

## **Tax Simplification Recommendations**

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no longer serves the purpose for which it was enacted, produces enormous complexity, and has unintended consequences.* Originally enacted in 1969 to address concerns that persons with significant economic income were paying little or no Federal taxes because of investments in tax shelters, the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 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.

### **Education Incentives**

*Harmonize and simplify education incentives.* In today's tax structure, there are eight different "education incentive provisions", including tuition credits, Education IRA's, 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 70½. It also provides that plan benefits may not be distributed before certain stated events occur, including attainment of age 59½. Further, premature distributions from a qualified retirement plan, including most in-service distributions occurring before an employee's reaching age 59½, 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 70½ and to 59 from 59½ 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 complex. 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.

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\* 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.