:05	0:34	0:40	0:40	1:59
1988	0:07	0:24	0:40	0:20	1:31

While the 1998 IRS Reform and Restructuring Act requires Congress to at least consider complexity before passing tax legislation, that has not provided enough incentive for Congress to avoid additional complexity or encourage simplification. The tax-writing committees should be required to quantify the costs of proposals that add complexity or the savings from proposals that simplify the law.

The National Commission on Restructuring the IRS suggested that Congress consider a quadrennial simplification process, and Congress and the President should implement such a process either through legislation or by executive order. The Commission found that many members of the private sector tax community were willing to volunteer substantial time to make suggestions for simplification.

A quadrennial simplification commission would harness this volunteer activity and give a broad group of people much more incentive to work for the adoption of simplification rules. This quadrennial commission would also give the Joint Committee on Taxation and the Treasury Department more incentive to suggest simplification of the law.

Conclusion: A New Approach to Taxes Is Needed

Fundamental overhaul of our tax system remains a critically-important goal. As the Internal Revenue Code becomes increasingly incomprehensible, the intrusive measures provided to the IRS for enforcing it seem to become more draconian. Every detail of a taxpayer's private financial life is open for government inspection. IRS

employees can make extraordinary demands on taxpayers, and can take extraordinary actions against them. Mixing such broad powers with a vague and complex law is a recipe for a civil liberty catastrophe. The threat of abuse is always present.

Until we change how we tax income, we will continue to have an intrusive agency with broad powers. It doesn't have to be that way. Our economy as well as our civil liberties would be better off with fundamental tax reform.

James D. Ericson
Chairman and Chief Executive Officer

May 7, 2001

Hon. Charles E. Grassley
Chairman - Committee on Finance
United States Senate
219 Dirkson Senate Office Building
Washington, D.C. 20510

Re: Hearing on Tax Code Complexity: New Hope for Fresh Solutions (April 26, 2001)
Statement in Support of Repeal of Section 809

Dear Mr. Chairman:

This is a statement in support of repeal of Internal Revenue Code section 809 submitted for the record of the Committee's Hearing on Simplification of the U. S. Federal income tax system. The statement is submitted on behalf of the Mutual Tax Committee, an organization of current and former mutual life insurance companies.

The Mutual Tax Committee urges the repeal of section 809 on both simplification and policy grounds.

The arguments for repealing section 809 from a simplification standpoint are compelling. We have attached a statement that describes the "Sources of Complexity Involving Section 809." The Statement outlines many aspects of section 809 that add to the complexity of the Code, complicate tax compliance and administration and produce bizarre results that are totally inconsistent with any sensible system of income taxation.

Section 809 should be repealed for policy reasons also because it was based on a tax theory that has been determined to be invalid and on competitive industry circumstances that no longer exist. The theoretical and industry circumstances on which section 809 was based led to the income imputation system embodied in the statute, and this, in turn, created many of the complexities of the law. We elaborate on these grounds in our attached Statement in support of the Life Insurance Tax Simplification Act of 2001, which would repeal section 809.

In our view, section 809 is the single most flawed tax provision applicable to corporate enterprises in the United States.

We appreciate your consideration of these views.

Sincerely,

James D. Ericson
Chairman
Mutual Tax Committee

The Northwestern Mutual Life Insurance Company • 720 East Wisconsin Avenue, Milwaukee, Wisconsin 53202-4797 • 414 271-1444

May 4, 2001

Sources of Complexity Involving Section 809

1. Section 809 requires a separate and additional measurement of each mutual life insurance company's net income pursuant to IRS Form 8390. The measurement is based on a combination of –

- annual statement accounting
- tax accounting and
- special rules unique to section 809.

Consequently, compliance with section 809 entails compliance with a separate and additional income measurement system.

2. While generally, the amount of capital a taxpayer holds is not material to the computation of its Federal corporate income tax liability, the section 809 tax liability of each mutual life insurance company (sometimes referred to as "MLC") depends upon its "average equity base". Compliance with section 809 requires measurement of average equity base in accordance with a page of finely printed Internal Revenue Code rules defining that term.

3. Section 809 also requires the measurement of section 809 earnings by the 50 largest stock life insurance companies each of which must prepare and file a separate report of earnings and equity on Form 8390. This measurement has no effect on the taxable income of any stock company, but instead affects the section 809 tax liability of each mutual life insurance company.

