THE IMPACT OF THE COMPLEXITY OF THE TAX CODE ON SMALL BUSINESS: WHAT CAN BE DONE ABOUT IT?

HEARING

BEFORE THE

SUBCOMMITTEE ON TAX, FINANCE, AND EXPORTS

OF THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

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THURSDAY, SEPTEMBER 7, 2000

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON TAX, FINANCE AND EXPORTS,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The Subcommittee met, pursuant to call, at 10:05 a.m., in room 2360, Rayburn House Office Building, Hon. Donald A. Manzullo (chairman of the Subcommittee) presiding.

Chairman MANZULLO. We are going to get started in an a little unusual manner. We are waiting for two Members of Congress to come who constitute the first panel. They are on their way. I would like to take half of the second panel and get started with their testimony. We are going to have a tyranny of the bells today with voting going on, etc.

Martin Davidoff is here. Martin, why don't you take the seat on the end here? Who else is here from our second panel? Okay. Why don't you come on up, and let's get half of the second panel. Leave two chairs on the end for the Members of Congress, and as soon as they come in, if you don't mind, we will interrupt your testimony in order to accommodate them so they can get on with their other duties.

Mr. Tauzin has been a little busy, if you know from watching C–SPAN. When I was going to bed last night, he was still grilling Firestone.

I want to immediately get into the testimony. I will not do much in the way of introductions, except that I am going to start with Martin Davidoff of Martin Davidoff & Associates from Dayton, New Jersey, who is here on behalf of the National Federation of Independent Businesses.

We have the 5-minute rule here. When it turns yellow, you have 1 minute. When it turns red, the gravel comes down.

[Mr. Manzullo's opening statement may be found in the appendix.]

Chairman MANZULLO. Mr. Davidoff.

Mr. DAVIDOFF. Thank you, Mr. Chairman, Members and their staff which have been most helpful. First of all, I would like my written statement entered into the record.

Chairman MANZULLO. Without objection, all written statements will be admitted.

Martin, I will interrupt.

Mr. Sununu, do you want to come up? And we will start with you.

Mr. Davidoff, we will be back to you shortly.

Mr. DAVIDOFF. Thank you.

Chairman MANZULLO. It is my pleasure to introduce to you Congressman John Sununu from the great State of New Hampshire. And, Congressman Sununu, we are on the 5-minute rule that I enforce, so if I get somebody who can operate this timer. Please start.

STATEMENT OF HON. JOHN E. SUNUNU, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW HAMPSHIRE

Mr. SUNUNU. Thank you, Mr. Chairman. I am familiar with the 5-minute rule, and I will do my best to comply. And I apologize for arriving a little bit late and hope that the panelists and in particular Mr. Davidoff won't hold it against me in any way.

It is a pleasure to be here. I am pleased that you are holding this hearing today on the complexity of our Tax Code and in particular its effect on small business. For anyone that has traveled around the country and spent a little bit of time with small business owners and entrepreneurs, the Tax Code is probably the first thing that comes up, even, in most cases, before regulation, because it is something they deal with year in and year out. And it is not just once a year when they pay their taxes. It is every day, as I will describe, and it is a source of endless frustration for entrepreneurs.

In a previous part of my career, I worked as chief financial officer and director of operations for a small electronics firm of about 30 employees and dealt with the financial issues for the owner of a firm that was a Sub-Chapter S corporation, and dealt with a lot of these issues on a personal level. So in many cases I speak from anecdotal, but really personal experience as well.

The complexity of the Tax Code and its impact on small business, I think, is felt in three particular areas. There is the outright cost of the complexity, the cost of doing your returns every year, paying someone to prepare your returns and submitting them.

Of course, there is also the opportunity cost, the time that is lost, lost not just from business operations, but from time from the family as well, because so many small businesses are family-owned, and so many entrepreneurs and managers put in such an extraordinary amount of their personal time in their companies.

The third cost of the complexity of our Code is in what I just call distrust. The complexity breeds distrust. It breeds uncertainty as to whether or not the same system applies to both larger and smaller corporations. I think that undermines public confidence in the way we tax and raise revenues for the Federal Government.

We can solve this problem. We can do better. And I am here to testify on behalf of tax reform, fundamental tax reform, and the implementation of a flat tax, an issue that I have worked very hard on with the Majority Leader Dick Armey. He has taken a strong leadership role on the objective of scrapping the current Code and replacing it with a system that is simple, honest and fair and that addresses each of these costs that I mentioned.

First a few words about the exact complexity of the system and its effect on small businesses. First, the estate taxes. An inordinate amount of time at the small business level and at the family busi-

ness level is taken in preparing, avoiding, understanding our complex estate taxes, trying to maintain the small business flavor, and that means keeping the small business in a family. An entrepreneur often has worked hours, years managing a business. He has had his family members involved. They want to keep it in the family, but the estate tax burden can be crushing, and the complexity of the estate taxes can be overwhelming on a yearly basis.

Depreciation schedules. We have called on small businesses to depreciate equipment, sometimes, for example, computers, over 5 or 7 years, which doesn't make any sense in and of itself in that we ask small businesses to keep separate books for depreciation for an income-reporting basis and for IRS purposes. Keeping multiple books doesn't serve any real useful purpose, and, of course, the time and effort required to keep on top of the depreciations rules can be very burdensome for a business that only has 10 or 15 or 20 employees.

Capital gains taxes. Small businesses spend an enormous amount of time dealing with the complexities of employee stock ownership plans, the Sub-Chapter S filings and the impact of potential sales of stocks on their capital gains liability.

And finally retirement savings, IRAs and 401(k)s for employees, but also retirement savings plans that are necessary to avoid the crushing burden of estate taxes.

All of these complexities have the impact of raising the cost of running a small business, taking up an inordinate amount of management time and, of course, undermining confidence in the way we fund government.

How can a flat tax solve this problem? I believe that a flat tax would have enormous benefits for both individuals and corporations, but in particular for small businesses because now small business is going to be able to take a look at its revenues for the years, deduct all of its legitimate expenses, cost of goods, wages, salaries, all capital equipment and investment and then pay a simple, honest, fair rate. The same system applies to corporations large and small. It is understandable. You don't have to keep two sets of books. You don't have to go through the complexity of estate tax planning. In fact, there would be no estate taxes, no capital gains taxes, no inheritance taxes, no taxes on Social Security benefits, and no depreciation schedules.

All of those add to the burden of running a small business. They would be eliminated. And by having the same system for everyone, we restore public confidence in the way that we finance government. I think it would make an enormous difference for the small business community in time, in money, and in confidence, and it would create the right set of incentives for entrepreneurs to invest in their employees, invest in their firms and create economic opportunity. And that ultimately should be our goal here, not to try to distort the market, but to create an environment where entrepreneurs can do the job of creating economic opportunity.

Thank you, Mr. Chairman.

Chairman MANZULLO. Thank you, Congressman Sununu.

[Mr. Sununu's statement may be found in the appendix.]

Chairman MANZULLO. If you would like to join us on the panel, you are welcome to.

Mr. SUNUNU. I have a commitment, Mr. Chairman. I would like to thank you for having the hearing and thank the panelists for being here. My experience in this regard, as I said, working for 4 years in a small business setting, but my guess is the panelists have far more depth of experience with the kinds of frustrations I have touched on in my testimony.

Chairman MANZULLO. Thank you very much. I appreciate it.

Martin, we will start with you again, knowing full well that if Mr. Tauzin comes in, which he probably will after six words of your testimony, we will have to interrupt you again. If you are almost through, we will make sure we finish up.

STATEMENT OF E. MARTIN DAVIDOFF, E. MARTIN DAVIDOFF & ASSOCIATES, DAYTON, NJ, ON BEHALF OF THE NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. DAVIDOFF. Thank you. Thank you very much. I am here representing 600,000 small businesspersons on behalf of the NFIB. I come before you with a unique perspective, one of an attorney, a CPA, a small business owner myself, having participated in two White House conferences, and an advisor to hundreds of small businesses. So I see this day in and day out.

