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Opening Comments

Senate Finance Committee Hearing

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My name is Carol Markman. I am a partner of Feldman, Meinberg & Co. LLP of Syosset, New York and a member of the Internal Revenue Service Advisory Council. I have served as President of the National Conference of CPA Practitioners, NCCPAP, the only professional organization representing only Certified Public Accountants in Public Practice, and as Chairperson of its Tax Policy Committee. I am a member of the American Institute of CPAs and the New York State Society of CPAs. Accompanying me is Neil Fishman, CPA, principal of Fishman Associates CPAs PA of Boynton Beach, Florida, currently the Chairperson of the NCCPAP Tax Policy Committee and Mark Meinberg, CPA, managing partner of Feldman Meinberg & Co. LLP, currently the President of the Nassau Chapter of the New York State Society of CPAs.

The membership of NCCPAP consists of Certified Public Accountants in public practice located throughout the United States with a concentration of chapters in the Northeast. We have several chapters in New York and New Jersey and a chapter in Florida. The members of NCCPAP deal with the Internal Revenue Code on a daily basis directly with the public and sort through its complexities constantly. We estimate that our members serve more than 500,000 businesses and individual clients throughout every state of our country. We appreciate the invitation to participate in this hearing.

My topic today is the phase-out of itemized deductions and personal exemptions, the so-called Pease and PEP provisions, and other phase-out provisions. The Pease provisions are named after the late Representative Donald J. Pease (D-Ohio) and PEP stands for Personal Exemption Phase-out. The phase-out rules for Pease and PEP do not exist for 2010 tax returns but will come back in full force in 2011 unless Congress acts to change the law. The current situation, where taxpayers and tax preparers do not know if Congress will act or what the tax law will be in 2011 creates uncertainty and makes tax planning very difficult. Many of the financial publications have recently included articles on what to do if the PEP and Pease phase-outs return but this advice may not be correct if the phase-outs do not return.

Until the Tax Reform Act of 1986 (TRA86) was enacted, any deduction or credit in the tax code was available equally to almost every taxpayer without regard to his or her Adjusted Gross Income (AGI). TRA86 changed the tax rates, from 15 brackets ranging from 11 to 50 percent to two brackets, 15 and 28 percent. The offset to this simple rate structure was the beginning of the phase-ins and phase-outs of exemptions, deductions and credits.

Subsequent laws changed the tax rates to four tax brackets in 1989, three in 1990 ranging from 15 to 28 percent, five in 1993 ranging from 15 to 39.6 percent, and six brackets in 2002, ranging from 10 to 35 percent. The 2002 brackets are still in effect for 2010. But these changes do not tell the whole story. The phase-out of itemized deductions and personal exemptions effectively created many more brackets for higher income taxpayers in all of these periods except 2010 when there are no PEP or Pease phase-outs. If Congress does not act, the five brackets in effect in 2000 ranging from 15 to 39.6 percent will return.

The phase-out rule for personal exemptions was enacted as part of the TRA86. The phase-out of itemized deductions was enacted as part of Omnibus Budget Reconciliation Act of 1990 (OBRA'90).

In 1988, for the first time, the personal exemption, then $1,950, began to be phased out when the AGI of joint filers was $149,250. The exemptions were completely eliminated when AGI exceeded $171,650.

One of the earliest phase-out provisions of itemized deductions has to do with medical expenses. The phase-out of medical expenses first became part of the tax law in 1942 with a five percent phase-out and a $2,500/$1,250 maximum deduction. Beginning in 1954, the itemized deduction for health insurance and medical expenses was subject to a three percent of AGI phase-out. The Equity and Fiscal Responsibility Act of 1982 changed the floor to five percent of AGI and TRA86 set the floor at 7.5 percent of AGI with no maximum deduction. The phase-out is scheduled to increase to ten percent of AGI for most taxpayers beginning in 2013 and all taxpayers beginning in 2017 due to the 2010 health care reform legislation.

Beginning in 1991, the first year a phase-out of itemized deductions was in effect, taxpayers with AGI above an "applicable amount" ($100,000 for all taxpayers except married filing separately "MFS") began to lose a portion of their itemized deductions. This limitation is calculated after all the other limitations. Up to eighty percent (80%) of itemized deductions can be lost as a result of this provision. In 2009 the phase-out range began for taxpayers with AGI above $166,800 ($83,400 for MFS).