4. Each year the IRS must determine which companies comprise the list of the 50 largest stock companies. Issues that arise include how to count related companies (are they separate companies, or should they be combined?), and what companies constitute stock companies? The list of the 50 largest stock companies changes each year. Currently, about one-half of the 50 largest stock companies are former mutual life insurance companies, life insurance subsidiaries of mutual property and casualty companies, life insurance subsidiaries of mutual holding companies and exempt or non-profit organizations, and U.S. subsidiaries of foreign mutual life insurance companies. The stock company earnings rate is based on a numerical average of the 50 largest stock companies. Consequently, the decision to add or subtract a company from the list can materially affect mutual company tax liability if the company added or subtracted has an earnings rate that differs significantly from the average of other companies on the list.

5. Under arrangements made with the Internal Revenue Service, mutual companies annually request data from the IRS relating to stock company filings inasmuch as these filings affect each mutual life insurance company's tax liability. The IRS does provide mutual companies with some information from stock company Form 8390 filings. However, because of confidentiality concerns, such data are not fully available to mutual life insurance companies even though their taxes are dependent on such data. Importantly, it is not possible to compare the actual information filed by each stock company with publicly available data relating to that company. Accordingly, the tax liability of mutual life insurance companies is determined by data provided by competitors of mutual life insurers, and MLCs cannot determine the accuracy of such data.

6. Section 809 tax liability of each MLC is also affected by the section 809 income of all other MLCs. For example, an increase in expenses and deductions of one mutual life insurance company increases the tax liability of all other mutual life insurance companies under section 809. For a mutual life insurer to currently monitor its section 809 tax liability, theoretically, it would be required to continuously determine and review the effect of transactions by all other mutual life insurers and by the fifty largest stock life insurers. Of course, this is not possible.

7. Section 809 compares the difference between earnings rates of MLCs and stock life insurance companies ("SLCs"). If those comparisons were made for the same accounting periods, the amount of section 809 income would be greatly reduced, if not eliminated altogether. However, the formula compares the earnings rate of MLCs for the current year to the earning rates of SLCs for three prior years. Because of this mismatch in comparison, unintended section 809 tax may be generated. For example, assume the following pattern of earnings rates:

	Year 1	Year 2	Year 3	Year 4
SLCs Earnings Rates	10	10	10	5
MLCs Earning Rates	10	10	10	5

Even though the earnings rates of both segments are identical, MLCs would have section 809 tax liability imputed for Year 4 because section 809 compares the MLC Year 4 earnings with the average stock company earnings rate for the three prior years. Because the IRS regulation does not allow negative recomputed differential earnings rates to be recognized, this

imputation is never recovered even if earnings levels of both segments return to the 10% level in Year 5 and subsequent years. The failure to recognize negative recomputed differential earnings rates coupled with the failure to compare earnings rates for the same years both distorts the measurement of the difference between stock and mutual company rates over time and increases the unpredictability of the tax imposed by section 809.

8. Because of the mechanics of section 809, MLCs do not know how much section 809 income will be imputed to them until after the year is completed. For example, tax liability associated with the year 2000 depends upon the measurement of (1) the stock earnings rate for 1999, which is not announced by the IRS until 2001 and (2) the average mutual earnings rate for 2000, which is not announced by the IRS until 2002.

9. Section 809 requires that each MLC compute a differential earnings amount for each tax year (e.g, the year 2000). The differential earnings amount is based on the excess of the imputed stock rate (based on stock company earnings for the three prior years – e.g., 1987, 1988 and 1999) over the average mutual earnings rate for the second preceding year (1998). In the following tax year (e.g., 2001), the differential earnings amount is recomputed based on the mutual earnings rate for the prior year (2000). In the second following year (2002), when the tax return for 2001 is filed, an additional payment or refund applicable to the year 2000 is due. In summary, the section 809 tax process for a year takes place over three years for each mutual company (2000 – 2002 in the example), and is based on tax information for three preceding years. Thus, six years are immediately relevant to the section 809 tax computation of each mutual life insurance company.[1]

10. The starting point for measuring section 809 income is annual statement income. It is unclear, however, what happens when one or more states change the requirements for reporting annual statement income. Sometimes the IRS recognizes such changes; on other occasions, changes in annual statement reporting are ignored by the IRS. For example, when the annual statement rules were changed to require companies to smooth the recognition of capital gains through the establishment and amortization of interest maintenance reserves, the IRS mandated that annual statement accounting be ignored for

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[1] The stock company "imputed rate" for each year is indexed based on stock company earnings for 1982, 1983, and 1984, so that if this is taken into account, nine years are relevant to each year's section 809 tax computation.

purposes of determining stock and mutual company earnings rates under section 809.