Every time Congress attempts to deal with simplification and simplifying the Tax Code, we get something called "complification". We get a morass of tax law that is even more complex. Just take a look at what has happened in the last couple of years.

In 1996, Steve Forbes is talking about the flat tax and simplification, and everybody was gung-ho, yes, let's do it. Then in 1997, 1998 and 1999, you added infinitely more complexity. Just a couple of examples, we changed the safe harbor for estimated taxes for high-income taxpayers three times. If you look at page 5 of my testimony, you will see a table that shows public laws and the percentages that were changed time in and time out. One of the bills was just to change it from 105 to 106 percent for 2 of the 4 or 5 years that are in the table. It is really crazy the way Congress goes about it. Instead of changing the tax rates, they add complexity to the tax law because they don't want to tell the American people the correct tax rates.

Other things that have been done, you added a child credit, but then from $110,000 to $130,000 you are phasing out that credit. You added complicated learning credits and retirement alternatives, each with its own phaseout limitations.

And that takes us to really the most complex problem for all taxpayers, not just for small business, and that is the phaseout. It started with Congressman Claude Pepper in phasing out 3 percent of your itemized deductions to the extent that your income exceeded a base and in phasing out exemptions. They are bad ideas. Why are they bad ideas? Because what happens here is you have changed the tax law to look not at taxable income, but you are looking at adjusted gross income. For example, with the phaseout of exemptions, if I am making $200,000 a year adjusted gross income, and I am a family of four, you are adding 3.3 percent to my 36 percent tax rate. My real tax rate is 39.3 percent, even though the stated original rate is 36 percent. And after I am phased out, the tax rate comes back. So what have you done?

We have all argued should there be a flat tax, or should there be a progressive income tax like we have? What you have done with phaseouts is you have given us a regressive tax. The tax rate is lower for people who get beyond the thresholds. And when you have thresholds of $110,000 for learning credits and $74,000 for double E bonds, and all these phaseins and phaseouts at different levels, all you are doing is you are imposing a higher tax rate.

And I say to you bring back taxable income. Congress defined taxable income as the basis on which you are going to set one's ability to pay. I will throw out the following example: If you have two families—one with 10 exemptions, 10 children, and one with zero children. Let's say they are making $300,000, so they have fully phased out their exemptions. Are you telling me that the family with 10 children is in a position to pay the same tax as the family with no children? Clearly not.

On every level you look at this, regression of taxation, or fairness, phaseouts don't work. They are a terrible idea. Get rid of them, please.

Let's go to a couple of specific examples about small business. First of all, we have meals and entertainment expenses. It is a complexity issue. If somebody comes down to Washington on business, and they stay in a hotel they turn in their bill back to the comptroller back in the office, and the comptroller says, okay, I will classify that as travel. That is what it used to be. But now they have to look at that bill and segregate out the meals, because meals are only 50-percent deductible. And they have to put that in a different account called meals and entertainment. But then if I have a picnic for all my employees, I have to put it in another account because picnics for employes comes into one of the 10 exceptions under Section 274 that say you can deduct 100 percent.

Chairman MANZULLO. Just eat outside every time.

Mr. DAVIDOFF. Eat outside every time. Well, you have to pay for your employees every time. That is the bottom line.

So basically what we have here is we have a situation with meals and entertainment that adds much complexity. And people talk about the three-martini lunch. You have plenty of provisions in section 274 that prevent abuse.

I see that my time is almost up, so let me just wrap up with two concepts. One other concept is a tax trap. Congress has come forward and said, we are going to let everyone deduct $20,000 with certain exceptions for capital improvements. So Joe Taxpayer files his tax return, and he says, I know about that $20,000 rule. I have purchased a $3,000 computer for my business. It is classified as office supplies, and those who work with real taxpayers know that happens. The fax machine, everything ends up in office supplies. He deducts it on the return. It is $3,000. He is perfectly entitled to it under the law. However the law says you have to make an election. He didn't make the election, and there are approximately a dozen court cases that basically take that deduction away for failure to make the election. In my materials there are citations of a couple of those cases. And a very simple change that you can make that would probably be practically revenue-neutral that would just say if somebody takes a deduction, let's deem it to be an election.

My time is up. I just wanted to say I would like to thank the Chairman for taking his time to fix the installment sales problem for accrual-based taxpayers and to say that for cash-basis taxpayers that we ask that we index for inflation the $5 million threshold of 1986 and increase that to apply to businesses of similar size back then, which today would be businesses of $6 and $7 million. Thank you very much.

Chairman MANZULLO. Thank you, Mr. Davidoff. I appreciate it.

[Mr. Davidoff's statement may be found in the appendix.]

Chairman MANZULLO. Good timing. Congressman Billy Tauzin. What time did you finish last night?

Mr. TAUZIN. I think I have been called and recalled. We finished about 11 o'clock.

Chairman MANZULLO. Well, you are up.

Mr. TAUZIN. Thank you, sir.

Chairman MANZULLO. And we have the 5-minute rule here.

STATEMENT OF HON. W.J. "BILLY" TAUZIN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF LOUISIANA

Mr. TAUZIN. I will hit it really quickly for you.

In a nutshell we have an outdated, outmoded Tax Code, and Americans know it; 7 million words of instructions from Washington, D.C., that nobody can understand anymore. And if you try to get information on what it means, even from the IRS, you get wrong answers all too often. It is a mess. More importantly, it is a set of instructions on how to live your life from Washington, D.C.; if you think about it, 7 million words about how you should earn, spend, save, what you ought to do with your money. There are government preferences built all over it. We set them. We change them every now and then.

In fact, since Ronald Reagan left town and simplified the Code—do you remember—from 14 different rates down to a couple, we are back up to five effective rates, over 5,000 changes later. Many of those changes we put in thinking we are doing a good thing for America. But we "complexed" that Code up, and we literally give instructions through it about how to live your life.

When you look at the instructions, you ought to think about what instructions we are getting. Think about it. The power to tax is the power to discourage or destroy. So look at what the Code tells you. What does it discourage? Look at what it taxes. It discourages you from earning income. It taxes incomes. It taxes savings; therefore, that must be bad. It taxes investments. It taxes gifts to your kids in life. It taxes gifts to your family in death. And worst of all, it even taxes you for buying an American product and rewards you for buying a foreign product. You haven't thought about that one. Think about it.

Dr. Dale Jorgenson at Harvard University, who is the dean of the economics department, did a paper on the subject, and his paper says in effect that the income tax adds on average 25 percent to the cost of every product and service made in America. That is on average. The price of bread, for example, is 35 percent. The reason that is true is every person in the manufacturing process, from the farmer all the way to the retailer, has to pay taxes. The employer pays taxes. You pay taxes on the business. You pay taxes

on compliance costs. You have to hire accountants and lawyers. All that adds up to the point where by the time we buy a loaf of bread, instead of it costing $1.30, it costs $2. That is a fact, according to Harvard School of Economics, not necessarily a bastion of conservative thought.

What does that tell us? That tells us the income tax code is really pernicious. It taxes your income when you earn it, and then if you dare buy anything that was made in America, made with your own hands in some cases, you get taxed again with a hidden tax of 25 percent or so. If you buy a foreign product, on the other hand, very often those products—they are burdened with some income taxes overseas, but they are not burdened by the other taxes that are assessed overseas, the VAT taxes. The VAT tax, the value added taxes, are rebated back to the manufacturer before products are shipped into this country. An American product burdened with our income tax goes over there and pays the VAT tax again. It gets taxed twice. Their product comes in and escapes the second tax. So we have a tax system in a global free trade economy that in effect tells American workers it is better to buy foreign goods. We will tax you twice if you buy an American good.

If I am an American worker, and my government is penalizing me for buying my own products, I should be hopping mad. I would want to get rid of that system. I would want a border adjustable tax system that is fair, decent, taxes me only once, and rewards me for doing the right things instead of punishing me for doing the right things.

So we built one. We have offered you a bill to replace the income tax code with a simple, fair, national retail sales tax. It is automatically border-adjustable. Here is how it works.