The itemized deductions for charitable contributions and home mortgage interest were included in the phase-out. Most miscellaneous itemized deductions including un-reimbursed employee business expenses, which were deductible only to the extent that they exceeded two percent of adjusted gross income, were also included in the phase-out.

Since that time, tax rates have increased to a current maximum rate of 35 percent and the phase-outs have proliferated, effectively raising this marginal tax rate beyond the current stated rate of 35 percent. As new tax benefits have been introduced, many are limited by AGI. The public's perception is that the tax code gives benefits, deductions and credits with one hand and takes them away with the other.

The Taxpayer Relief Act of 1997 and subsequent laws established a proliferation of education incentives in the form of tax credits and deductions for qualified tuition and related expenses paid to eligible post-secondary educational institutions by the taxpayer. These credits and deductions were designed to benefit low and middle-income taxpayers. Income limits were established for single taxpayers with the phase-out beginning at $80,000 of AGI and ending at $90,000 of AGI. For married taxpayers filing jointly, these phase-out levels are doubled. The laws do not differentiate between a single taxpayer and a single taxpayer with dependent children (Head of Household). The cost of living is significantly different when an individual must pay expenses for additional family members yet they are subject to the same phase-out limits as a single taxpayer. An expense such as child-care so that the single parent can go to school is not considered.

Code Section 25A should be expanded to permit taxpayers claiming Head of Household status a higher income phase-out than single taxpayers, in order to allow more single parents to claim tuition tax credits. Alternatively, the phase-outs for education credits should be made uniform or eliminated.

For the first time, starting in 1987, only taxpayers who were <u>not</u> active participants in an employer pension plan and those with very limited incomes could make tax-deductible IRA contributions. The deductibility of an IRA contribution was phased out for employees with employer-sponsored retirement plans with income above $35,000 for single filers and above $50,000 for married filing joint filers. The limitation for joint filers applies if either spouse is covered by a pension. Some taxpayers who would prefer to make an IRA contribution early in the year to take advantage of the tax deferral may not be able to do so because an unexpected event at the end of year may render them ineligible to make the IRA contribution due to the phase-out.

There are many other phase-outs in the current tax law. Most are based on modified AGI and filing status. Others are different only for MFS taxpayers. Some phase-outs have kept pace with inflation and others have not. Some phase-out ranges are $10,000, others are $15,000 and still others are $25,000 or more. The phase-out range for personal exemptions is $122,500 for all taxpayers except MFS. The phase-out range for Alternative Minimum Tax (AMT) can be as much as $283,800.

Speaking of the Alternative Minimum Tax – this tax is the ultimate in phase-out provisions. This tax first became effective in 1970 and was intended to target the rich, specifically 155 individuals with incomes over $200,000 who claimed so many tax benefits that they owed no income tax in 1967. The initial AMT rate was 10 percent. The AMT tax rate inched up every few years. The AMT was significantly changed in the 1986 Tax Act and the exemption amount, which is subject to a phase-out, was not indexed for inflation and has been adjusted by Congress annually since 2000. The current AMT rates are 26 and 28 percent.

The recent annual adjustments in the AMT exemption amounts, not knowing if Congress will act or not and sometimes the "fix" being enacted very close to the end of the year is another source of uncertainty and anxiety for taxpayers, tax professionals and the Internal Revenue Service.

It is NCCPAP's position that the AMT should be repealed. The AMT is too complex and imposes a large compliance burden. Taxpayer Advocate Nina Olson, in her December 2004 report, stated that the AMT now functions "randomly and no longer with any logical basis in sound tax administration." She believes that the AMT impacts the "wrong" taxpayers. We agree with Ms. Olson in this regard. The record keeping requirements for two sets of records is burdensome and unfair. Tax simplification can be achieved by an immediate repeal of this tax.

The National Taxpayer Advocate has recommended repeal of the AMT in her annual report to Congress every year since 2001. In addition, former President Bush's select committee on tax reform also advocated for repeal of the AMT. The rules for AMT are unnecessarily complex and result in affecting taxpayers not originally targeted when the AMT was first enacted. Rather than a provision to prevent high-income taxpayers from avoiding tax through tax planning, the AMT has become a tax on the middle class, burdening certain regions of the country more than others. Repeal, adjustment or reorganization is desperately needed to restore equitable taxation to the middle class taxpayer.