11. Based on actual results in prior years, section 809 can be expected to produce a material tax liability only once in a decade. However, companies cannot predict when the once-in-a-decade section 809 tax will arise. Consequently, under current conditions, 75 companies (50 stock companies and about 25 remaining mutuals) will file information returns for nine years (675 returns) which are examined and tabulated by the Internal Revenue Service, but which result in no tax revenues to the United States Treasury. In the 10th year, these 75 companies will file information returns to determine the tax liability of the 25 remaining mutual companies. During the ten-year cycle, a total of 750 information returns will be filed in order to determine tax liability on 25 returns; however, only four of these returns involve companies of substantial size. So in reality, over each ten year period, 750 information returns will be prepared, filed, and examined in order to determine material tax liability on four returns. In addition to filing information returns, the 25 mutual companies must complete the portion of their corporate tax returns (Form 1120L) relating to section 809. Over a ten-year period, these companies will file an additional 250 Forms 1120L. In summary, over a ten-year period, about 1,000 information and tax returns will be filed in order to determine material section 809 tax liability on four tax returns.

Statement of PricewaterhouseCoopers LLP

I. Introduction

PricewaterhouseCoopers LLP, on behalf of a number of its clients, appreciates the opportunity to submit this statement to the Finance Committee for the record of its April 26, 2001, hearing on tax simplification. We applaud the Committee for its interest in these important issues. This statement specifically addresses the tax-law complexities that are created by the corporate alternative minimum tax ("AMT").

PricewaterhouseCoopers, the world's largest professional services organization, provides a full range of business advisory services to corporations and other clients, including audit, accounting, and tax consulting. The firm, which has more than 6,500 tax professionals in the United States and Canada, works closely with thousands of corporate clients worldwide, including most of the companies comprising the Fortune 500. These comments reflect the collective experiences of many of our corporate clients.

In light of the significant concerns discussed in this statement, PricewaterhouseCoopers urges the Committee to repeal the corporate AMT in conjunction with consideration of tax-relief legislation this year. We applaud the staff of the Joint Committee on Taxation ("JCT") for recommending elimination of the corporate AMT as a key step toward simplifying the Internal Revenue Code, and we fully share the JCT's view that "the original purpose of the corporate alternative minimum tax is no longer served in any meaningful way . . . ."[1] Further, it is our view that repeal of the corporate AMT, if implemented to address unused AMT

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[1] Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS–3–01), April 2001, at 1–16.

credits now held by taxpayers, could serve as an effective form of fiscal "stimulus" in conjunction with the current round of tax legislation.

II. COMPLEXITIES CREATED BY CORPORATE AMT

The corporate AMT complicates the corporate income tax in two key respects. First, it frustrates basic tax law principles and tax policy objectives sought by Congress. For example, prevention of double taxation of income earned overseas by U.S. companies has long been a fundamental principle of U.S. tax law and tax treaties. The corporate AMT's limitation on the use of foreign tax credits,[2] which are designed to avert double taxation of worldwide incomes, undercuts this basic premise of U.S. tax policy. Specific Congressional policy goals are thwarted in that companies subject to the corporate AMT are unable to benefit from accelerated depreciation, thus discouraging investment in new plant and equipment, and are unable to utilize tax credits for research and development activities or for hiring disadvantaged workers, among other tax benefits intended to promote desired corporate activities.

Second, the corporate AMT imposes extremely onerous—and well documented—compliance and recordkeeping burdens. The AMT requires a calculation of a second income tax base and computation of a tax on that base. The inevitable result is that the AMT adds an additional layer of administrative burdens and complexity to the regular corporate tax system. A 1994 General Accounting Office survey of U.S. corporations found that all of the firms interviewed cited the corporate AMT as among the provisions in the Internal Revenue Code with the largest recordkeeping and compliance cost burden.[3]

The compliance costs of the corporate AMT are significant and rank among the highest of corporate tax administration expenditures. One analysis of tax compliance costs of large businesses finds that the AMT adds 16.9 percent to the cost of complying with Federal income taxes. The average total income tax compliance cost reported in the survey was approximately $1 million, meaning that the corporate AMT may require average expenditures of $160,000 annually.[4]