You get rid of income taxes, gift taxes, inheritance taxes, corporate taxes, individual taxes. All the income taxes are gone in our plan. We get rid of the gift and inheritance taxes so you don't have all this double taxation on income. We simply say, when you buy something at retail, not when you buy it for business purposes to make a product or to help your business along, but when you buy it at retail, you pay a retail tax. Whether it is a foreign product or a domestic product, you pay the same tax.

And we figured out a rate equivalent to the amount of money we needed to collect if we repealed all those other taxes. We did it very simply. We took those taxes and divided it into the amount of consumption in this country, and you come up with a number. It is 12.9 percent. We came up with a 15 percent rate, and I will tell you why. That extra 2 percent we put into and the extra 1/10 is all factored in for tax compliance problems as well as to cover the cost of something important in our plan.

You have probably often heard that retail taxes are bad because they are regressive. They tax poor people more than rich people. In a sense that is correct because poor people who have to spend all of their income to survive obviously would pay a bigger proportion of their income in taxes than a rich person who doesn't have to spend all his income. So we provide a total protection for income earned under poverty.

The way we do it is we also repeal the payroll tax, the 7½ percent you pay and your employer pays into the system on income

earned under poverty. The 2 percent of sales tax pays for that and goes back into Social Security and Medicare Trust Funds to cover that loss for the Treasury.

So we have got a plan that protects income at the bottom, that provides cheaper American products. According to the Harvard study, if you got rid of income taxes, products in America would cost 25 percent less than they do today or in cost of production. In a competitive marketplace you get cheaper prices. You have cheaper prices. You have more dollars to buy them with, and you are no longer penalized when you buy an American product.

The Harvard study says our exports would jump 29 percent. That would get rid of the trade deficit. That is 19,000 American jobs lost for every billion of that trade deficit, and we are over 300 billion today. Multiply that out; 6 million jobs or better. We get rid of the trade deficit. Our exports climb 29 percent on average yearly because now we are competitive overseas. We are not double-taxing our products. They get taxed once when they go overseas. They don't get taxed over here, just like their products only get taxed once when they come to America under our plan.

Thirdly, according to the Harvard study there would be an 80 percent shift of investment back into America. Why wouldn't you want to build your plant here and your manufacturing here if you didn't have to pay income taxes here, and there would simply be a retail consumption tax in its place? Why wouldn't you want to build closer to your markets instead of building somewhere else in the word? And the Harvard study confirms that.

Here is the bottom line. We have presented you with an alternative that instead of punishing you for earning income, it rewards you. No income taxes. Instead of punishing you for saving, it rewards you. No taxes on savings interest earned. Instead of punishing you for investing, no capital gains taxes. No investment taxes. No need for Washington to incentivize you to invest anymore, to tell you how to spend your money or save it. No gift taxes, so you can give things to charities and your kids and anyone you want to without fear of double taxation. No inheritance taxes; you can pass your businesses on without the death tax. And all of a sudden no penalty for buying American products. Equalized border taxation in a global free trade marketplace. We get rid of the trade deficit.

We got a simple taxation system now instead of this complex one, and the States administer it. They collect the commission for doing it under our plan, as well as the retailers who collect the tax while they are collecting the State sales taxes in 45 States of America that have such systems. For the five that don't, we would put a system in. If they would not want to do it, they would have the right to put it in for us and collect the commission.

It is a simple plan, much simpler than this complex Code. Hard to get to. It takes some courage to make that kind of change, but if we had the courage, Americans would love us for it.

Thank you, Mr. Chairman.

[Mr. Tauzin's statement may be found in the appendix.]

Chairman MANZULLO. Well spoken. Can you stay here for a while, Congressman Tauzin?

Mr. TAUZIN. Sure.

Chairman MANZULLO. What happened to Scott?

Mr. TAUZIN. You have to talk to Dr. Evil about that.

Chairman MANZULLO. Scott, do you want to come up here and sit to Billy Tauzin's right? I know he might get offended with anybody sitting to his right, but that is okay. Is that okay? There we are. Thank you.

Mr. TAUZIN. Hello, Scott.

Chairman MANZULLO. Let's go with Mr. Oveson, and then we will go back to Ms. Olson.

STATEMENT OF W. VAL OVESON, NATIONAL TAXPAYER ADVOCATE, DEPARTMENT OF THE TREASURY, INTERNAL REVENUE SERVICE

Mr. OVESON. Thank you very much, Mr. Chairman and distinguished members of the Committee.

Chairman MANZULLO. Would you pull the mike up closer?

Mr. OVESON. I appreciate being invited to be here today and speak with you. Again, I view my role as a national taxpayer advocate as working within the existing Code and will not get to other suggestions and ideas as has been talked about, but there is certainly a lot that can be done within the existing Code to simplify and make things better for small business.

There is both legal and administrative complexity in the Tax Code, and during the last 2 years that I have been the taxpayer advocate, I have mentioned in my annual report that complexity of the Code was the number one problem facing taxpayers. Based on the cases that we handle each year and input from practitioners and stakeholder groups, we have identified several areas of the law that are a particular burden and adds costs to small business. I will mention them today and put them in my written testimony.

The first issue is penalty administration. A lot has been done with penalty administration. The Joint Committee on Taxation has produced a report on that, but the number of penalties is staggering, and they have increased from 10 to over 100 in the last 7 or 8 years. And this is particularly true for small business. In the Taxpayer Advocate Service we see a large number of cases where taxpayers can't reasonably expect to pay off their liabilities because of one reason or another. Over time the amount of penalties that has been assessed and the interest that has accrued has been an insurmountable obstacle for the taxpayer.

One suggestion that we have made in the annual report is to completely repeal the failure to pay penalty. In my experience, few taxpayers are aware of the failure to pay penalty, so it really isn't an effective motivator to comply with it if they don't know about it. In fact, when a taxpayer is in financial trouble or hasn't filed returns for many years, the failure to pay penalty actually becomes a barrier to compliance rather than an enhancer.

The next issue I want to mention is capitalization and depreciation. That has been mentioned this morning in a couple of different ways. The depreciation section of the Internal Revenue Code has been altered many times over the last few years, and it just gets more and more complicated. Depreciation and capitalization are consistently among the most litigated issues that we see in the sys-

tem. I believe it is time to revise the depreciation rules or replace them with a simple or more consistent system.

One bold proposal that I have made the last 2 years in my annual report is to allow the section 179 expense deduction for all capital assets purchased. In some ways this is a back door to some of the other proposals. I acknowledge that. But a more modest approach would be a system that would mix the section 179 deduction with other depreciation rules. It is important that we have a simple set of rules.

I want to add that this suggestion is a major policy change, and the impact would be substantial. That analysis is beyond the scope of my office.

The third problem area is the employer/independent contractor dilemma. It has long been a thorn in the side of small businesses and even valiant attempts to solve this problem have fallen short. Small businesses have to weigh the common law requirements or the section 530 safe harbor rules to determine whether individuals who work for them are treated as independent contractors or employees. If the employer makes the wrong decision, they face potentially huge delinquent employment tax liabilities and just lots and lots of problems. The inequality in this area also creates distinct competitive advantages for some businesses that are not complying as compared with those that are, and I urge you to address this issue again.

You have asked me to highlight some of the areas that we can play a role in helping resolve complex problems with the small business owners. I give you three.

First, we can advocate changes in the law, as I am doing right now, and procedures and regulations. We have met with business groups and their practitioners to get their input. And this testimony and my annual report to Congress serve as examples of how we can gather information and make meaningful recommendations for change to the existing statutes.

Second, we can advocate for educational programs. For example, all new businesses should be invited to attend a local training session where their tax obligations can be thoroughly and completely explained and discussed.

And third, the primary service that we offer to individuals is to help them with their individual account issues. Business owners who encounter problems should contact their local taxpayer advocate. And while we can't guarantee a favorable result, we can guarantee a fresh look at the problem.

Mr. Chairman, thank you for inviting me here today. I am passionate about reducing the complexity in the tax law, and I think my recommendations here, and others that I have made over the last 2 years, show that. I applaud you for your efforts and wish you well in making a better system for the small business owners of the country. Thank you, sir.

[Mr. Oveson's statement may be found in the appendix.]