In 1980 Form 6251, the form used to calculate AMT was one page with 22 lines and one page of instructions. It began with AGI and allowed the subtraction of only some itemized deductions and required the add-back of certain amounts deemed "tax preference items". The 2009 Form 6251 is two pages with 55 lines and 12 pages of instructions. It begins with taxable income and adds back all personal exemptions and most itemized deductions and tax preference items and requires other adjustments and it still does not tax the people for whom the tax was intended. The people who should pay the AMT are those who structure their lives to avoid tax, not those who have another child.

One of the most serious problems for tax professionals dealing with the phase-outs is that even a very seasoned professional cannot sit down with a married taxpayer and prepare a projection using only a pencil, paper and calculator if the client's income is above a nominal amount. The code is so complex and provides for so many phase-outs with different ranges, and different beginning and ending points, that it is impossible to prepare an estimate of projected taxes and marginal tax rates without being armed with a series of worksheets, schedules and charts. Some phase-out limits change annually; others do not, so the preparer can never be sure of the applicable limits for specific phase-outs without resorting to numerous reference materials.

An example, identified by one of our members, concerns Qualified Performing Artists. Code section 62(b)(1) and (3) of the 1986 Tax Act defines the term "qualified performing artist" as a person who performed services in the performing arts as an employee for at least two employers during the tax year and received wages of $200 or more per employer.

This code section permits a deduction before arriving at AGI for the professional expenses of a performing artist, but only if the individual's AGI is below $16,000. This amount was not indexed for inflation and has remained the same since 1986. If the taxpayer is married, the $16,000 threshold applies to the couple's combined AGI. The constraints of this provision are so narrow as to preclude any benefit to almost all low-income performing artists who live in high cost areas such as California, Massachusetts, Texas, New Jersey or New York. This is a perfect example of giving with one hand and taking away with the other.

Another phase-out that began in 1987 limited the deduction of business meals and entertainment expenses to eighty percent of the amount paid. The Omnibus Budget Reconciliation Act of 1993 (OBRA '93) reduced the deduction of business meals and entertainment to fifty percent of the amount paid.

A related issue previously identified by NCCPAP is the treatment of all employee business expenses including business meals and entertainment. Internal Revenue Code section 67(a) requires an employee who incurs ordinary and necessary business expenses in the performance of his/her duties, and is not reimbursed by his/her employer, to list those expenses on Form 2106. This total is transferred to Form 1040, Schedule A, as a miscellaneous itemized deduction, which is required to be reduced by two percent (2%) of the taxpayer's AGI. The deduction for these expenses can be further reduced if the phase-out of itemized deductions returns. In many cases, these reductions cause the expenses to be eliminated and the employee is denied these legitimate deductions for tax purposes. In addition, employee business deductions are not an allowable expense for AMT purposes.

In contrast, "Statutory Employees" and businesses in all forms, i.e., corporations, partnerships, LLC's, LLP's and sole proprietorships are allowed to deduct all business expenses in full against gross income (subject to certain limitations such as 50% of business meals and entertainment that affect all taxpayers equally). The only business expenses that cannot be deducted in full are those incurred by employees. This is unfair to the typical wage earner who is required to make expenditures to earn a living.

The total of all employee business expenses listed on Form 2106 should be allowed as a deduction before arriving at AGI. It should not be listed on Form 1040, Schedule A, as a miscellaneous itemized deduction subject to a two percent reduction, or be an addback for the Alternative Minimum Tax.

The phase-outs have an erosive effect on tax compliance and taxpayer confidence in the fairness of tax laws. Tax practitioners are forced to tell clients that many tax saving provisions that they read about in the press during tax season each year do not apply to them. They are considered "rich," yet struggle to make ends meet living an ordinary life style.

My colleagues and I think it would be more prudent to permit taxpayers to utilize the deductions and credits currently available in the tax law before focusing on lower tax rates. The elimination of the phase-outs will simplify the tax law and make it more equitable.

If the phase-outs must be continued, there should be uniform phase-out limits for most provisions and these limits must be adjusted annually to reflect inflation and the costs in high tax states.

Respectfully submitted,

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On behalf of the National Conference of CPA Practitioners