Andrew Lyon (recently nominated to serve as Treasury Department Deputy Assistant Secretary for Tax Analysis) notes the huge and costly additional layer of complexity arising from the AMT in the area of corporate tax compliance:

> The compliance costs of the AMT relating to legal and recordkeeping expenses are notorious. For example, firms currently are required to keep track of depreciation using several different systems: assets purchased before 1987 are disregarded for purposes of depreciation adjustment of the AMT, but not for purposes of computing adjusted current earnings; assets purchased after 1987 must have a separate AMT depreciation deduction calculated; depreciation for adjusted current earnings is calculated differently for assets purchased prior to 1987, between 1987 and 1989, and between 1990 and 1993; finally, assets purchased after 1993 require no additional depreciation calculation for adjusted current earnings. These different treatments of depreciation under the AMT also give rise to separate calculation of inventory for AMT and adjusted current earnings purposes.[5]

These significant compliance costs are incurred regardless of whether a corporation actually ends up paying any AMT to the Federal government. Companies first must undertake the AMT calculation to determine whether they are liable. The GAO in 1995 reported that while only 28,000 corporations actually paid corporate AMT in 1992, 400,000 corporations filed the AMT form.[6] The 400,000 figure greatly understates the number of corporations that did the necessary calculations to determine whether they had an AMT liability.

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[2] Section 59(a) of the Internal Revenue Code imposes a 90-percent limitation on utilization of AMT foreign tax credits. Congress in 1999, in the "Taxpayer Refund and Relief Act of 1999" (H.R. 2488), vetoed by President Clinton, included provisions repealing this limitation. At the time, then-Treasury Department Assistant Secretary (Tax Policy) Don Lubick stated that the Clinton Administration viewed full utilization of foreign tax credits under the AMT as the appropriate policy. Similar legislation (S. 801) has been introduced in the 107th Congress by Senators James Jeffords (R–VT), John Breaux (D–LA), Kent Conrad (D–ND), Orrin Hatch (R–UT), and Frank Murkowski (R–AK).

[3] *Tax System Burden: Tax Compliance Burden Faced by Business Taxpayers* (GAO/T–GGD–95–42, Dec. 9, 1994).

[4] Joel Slemrod and Marsha Blumenthal, "The Income Tax Compliance Cost of Big Business," *Public Finance Quarterly*, 24 (October 1996), pp. 411–438.

[5] Andrew B. Lyon, *Cracking the Code: Making Sense of the Corporate Alternative Minimum Tax* (Washington, D.C.: The Brookings Institution), 1997, p. 73

[6] *Experience with the Corporate Alternative Minimum Tax* (GAO/GGD–95–88, April 1995).

Because relatively few corporate taxpayers are currently paying AMT, the tax is actually a net revenue loser under current law. That is because corporate AMT dollars going "out the door" in the form of AMT credit utilization ($13.6 billion over the 1995–97 period[7]) exceed the amount of corporate AMT currently being paid in ($12.1 billion over the 1995–97 period). The reduced incidence of AMT liability in recent years is the result of a relatively strong economy and legislative changes made by the Taxpayer Relief Act of 1997 to pare back the tax.

Another complicating feature of the corporate AMT is the fact that corporations often move into and out of the AMT from one year to the next. This fluctuation in AMT status may be due to external economic conditions, internal management decisions, or a combination of the two. The GAO found that nearly half of larger U.S. corporations paid AMT at some time over a five-year period but very few (about 3.2 percent of AMT payers) paid AMT in all five years. The greatest percentage paid once in the five years.[8]

The uncertainty of whether a corporation is liable for the AMT from one year to the next not only adds to the cost of compliance but also can increase the challenge of efficient corporate management. For example, AMT status can be affected by a basic management decision as to whether to engage in certain activities subject to tax preferences. The AMT has the effect of limiting the use of tax preferences, but only for those firms subject to the AMT.

As a result, an additional cost of tax administration and compliance is imposed on firms that may seek to engage in tax-preferred activities without triggering AMT liability. As Michael Graetz and Emil Sunley have illustrated, this effect of the AMT can produce additional complexity and compliance burdens of individual firms without changing the ultimate level of investment in tax-preferred activities:

> If a business engages only a little in activities or investments specifically encouraged by tax subsidies, no minimum tax will be imposed. But if the business is good at these activities and specializes in them, it will have to pay the minimum tax, perhaps putting it at a competitive disadvantage. If only efficiency considerations were relevant, the minimum tax would not receive very high marks. On efficiency grounds alone, no one should care if ten companies each invest a little in a tax-preferred activity or one company invests a lot.[9]

III. OPPORTUNITY FOR REPEAL IN 2001

The concerns over the corporate AMT that are discussed above have intensified over time. Numerous bills have been introduced in past Congresses that would repeal the corporate AMT, including legislation (S. 54) that was advanced in the 106th Congress by Sen. John Kyl (R–AZ). 2001 presents a perfect opportunity for repeal, particularly as such action could provide an effective and easily administrable form of fiscal stimulus.