Chairman MANZULLO. We appreciate your distinguished service to the taxpayers—I was going to say to the government, but it is to the taxpayers—in trying to simplify this code, and we wish you well in the private sector. Please stay in contact with us. Undoubt-

edly you will be back as a private sector witness. I appreciate that again.

Pamela Olson.

STATEMENT OF PAMELA OLSON, CHAIR, TAX SECTION, AMERICAN BAR ASSOCIATION, WASHINGTON, DC

Ms. OLSON. Thank you, Mr. Chairman.

My name is Pam Olson, and I appear before you today in my capacity as Chair of the ABA Section of Taxation to present testimony on behalf of the Section of Taxation. This testimony has not been approved by the House of Delegates or the Board of Governors of the ABA and accordingly should not be construed as representing the policy of the ABA.

The Section appreciates the opportunity to appear before the Subcommittee today to discuss the critically important topic of tax simplification. On behalf of the Section, I want to thank the Chairman and the members of this Subcommittee for their focus on eliminating complexity in the Internal Revenue Code. I also want to compliment Val Oveson on his work over the years. We will miss him very much when he returns to Utah.

Over a year ago the Section of Taxation testified before the House Ways and Means Oversight Subcommittee and the Senate Finance Committee on simplification of the Internal Revenue Code. On February 25th of this year, the Section of Taxation together with the AICPA Tax Division and Tax Executives Institute released identical simplification proposals.

Although tax law complexity adversely effects all taxpayers, it has a particularly adverse effect on small businesses because they are ill-equipped to deal with the complexity. For that reason our previous testimony has included a number of recommendations important to the small business community.

In recent years the tax law 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 tax law has increased, so has the complexity of the regulations that the IRS and Treasury have issued to interpret it. Moreover, the sheer volume of the 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, that affect 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 to voluntarily comply with his or her tax obligations. The willingness and ability to keep up with the pace and complexity of changes is now under serious stress.

We want to 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 significantly to complexity in the Code. Simplification or just preventing greater complexity may not garner political capital or headlines, but it is crucial.

In our view the tax law is replete with provisions, the complexity of which far exceed the perceived abuse to which the provision was directed or the benefit that was deemed gained by its addition. Furthermore, the tax law contains many provisions that at the time of enactment may well have been desirable, but with the passage of time or, more importantly, the enactment of other changes have truly become dead wood. Despite the lack of utility of these provisions whether in a relative or absolute sense, analysis of their effect may nevertheless be required either in the preparation of a tax return or in simply planning business affairs.

The elimination of these provisions would greatly simplify the law, but, again, the work necessary to do so will be dull and unlikely to garner political headlines. Nevertheless in our view it is essential.

Our written statement includes—and this is lengthy—several examples of provisions that when analyzed do not justify their continuation in the law. These are but a few examples, not an extensive analysis, of all the complexity that could be addressed in the tax law.

I would like to briefly mention a few areas of particular importance to small business. The first is an area of which this Committee is well aware: Accounting methods. You have already addressed this year the problems caused by the repeal of the installment method of accounting for accrual-method taxpayers. You are also aware of our proposal to expand the use of the cash method of accounting for small businesses that satisfy the $5 million gross receipts test included in section 448, even when the purchase, production or sale of merchandise is an income-producing factor. In addition, we have proposed permitting those same small businesses to elect not to maintain inventories and to deduct materials and supplies as purchased rather than capitalizing them as materials and supplies under the regulations.

There are other significant accounting issues that have been alluded to this morning, whether an expense must be capitalized or may be deducted, the depreciation rules, the uniform capitalization rules. Another area is the rules governing pension plans. The tax rules in this area contain numerous traps for the unwary. Among the rules that are badly needed to be simplified are the minimum distribution rules and the top heavy rules.

A related area requiring attention is another that has been mentioned this morning, and that is the test for determining whether a worker is an employee or independent contractor. This determination 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. The current complex and highly uncertain determination should be replaced with an objective test that applies for Federal income tax purposes and for retirement plan purposes as well.

Another area requiring simplification is the multiple rules limiting the ability of a taxpayer to use losses. These include sections 465, 469, 704(d) and 1366(d).

The fifth area is the international tax rules. Although the complexity of the international rules has generally been the problem of large business, the growth of global business opportunities is expos-

ing an increasing number of small businesses to the complexity of these rules.

Finally, let me point out the importance of addressing some individual provisions that often affect small business owners. These include the individual AMT, which no longer serves the purpose for which it was enacted, the rules for calculating estimated income taxes that Marty mentioned, the 2 percent floor on miscellaneous itemized deductions, the capital gains regime, and the estate tax and special rules within the estate tax.

We appreciate your attention and interest in these matters, and we will be pleased to work with the Committee and its staff on these important issues as well as other tax issues of significance to small business. Thank you.

Chairman MANZULLO. Thank you very much.

[Ms. Olson's statement may be found in the appendix.]

Chairman MANZULLO. Congressman Tauzin was nodding his head with an "I told you so" in his eye, with all these different types of taxes.

David Lifson.

STATEMENT OF DAVID A. LIFSON, CHAIR, TAX EXECUTIVE COMMITTEE, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, NEW YORK, NY

Mr. LIFSON. Thank you, Mr. Chairman and members of this distinguished Committee. I am David Lifson, the chairman of the Tax Executive Committee of the American Institute of Certified Public Accountants, and I come before you representing more than 330,000 members, who in turn represent countless millions of small business taxpayers, many of whom work daily with small business units that are responsible to comply with the tax provisions that you enact.

I would like to mention with respect to the competing alternate proposals for tax systems, the AICPA has published a book "Flat Taxes, A Guide To The Debate" that analyzes four of the more popular, brand new ideas to revamp the Internal Revenue Code. I would suggest that each of these ideas sound like a very efficient and good idea until you analyze the details, and as they say, the devil is in the details. Those same details are horribly weighing down our tax system right now, and I think the analysis has to be made of the competing details, as opposed to the competing concepts of equity and fairness, and just and appropriate tax systems to fund our society.

The fourth alternative to the four competing tax systems is the alternative that we came here today to speak of, and that is the alternative of fixing the Code, we have rather than adopt a brand new, untested system. We don't take a position whether the solution is the fifth or any one of the first four, but offer you an analysis of each.

Our tax laws are certainly too complicated. There appears to be very broad agreement on that level here. The current outcry for tax simplification is not new. In fact, the AICPA has warned Congress for more than a decade that the tax law is growing so dense that it threatens to undermine voluntary compliance. Small businesses

in particular need an advocate such as the AICPA to collect and voice their concerns about the burdens that are imposed on them.

As you know, we are not alone in our deep concerns about the ill effects of complexity in our tax system. Last year we were pleased to join with the American Bar Association's Section of Taxation and the Tax Executives Institute in a bipartisan effort to work toward the common goal of suggesting ways to make our current tax system simpler and more rational for a broad range of business and individual taxpayers.

In collaboration with our professional colleagues, we developed an initial big-picture package of tax simplification recommendations that was submitted to Congress in February of this year. You need to know that there are a growing number of taxpayers who perceive the law to be unfair, that complexity impedes the continuing efforts of the Internal Revenue Service to administer and enforce the law, that the cost of compliance for taxpayers is increasing disproportionately with everyone's income, and that complexity interferes with economic decisionmaking.

The worst part of all of this is that the end result is erosion of voluntary compliance, and we have the voluntary compliance system that is the envy of the rest of the world. Now, by and large our citizens obey the law, but it is only human to disobey a law if you do not or cannot understand the rules. The dynamic American economy is changing and moving rapidly against an unnecessarily cumbersome and in some areas, an absolutely outdated income tax system.

There are various types of simplification. You can simplify calculations. You can simplify the filing burden. But most importantly, you can reduce the chance of having a dispute between the IRS and the taxpayer.

Now, the first two types of simplification are sometimes the easiest to identify and fix, although the repairs involve some very hard choices. Computers help, forms help, technology will help. But this is not just about math. The last type of problem, adding certainty to the law and thereby reducing the likelihood of a dispute, is the most difficult to effectuate, yet, in my view, the most important. Clarifying law that is hard to understand must be a priority if we are to achieve a simpler system that is based on anything like our current Internal Revenue Code.

Now, the AICPA, in their blueprint for Tax Simplification issued back in 1992, identified four elements to consider in creating a simpler tax system. That blueprint was largely adopted as part of your 1997 legislative action. But starting to consider simplification falls way short of delivering less complex tax rules. The blueprint, the related complexity index and our written remarks submitted for the record go into greater detail, and I hope you will review both.

The bottom line is there has been much talk about simplification, but simplification still has a difficult time finding its way into enacted legislation. Nevertheless, the basic principles outlined above still apply and should be used in today's tax legislation environment. We need to look at worker classification, capitalization versus expensing, installment sales of business, and safe harbors; especially safe harbors from the most complex rules, and particu-

larly when those rules were designed for large corporations. Many of the other witnesses have discussed these items.

I thank you for your time. We recognize that a tax system that is simple for all taxpayers may never be designed, but we do believe a simpler system is attainable.

Thank you for the opportunity to voice our concerns.

Chairman MANZULLO. Thank you very much.

[Mr. Lifson's statement may be found in the appendix.]

Chairman MANZULLO. Scott Moody. Do you want to pull that mike close to your face?

STATEMENT OF SCOTT MOODY, ECONOMIST, TAX FOUNDATION, WASHINGTON, DC

Mr. MOODY. Thank you, Mr. Chairman and members of the Committee. My name is Scott Moody, and I am an economist with the Tax Foundation.

It is an honor for me to be here before your Committee today on behalf of the Tax Foundation to discuss tax complexity on small businesses.

The Tax Foundation is a nonprofit, nonpartisan educational organization that has been monitoring fiscal policy at all levels of government since 1937. The Tax Foundation is neither a trade association nor a lobbying organization. As such we do not take a position on specific legislative proposals.

Our goal is to explain precisely and as clearly as possible the current state of fiscal policy in light of established tax principles. According to these principles a good tax system should be as simple as possible, not be retroactive, be neutral in regards to economic activities and, of course, be stable.

All of the studies that the Tax Foundation has ever undertaken on tax complexity demonstrate that there are economies of scale when it comes to tax compliance. For instance, in 1996, small corporations, those with less than a million dollars in assets, spent at least 27 times more on compliance as a percent of assets than the largest U.S. corporations or those with more than 10 billion in assets.

This is especially important to consider because most smaller corporations, 90 percent in fact, have assets of less than $1 million.

While some tax simplification for small business has occurred since 1996, most notably the Taxpayer Relief Act of 1997, we believe our results remain illustrative of the magnitude of the tax burden faced by small businesses. For instance, two important measures of the tax complexity, the size of the Tax Code and the instability of the Tax Code, have been continuing to increase. The number of words in the Tax Code, for example, have been steadily increasing. We have looked back in time, and since 1955, there were slightly more than 400,000 words that we estimate in the Internal Revenue Code. Today there are more than 1.6 million, and that is up by 200,000 words only 5 years ago.

In addition, the number of sections in the Internal Revenue Code have been climbing even faster than the word count. In 1954, there were 103 sections in the Tax Code. Today there are 725. That is an increase of over 600 percent.

In addition to the complexity associated with the sheer size of the Tax Code, small businesses must also contend with the instability of the Tax Code itself. In other words, it is not just a matter of learning the Tax Code a single time, rather it is an ongoing process of keeping up to date with the latest legislative changes, regulatory changes, and Tax Court rulings.

In terms of legislative changes, the Tax Foundation research has estimated that on average every section of the Internal Revenue Code is amended once every 4 years. This is a direct result of the 32 significant Federal tax enactments that have taken place since 1954, or approximately one every 1.4 years. However, this legislative instability does not take into account the fact that when tax law changes, so do regulations. As a general rule, surges in proposed IRS regulations occur within the first 3 years after significant tax legislation has been enacted.

So you can see between the changes in legislation and regulation, the Tax Code is almost always in a state of constant fluctuation. Such instability also spills over into the tax courts, and since it typically takes a taxpayer's dispute 3 years to appear on court dockets, small businesses are at an inherent disadvantage.

If small business owners cannot accurately predict the consequence of a particular economic activity either because of the size or instability in the Tax Code, then the tax policy is handicapping the growth of small businesses and the U.S. economy in general. The benefits of reducing tax complexity would dramatically benefit small businesses since they currently bear a disproportionate amount of the burden. This could be done in a comprehensive revision of the Tax Code guided by established tax principles. In addition, such tax reform would diminish the need for future corrective tax legislation and thereby increase the stability of the Tax Code and regulations.

Thank you very much.

Chairman MANZULLO. Well, thank you. I appreciate it very much.

[Mr. Moody's statement may be found in the appendix.]

Chairman MANZULLO. Congressman Tauzin, I know you have an 11 o'clock Subcommittee hearing, so if you have to leave us you are excused. If you want to stick around that would be fine, too.

Mr. TAUZIN. Thank you. I have to leave. I really enjoyed the presentations, and let me say big kudos to Scott. That was excellent.

I want to say one more thing. I don't know—certainly not in this session of Congress, but there are growing cries for tax reform. And Dick Armey and I went on a tax debate around the country. We did 40 cities in the last several years. I have never touched a hotter political button. Americans are so ready for us to do major reform, not just little fixes, not just minor reforms, but major reforms that really simplify matters.

And I agree with the accountants. I have been close with the accountants for many years. We have worked closely together. There are a lot of good plans out there. I don't have any pride of authorship. I think we have a good one, and I will defend it with anyone, but if someone has a better one, bring it on. Americans are ready for this, and small businesses in particular, and people generally

who have less resources, the small business community than the big business community, are indeed the ones most impacted.

Let me urge you to keep up your good work. Count on me to help you any way I can.

Chairman MANZULLO. Thank you very much. I appreciate that. Todd McCracken.

STATEMENT OF TODD McCRACKEN, PRESIDENT, NATIONAL SMALL BUSINESS UNITED, WASHINGTON, DC

Mr. MCCRACKEN. Thank you, Mr. Chairman. It is a pleasure to be here today. Again, my name is Todd McCracken. I am president of National Small Business United. We are the Nation's oldest small business advocacy organization. I appreciate the opportunity to be here today and to make a few comments about the problems that small businesses have with the complexity of the Tax Code. I would like to take time to discuss a tax proposal that we have endorsed that I believe could really revolutionize the existing tax system.

Mr. Chairman, the NSBU was founded when the income tax was only 23 years old, with only two pages in forms and several pages of instructions. While we have not grown at the exponential rate of the income tax laws, we do now represent 65,000 small businesses nationwide.

We have given a great deal of thought and attention to the problem of simplification and agree with every one of the areas that were mentioned here this morning as important areas that need to be simplified for small business, but as you can see, when you put up those—and what we have heard this morning are for the most part broad areas, and within each of those broad areas are enormous numbers of issues that need to be addressed to simplify the Code for small business.

It is a monumental chore that we are faced with to truly simplify the system for small businesses, and the reason this is the case is because we insist on continuing to tax income, which means we have to define income, which means we have to do it in an equitable way.

We are faced with so many political agendas in trying to do that, and there are so many political advantages to simplifying the current system that we have grown unfortunately cynical and skeptical that this system can really be fixed and simplified for small business. And to the extent that it can be, and we are prepared to work with anybody on any of these proposals to truly get some additional simplification in the Code, we are also unfortunately of the belief that any simplification that we do see is likely to be temporary, just given the lessons that we have seen since 1986 and even before that the forces that work on this Code continued to make it more complex and continued to make it more unwieldy for smaller businesses.

Most entrepreneurs, that is unless they make a career of selling tax shelters, correctly see the current system we have as punishing each step toward the American dream. Every step of a business's life faces significant tax obstacles. At the start-up level the savings are taxed and start-up costs are not deductible. Capital investments are made from after-tax dollars and then taxed multiple

times when the income is earned and when the underlying asset that generates that income is sold. They are taxed when growing because the government takes an increasing share of income as more money is made. They are taxed on exporting because U.S. taxes raise the price of our goods relative to foreign goods. They are taxed when they add jobs because of our extraordinarily high payroll taxes, increased costs of hiring.