Repeal of the corporate AMT could provide an immediate stimulative effect if it were structured to allow companies to take into account AMT credits immediately. By way of background, each dollar of corporate AMT paid results in an AMT credit. At present, approximately $22 billion in unused AMT credits are in existence, the residue of many years of AMT payments. Under present law, these credits may only be used when the taxpayer holding the credits pays regular income tax liability, and only to the extent the taxpayer's regular tax liability exceeds tentative minimum tax liability. For many companies, it will take many years to utilize fully these AMT credits. It would be possible, in conjunction with corporate AMT repeal, to speed these recoveries.

Specifically, we urge the Finance Committee to consider, in conjunction with tax stimulus legislation this year, a proposal that would repeal the corporate AMT, effective for taxable years ending after the date of enactment, and allow taxpayers with unused AMT credits to carry back these credit amounts to offset tax liabilities they have paid under the AMT. Because the proposal would be effective for taxable years ending after the date of enactment, companies with unused AMT credits immediately could file a claim for refund with the IRS for the total amount of the carryback. The upshot of the proposal would be to pump $22 billion into the economy in the two calendar quarters following enactment. For example, if this proposal were enacted by July 1, 2001, we could expect that about half of the $22 billion would flow into the economy in the final quarter of FY 2001 (ending September 30,

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[7] IRS, *SOI Bulletin*, Spring 2000, p. 230. 1997 is the most recent year for which these data are available.

[8] Ibid.

[9] Michael J. Graetz and Emil M. Sunley, "Minimum Taxes and Comprehensive Tax Reform," in Henry J. Aaron et al. (eds.), *Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax* (Washington, D.C., The Brookings Institution, 1998), p. 406.

2001), with the other half coming in the first quarter of FY 2002 (ending December 31, 2001).

Unlike almost all other tax stimulus proposals now being discussed, this proposal focuses on capital formation and business investment. Declines in business investment have been noted as a major reason for the softening in the economy. The proposal would help to reverse these trends. Because the corporate AMT hits capital-intensive companies hardest of all, the companies that would benefit from the credit carryback provision are those most likely to make new investments in plant and equipment—if only they had available cash. This proposal would serve as an effective complement to other stimulus tax proposals aimed at spurring individual consumption.

Also, unlike other stimulus proposals currently under discussion, the proposal would be easily administrable. The process of filing refund claims with respect to AMT credit carrybacks could utilize existing procedures for payment of refund claims that are well understood by the IRS and corporate taxpayers. Alternatively, the legislation could allow taxpayers to apply the refund amount against estimated tax payments of current-year tax liability, which could raise even fewer administrative issues.

Finally, it should be noted that the revenue effect of the proposal would dovetail perfectly with current budgetary needs. If enacted soon, the proposal likely would be estimated by the Joint Committee as losing approximately $22 billion in FY 2001 and then having very little revenue impact in later years within the budget 10-year window. In other words, the proposal would create a one-time revenue loss, which fits the parameters for a tax stimulus set by the FY 2002 budget resolution approved by Congress.

PricewaterhouseCoopers would be pleased to work with the Finance Committee in exploring this proposal and in its ongoing efforts to reduce Tax Code complexity and tax-law impediments to economic growth.

Statement of the Savings Coalition of America

[SUBMITTED BY KATHY HAMOR]

Thank you, Mr. Chairman, for giving the Savings Coalition of America the opportunity to provide comments on the Committee's hearing on the simplification of the tax code. The Savings Coalition was established in 1991 to support incentives to increase personal savings in the United States. Its main objective is to win passage of expanded Individual Retirement Account (IRA) legislation for all Americans. There are approximately 75 member organizations of the Savings Coalition representing a wide variety of private interests including banking, securities, financial services, consumer groups, engineering, home-building, realtors, tangible assets, trust companies, health care industry, insurance, education and business groups.