Family businesses are discouraged because they are taxed when they are sold. And finally the owner gets to meet the undertaker and the IRS on the same day as the government effects a leveraged buyout of the business.

In February of this year, a national survey conducted by American Express confirmed what NSBU already knew. A survey showed that 74 percent of entrepreneurs consider tax reform a top priority, but since the majority of Americans share our common dislike for our present system, it is unfortunately easier to demagogue the current system than to reach consensus on what a new and more ideal system should look like.

NSBU leads entrepreneurial organizations not only by defining the principles on which tax reform should be based, but lending our full support for a specific proposal, the FairTax national sales tax plan. The FairTax, we believe, is an enlightened policy. The FairTax abolishes all Federal income, FICA, estate and capital gains taxes, and so it allows small businesses to prosper as never before in this country by instituting a 23 percent tax on all end-use goods and services. The FairTax would sweep away the burdens of the current tax system and create a new dawn of American entrepreneurship and economic growth.

The FairTax would allow small businesses to begin with savings put aside with pre-tax dollars. It would allow them to grow unfettered by the income tax, and without an eye on the capital gains tax. It would allow them to hire without discouragement from the payroll tax. It would allow them to export unfettered by punitive American taxes on our exports. It would allow them to make capital investments, unfettered by hidden costs in the capital assets. It would not penalize good years and bad by implementing the best of income averaging, a zero rate of tax. It would discontinue the charade of taxing income multiple times. But most importantly, it would repeal the self-employment taxes that are the most despised by entrepreneurs.

The FairTax would tax Americans on income, but only at the point that they consume that income, not when they invest and save. Small business owners would have greater access to capital, the lifeblood of a free economy. Small business owners would be able to pass their businesses on to their children.

I would like to make one final point about this kind of system that I think gets on the point that other people made, and then I will end.

As the complexity disappears, we would reinstate the novel concept that Americans have the right to understand the law to which they are subject. Moreover, they will immediately see and understand the tax rates and any changes that occur.

The current complexity of the Code leaves most Americans, rightly or wrongly, feeling that they bear an unfair share of the tax bur-

den. The poor believe that advantages must lie with those who are well off. The wealthy see the high marginal rates and limited deductions and feel singled out by the tax system. The middle class assume that credits for the poor and loopholes for the wealthy mean they alone bear the country's tax burden.

While there are fallacies and accuracies in each group's assumption, the unfortunate side effect is a polarization of the country and a universal feeling of victimization. It should be clear to any observer that this feeling leads to tax avoidance and cheating on an unprecedented scale.

If we can remove these hard feelings about the Tax Code, we can markedly improve compliance and give a boost to the national comity at the same time.

There are all kinds of other reasons that Mr. Tauzin got into for moving to this kind of system, but I appreciate the opportunity to be here and look forward to talking some more about this topic. Thank you.

Chairman MANZULLO. Thank you very much.

[Mr. McCracken's statement may be found in the appendix.]

Chairman MANZULLO. I have a few questions.

Scott, do you want to scoot around there so you can share the mike there with Mr. McCracken?

First of all, we want to thank you for coming. We did get the testimony in prior to the bells going off.

And, Mr. Oveson, this question is to you. We have a constituent who has a petition for a private letter ruling pending before the IRS for 6 years. And I have a phone conference call with Mr. Rossotti today between noon and 12:30, I have found him to be extremely helpful in going right to the top on helping to move some things. It involves approval of some pension plans. I just don't want to get into great detail. But I am willing to go to the floor next week if we don't get action from the IRS and mention specifically the people within the IRS who refuse to answer a Congressman's phone call. That will take full use of the liability immunity under the Constitution in order to move these bureaucrats off center so they can do their specific jobs.

That may sound like a threat, and it certainly is. But unfortunately sometimes the only way to get something done around this city is to threaten to expose people by name, and then all of the sudden something miraculously gets done.

But notwithstanding that, we have found Mr. Rossotti to be extremely helpful. Some of you may have dealt with him. He is the first—and forgive me, Pam, because I am an attorney also—non-tax lawyer to take over the IRS. He is a systems person. He understands analysis. He understands the concepts you are talking about in terms of predictability and ability for small businesses to thrive. So I have a lot of respect for him.

Val, let me ask you this question: In terms of your office, what type of independence do you have from IRS? Tell us how you are set up legally.

Mr. OVESON. I am not independent from the IRS. There were various proposals that——

Chairman MANZULLO. Legally.

Mr. OVESON [continuing]. That came up that would have had me, the taxpayer advocate, be independent, but I report to Commissioner Rossotti, whom you have appropriately praised. I feel the same way about him. I report to him. He does my evaluations. I am not independent from the IRS. The independence that is talked about is with the individual taxpayer advocates out in the field of which the law requires there be at least one per State.

Chairman MANZULLO. Explain how that works.

Mr. OVESON. They are independent from the district directors, from the regional commissioners in the current system, from the unit commissioners in the future system.

Chairman MANZULLO. How are they paid?

Mr. OVESON. They are IRS employees.

Chairman MANZULLO. Through IRS, but they have true legal independence in terms of their thoughts?

Mr. OVESON. Well, they report up to me rather than to the other parts of IRS, so they are independent in the same way that appeals is independent from the other portions of the IRS. But this issue is one that I deal with and answer daily around the country with the perception or misperception that we are independent from the IRS, which we are not. We are independent within the IRS and not independent from the IRS. Does that help?

Chairman MANZULLO. That does. We have a similar situation with Jerry Glover in SBA, who heads the Office of Advocacy. He ends up going head to head with other government agencies. We appreciate that.

I have a question for Pam Olson, and for any of you who may want to answer too. Everyone agrees the present system is anywhere from bankrupt or corrupt to unfair. Where do you start? Where do you start without getting somebody else's feathers up? Can there be a consensus of 10 points upon which everybody agrees, or even one point in this whole process of reforming?

Pam, do you want to start with that?

Ms. OLSON. Well, yes, that is a question you could probably spend a couple of days talking about. I guess I would say there are two sources—there are millions of sources—but two sources of complexity we need to address.

One of them comes from the IRS, and I actually share your admiration of Commissioner Rossotti. And long before a non-tax lawyer was appointed to the Commissioner's job, I suggested to people that I thought it was an appropriate thing to do because I don't think that all tax lawyers have the predisposition needed to run an organization the size of the Internal Revenue Service. And I think bringing somebody into the IRS from the outside business community was a very smart thing to do. Lawyers have too much of a tendency to dot every I and cross every T and not enough sense that what we are doing here is running a very large business institution. It has got to be run like a business institution.

For the same reason I applauded bringing in Val Oveson from outside the IRS, somebody with a different mindset about how things have to get done and what you have to do to run the system. That attitude on the part of Mr. Rossotti and Mr. Oveson needs to spill over into the Chief Counsel's Office and needs to permeate down through the Agency so that there is an appreciation for the

fact that we need to make decisions; we need to have those decisions whenever possible have prospective effect, not retroactive effect, so that people can plan; and the answers need to be clear, simple and administrable. We can't spend our time splitting hairs forever, because if we do, we end up with a law that is so complex that nobody can comply with it.

Chairman MANZULLO. We have 5 minutes. It gives everybody here about a minute.

Martin.

Mr. DAVIDOFF. I agree with Pam. Also, the constituency of the ABA and the AICPA have come forth with proposals that I think very few people could disagree with, and you can start with that as a means. Also I think Mr. Oveson in his annual report has talked about phaseouts and getting rid of that, which I have talked about today. I don't think anybody really disagrees with that, other than people who want to trick the American public on what the tax rate is.

I want to comment on the reason why Mr. Oveson and everyone else thinks the National Taxpayer Advocate is independent even though they are not is the way that Mr. Oveson has run that office and Mr. Rossotti has given him the freedom to run the office, and I think they have done a magnificent job.