At the outset, I would like to commend the Chairman and this Committee for its efforts to make it easier for Americans to understand the tax code thereby effecting their actions in such important areas such as saving for retirement. In particular, the Savings Coalition supports the Joint Committee on Taxation's recommendation to eliminate income limits on eligibility to make deductible IRA contributions, Roth IRA contributions, and conversions from traditional IRAs to Roth IRAs. With the tax code becoming more complex on an almost annual basis, we salute the Chairman's efforts and the Joint committee's recommendations to simplify the code in this area which members of the Savings Coalition believe will result in more Americans saving for their retirements. One positive way to reduce the tax burden on Americans, while also fulfilling other important national objectives, is to alleviate the anti-savings bias in the federal tax code. By providing families with enhanced savings incentives, not only will the individual tax burden be reduced, but important future retirement needs will be financed. As a bonus, we will generate the increased national savings that is critical to fueling continued economic growth in the future.

In recent years, this Committee has been pivotal in providing American families with exciting new tools for retirement savings. Mr. Chairman, your leadership on savings issues, particularly with respect to retirement security, is well-known and well-documented

Mr. Chairman, as you well know, Americans are living longer, but they are not savings enough to ensure a secure retirement. In 1997, Congress enacted new laws expanding eligibility for participation in IRAs, establishing Roth IRAs and enhancing the spousal IRA. Although these a re important, successful first steps, Congress needs to do more to give Americans a meaningful opportunity to save for retirement.

Personal savings are a critical component of a financially secure retirement. IRAs have proven to be the most effective incentive for promoting personal savings. To a significant extent, however, the effectiveness of IRAs as a savings promoter is being undermined by the complex income-based eligibility limits that apply to IRAs.

BACKGROUND

Before the 1986 Tax Reform Act, IRAs were available to all Americans with earned income. Although the intention may have been to take the IRA away from more affluent households, the end result of the 1986 Act income limits was to drive over seven million Americans with income below $50,000 out of IRAs. In fact, IRA contributions dropped by more than 40% for those who continued to be eligible for deductible IRAs in the year after the income limits were imposed, and participation by those with income under $50,000 has since dropped by over 65%. This imposition of income limits has generally caused Americans to confuse the loss of the IRA deduction with the loss of eligibility; many Americans felt that "I make too much to contribute."

Today, eligibility for all IRAs, Roth IRAs and spousal IRAs can be determined only after the taxpayer works through a maze of eligibility requirements that include a variety of income limitations. Which of the various income limits applies depends, in part, on the type of IRA the individual wishes to establish and whether the individual (or the individual's spouse) actively participates in certain types of employment-based retirement plans.

ISSUE

The current income caps on IRAs are counterproductive. Those income limits preclude many middle income Americans from making deductible IRA contributions and impose a sizeable marriage penalty in certain cases. Moreover, the complexity of those rules id driving away many of those who are eligible. Even with the improvements that were made in the 1997 legislation, many middle income Americans are still not eligible for fully deductible IRAs. For some couples, the current income limits also impose a severe marriage penalty. For example, two individuals with $30,000 are each allowed to deduct $2,000 of IRA contributions today ($4,000) total. If they marry, their IRA deductions will be reduced to $200 each—an increase of $1,000 in their Federal income taxes that directly results from the IRA income limits.

To the wealthy, the relatively small IRA tax advantage has a negligible impact on overall taxes. In the end, the IRA income limits hurt those who are stuck in the middle—Americans who may not have tax planners and accountants. Those families will not lock money into an IRA unless they are sure they understand the rules. Some of these people will delay contributions to make sure they will qualify and then later forget to make the contribution, or spend the money in the meantime.

For many people, income fluctuates from year to year. A universally available IRA ensures that these individuals can make the IRA contributions in the good years—the years in which they have the financial resources to make a contribute. This is particularly important for the self-employed and for individuals in cyclical industries such as farming. Similarly, women who left the paid workforce for a period of time to raise children could save more through an IRA during those years.

CONCLUSION

The Savings Coalition of America appreciates the opportunity to present this statement on the critically important issue of universal availability to retirement savings vehicles such as the IRA. We need to give Americans the best tools we can to help them prepare for their retirements.

In the end, each American must accept significant responsibility for saving for their future needs. But the government must help by reducing the tax burden on those who save and by making the savings choices simple and understandable. With that end in mind, our national savings strategy must include an effective set of incentives that will expand personal savings, especially for retirement. Improving existing savings vehicles like the IRA should be the backbone of that effort.