But there are plenty of proposals on the table today; I mean, section 179 traps, and a lot of other things. If you dedicated yourself to spending the next 2 years to doing that and avoiding things like changing estimated tax, safe harbors and consulting us before you do things like you did last year with the installment sales, we wouldn't do this. The problem is Congress too often says, I need revenue, and refuses to go back to the American public and say, I need to increase the rate. Well, now you have an opportunity. You have a surplus. So instead of saying we are going to give a 10 percent across-the-board tax cut, say we are going to start fixing some of these things, because we have the revenue, and now we can undo some of these things and make them more fair.

Chairman MANZULLO. I appreciate that.

David.

Mr. LIFSON. We all know that simplification is complex. And in the words of a former IRS Commissioner who happened to be a tax attorney, but a very insightful one, I think one of the keys is the appropriate balance of rough justice. And the difficulty with simplification is enacting a single act of simplification which often leads to a rough justice where there are winners and losers in that particular thought or in that particular change.

If you actually were on a mission to create simplification and you took 10, 20 or 30 simplification ideas, it would blur the winners and losers because so many people would be affected by multiple changes that by the time you were all done, you would wind up with a system that, I am sure, you could find one person in some small town somewhere got cheated; but in the end of the game, you will have your rough justice system and the advantages of understanding, and, in our view, the increase in the tax compliance rate would more than pay for the revenue losses from averaging down or simplifying the law so a few people paid a little bit less tax.

Chairman MANZULLO. Does anybody else want to respond to the same question? We will conclude here.

Mr. MCCRACKEN. I think the most important thing to be done—obviously, a lot of these things that have already happened have to be addressed or need to be addressed. I agree with something somebody else said earlier, and that is the foremost thing is to stop making it more complex. And probably the smartest way to do that is, yes, we have a surplus now, and most of the talk is not how do we raise taxes, but how to find some consensus on lowering them. I guess my admonition would be avoid highly targeted, phased-in strange things in the Tax Code. If you are going to change the tax system, change it.

Mr. DAVIDOFF. Here, here.

Mr. MCCRACKEN. And stay away from "targeted" tax cuts—targeting always sounds nice because we will help the people that really need the help, but it usually ends up meaning we are adding enormous complexity to the Tax Code.

Chairman MANZULLO. Scott or Val, do you want to add anything to that?

Mr. OVESON. I just want to reemphasize that every change or every deduction credit or line you add to the Code geometrically complicates the Code.

Chairman MANZULLO. Scott, did you want to have the last word on that?

Mr. MOODY. One thing I wanted to mention is the instability. There is a trade-off. Every time you make these small changes, you are increasing the instability, and instability is a huge component of tax complexity. It is hard to measure, but it is something that is there.

Chairman MANZULLO. I want to thank you very much. Our goal was to conclude the hearing before the votes started, and we accomplished that. This is extremely significant in terms of the small businesses that we represent. My brother has a small restaurant with 13 tables, and he literally just pulls his hair out because he doesn't know what to do. He does not know what is expected of him with the complexities of the tax code.

What bothers me, and it did not come up here, is the social consequence of a complex Tax Code which is to push small businesses out of business and make way for larger chain stores. I am not saying there is anything wrong with that, but people ask what happened to the corner drug store? What happened to the corner grocery store? What happened to this? The corners are gone now because the trucks have to make right turns, and along with them the businesses are gone. But so often they are gone because they just can't keep up with all the regulations and all the taxation, and they end up selling out.

Our Ranking Minority Member Mrs. McCarthy is having emergency dental surgery. Otherwise she would have been here. She is always at these meetings, and we miss her. If she wanted to submit some statement to the record, we will do that.

And this Subcommittee is adjourned. Thank you.

[Whereupon, at 11:14 a.m., the Subcommittee was adjourned.]

DONALD A. MANZULLO, ILLINOIS
CHAIRMAN

CAROLYN McCARTHY, NEW YORK
RANKING MINORITY MEMBER

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REMARKS OF CHAIRMAN DONALD A. MANZULLO

"THE IMPACT OF THE COMPLEXITY OF THE TAX CODE ON SMALL BUSINESS: WHAT CAN BE DONE ABOUT IT?"

September 7, 2000

The Subcommittee today looks at a fundamental problem facing small business owners – the complexity of the tax code. Like the weather, everyone talks about it but no one does much about it.

Later this week, the House will attempt to solve one small aspect of this problem with the veto override vote of the estate or "death" tax repeal. Last week, I was out on the farm of Richard and Judy Beuth in Seward, Illinois lamenting the President's veto. Like most farmers, the Beuth's are "dirt rich" but "cash poor." Richard and his two sisters paid $185,000 in estate taxes when their father died in 1998. They had to mortgage the 470 acre farm to keep it in the family. Richard had originally planned to have his 15 year old son inherit the family farm. But now, with the veto of the *Death Tax Elimination Act*, Richard isn't so sure. If Richard and Judy died, their children would have to pay nearly $1 million in estate taxes to keep the farm in the family. Death tax repeal would not only make Richard's business life less complicated but would also remove an emotional toll on his family. I only wished the President visited the Beuth's farm to explain to them why he thought they are "rich."

I realize that we in Congress are mostly responsible for the tax complexity problem that has been over 80 years in the making. I called this hearing today to see what more can be done to alleviate this burden on small business.

Small business owners are responsible citizens. They are willing to pay their taxes. However, most small businesses have to hire tax experts to help them comply. Unfortunately, the complexity of the tax code has sometimes driven some small businesses into technical non-compliance. In some cases, the penalties have created a "gotcha" mentality at the Internal Revenue Service that frustrates law-abiding small business owners.

I appreciate the work of all the witnesses who will testify before this Subcommittee. While the purpose of this hearing is not necessarily to focus solely on comprehensive tax reform, I also want to hear some specific, common-sense solutions that this Congress or the next Congress could enact to ease the tax complexity burden on small business.

I want to take this brief opportunity to commend Chairman Jim Talent for his leadership on small business tax issues. His introduction of the *Small Employer Tax Relief Act* helped to prioritize the key small business tax issues for the 106th Congress. Almost all seven sections of his bill have a serious chance of passing Congress, in one form or another. If the people of the 16th District of Illinois see fit to send me back here to represent them next year, I want to work with my fellow Small Business Committee colleagues in introducing and moving a similar bill that would prioritize the top ten tax simplification proposals to specifically benefit small businesses.

I now yield for an opening statement by my good friend and colleague from New York, Mrs. McCarthy.

Testimony of
Congressman John E. Sununu
Before the
Small Business Subcommittee on
Tax, Finance, and Exports
Regarding
The Impact of the Complexity of the Tax Code
on Small Business: What can be done about it?

September 7, 2000

Thank you, Mr. Chairman. It is my pleasure to be here. I am pleased that you are holding this hearing today on the complexity of our Tax Code and in particular its effect on small business.

For anyone that has traveled around the country and spent a little bit of time with small business owners and entrepreneurs, the Tax Code is probably the first thing that comes up, in most cases, before regulation. They deal with our Tax Code year in and year out; and it is not just once a year when they pay their taxes. It is an every day event, as I will describe, and it is a source of endless frustration for entrepreneurs.

In a previous part of my career, I worked as chief financial officer and director of operations for a small electronics firm of about 30 employees and dealt with the financial issues for the owner of the firm. So in many cases I speak from a very personal experience.

The complexity of the Tax Code and its impact on small business, I think, is felt in three particular areas. First, there is the outright cost of the complexity, the cost of doing your returns every year, paying someone to prepare your returns and submitting them.

Second, there is also the opportunity cost, the time that is lost, not just from business operations, but from time away from the family as well. So many small businesses are family-owned, and so many entrepreneurs and managers put in such an extraordinary amount of their personal time into their companies.

The third cost of the complexity of our Code is in what I just call distrust. Complexity breeds distrust. It breeds uncertainty as to whether or not the same system is applied fairly to both larger and smaller corporations. I think that undermines public confidence in the way we tax and raise revenues for the Federal Government.

We can solve this problem. We can do better. And I am here to testify on behalf of tax reform, fundamental tax reform, and the implementation of a flat tax, an issue on which I have worked very hard on with the Majority Leader Dick Armey. He has taken a strong leadership role on the objective of scrapping the current Code and replacing it with a system that is simple, honest and fair and that addresses each of these enormous costs that I mentioned.

First, a few words about the specific complexities of the current system and its effect on small businesses. First: Estate Tax. An inordinate amount of time at the small business level and at the family business level is taken in preparing, avoiding, and understanding estate taxes, and trying to

maintain the small business flavor, and that means keeping the small business in a family. An entrepreneur often has worked hours on end through many years managing a business. He has had his family members involved. They want to keep it in the family, but the estate tax burden can be crushing, and the complexity of the estate tax burden can be overwhelming on a yearly basis.

Second: Depreciation schedules. We have called on small businesses to depreciate equipment, sometimes, for example, computers, over five or seven years, which does not make any sense in and of itself. We also ask small businesses to keep separate books for depreciation for an income-reporting basis and for IRS purposes. Keeping multiple books does not serve any real purpose, and, of course, the time and effort required to keep on top of the depreciation rules can be very burdensome for a business that only has 10 or 15 or 20 employees.

Third: Capital gains taxes. Small businesses spend an enormous amount of time dealing with the complexities of employee stock ownership plans, Sub-Chapter S filings, and the impact of potential sales of stocks on their capital gains liability.

And finally, retirement savings, including the tax treatment of IRAs and 401(k)s for employees, but also retirement savings plans that are necessary to avoid the crushing burden of estate taxes.

All of these complexities have the impact of raising the cost of running a small business, taking up an inordinate amount of management time and, of course, undermining confidence in the way we fund government.

How can a flat tax solve this problem? I believe that a flat tax would have enormous benefits for both individuals and corporations, but in particular for small businesses. Under a flat tax, a small business simply takes a look at its revenues for the year, deducts all of its legitimate expenses, cost of goods, wages, salaries, all capital equipment and investments and then pays a simple, honest, and fair rate. The same system applies to corporations large and small. It is understandable. You do not have to keep two sets of books. You do not have to go through the complexity of estate tax planning. In fact, there would be no estate taxes, no capital gains taxes, no inheritance taxes, and no taxes on Social Security benefits. All those would be gone -- and no depreciation schedules.

Each of those add to the burden of running a small business. They would be eliminated. And by having the same system for everyone, we restore public confidence in the way that we finance government. I think if would make an enormous difference for the small business community in time, in money, and in confidence. And it would create the right set of incentives for entrepreneurs to invest in their employees, invest in their firms and create economic opportunity. Ultimately this should be our goal here, not to try to distort the market, but to create an environment where entrepreneurs can do the essential job of creating real economic opportunity.

Thank you, Mr. Chairman.

Testimony of

E. Martin Davidoff, CPA, Esq.

before the

Committee on Small Business
Subcommittee on Tax, Finance, and Exports

September 7, 2000

Mr. Chairman, members of the Subcommittee, thank you for inviting me to speak this morning.

I am critically concerned with the potential breakdown in the American system of taxation.

1. Complexity;
2. An audit rate too low to ensure equitable compliance;
3. A perception of unfairness; and
4. An inability to resolve routine problems or handle routine transactions easily

threaten our system of self-assessment. The issue of complexity was a hot topic in the 1996 presidential election campaign. At that time, supporters of the Flat Tax or a National Sales Tax had a national platform. However, since the 1996 elections, Congress has insisted on making our tax laws more complex in, what appears to me, the interest of political expediency rather than in the interest of good tax policy.

It is obvious that our National Taxpayer Advocate, W. Val Oveson, realizes this. His FY 1999 Annual Report to Congress did an excellent job of highlighting the complexity problem. You will find in these materials an excerpt of my July 12, 2000 letter to Mr. Oveson commenting on his report.

I come to you with a diverse background as one who is a small businessperson, a small business advocate volunteer, and a professional who sees small businesses up close day in and day out. I also come with a clear understanding of the political process that pushes and pulls each of you toward complexity. Everyone wants their special deduction or their special benefit. Yet, everyone wants to see their overall tax burden reduced. So, you provide the deductions and then put in formulas that limit them. Then you find yourselves short on revenue and your creative staffs come up with phase-outs and other creative ways of increasing taxes but making the public think that you have not done so.

Today, I will only touch on the tip of the iceberg of complexity. It has taken Congress nearly 90 years to build in all of the current law's complexity. So, it will not go away overnight. However, you must take the first step. You must acknowledge that the complexity of the tax law is YOUR responsibility to end. You should promise to add no further complexity! And, then, begin to focus on eliminating complexity one step at a time. Keep in mind that minimizing change (and, thus, keeping the rules the same) helps ease the burden of complexity.

I. PHASE OUT THE PHASE-OUTS!

In the year 2000, married individuals with Adjusted Gross Income of $193,400 through $315,900 lose their personal and dependent exemptions ratably over that income range (IRC § 151(d)(3)(C)). However, the reality is that this is little more than a 3.3% increase in the tax rate for a family of four

falling within that income range.[1] The current form of the legislation was enacted in 1990 as a means of raising revenue from higher income individuals. This same legislation introduced us to the phase-out of itemized deductions discussed below. The theory that supported this complexity was simple. "Rich people shouldn't get deductions meant to help the middle class." Yet, the premise just doesn't work and it has led to dozens of phase-outs and phase-ins that, today, impact heavily on the middle class, many of whom are small business owners.

Let us make no mistake about it. The reason for the phase-out of the exemptions was for Congress to increase the tax rate more than Congress was willing to tell the American public. In phasing out exemptions, Congress told America that a family with six children could reasonably pay the same amount of income tax as a family with no children, so long as their income was high enough. Hogwash! The basic premise is false! In addition, the marginal rate of a family within the phase-out zone is higher than wealthier people. Thus the very wealthy are paying a lower marginal tax rate than the upper middle class and the wealthy, depending upon what deductions are being phased out. The highest income individuals will never pay a federal marginal tax rate in excess of 39.6%. However, those subject to phase-in and phase-outs can easily be paying at marginal rates of 42%, 43% and higher.

Some argue that the phase-out is mandated by an ability to pay. Well, the tax system defines "Taxable Income" for that express purpose, to fairly measure one's ability to pay. By determining one's ability to pay based upon "Adjusted Gross Income" (the "above-the-line" amount) to phase-out deductions and exemptions, Congress distorts the purity of a progressive income tax system. For, with phase-outs as they are now, there are indeed many examples of a system of taxation that is neither progressive nor flat, but rather regressive in its operation.

Thus, you might be able to eliminate the exemptions phase-out which taxes a family of four an additional tax rate of 3.3% by increasing the top rate from 39.6% to 39.8%. (Yes, the rate might be 39.9% or even 40.2%, I don't pretend to have all the data.) By doing so, Congress would simplify the computations and add fairness to our tax system.

The first cousin of the Exemptions Phase-Out is the Itemized Deductions Phase-Out of Internal Revenue Code section 68. This phase-out, starting at Adjusted Gross Income of $128,950 for married families, currently hits upper middle income families who support our nation's social programs and get little benefit from those programs (e.g. college grants/scholarships are generally unavailable for these families). Also, the phase-out hits those in high income tax states harder than those from low/no income tax states who are less likely to itemize.

Congress is now addicted to phase-outs. Here is just a sampling:

Description	Code Sec.	Phase-out Starts	Phase-out Ends
Child Care Credit	23	110,000	120,000
Adoption Credit/Exclusion	23/137	75,000	115,000
Learning Credits	25A	80,000	100,000
AMT Exemption	55	150,000	330,000
EE Bond Interest Exclusion	135	81,100	111,100
IRA Deduction	219	52,000	62,000
Roth IRA	408A	150,000	165,000
$25,000 Rental	469(i)	100,000	150,000

[1] Assumes married filing jointly with the marginal rate of taxable income at 36%.

II. REPEAL SUBSECTION 274(n) REGARDING MEALS & ENTERTAINMENT EXPENSES

Repealing subsection 274(n) would eliminate great complexity and add fairness within the U.S. tax code. Generally, section 274(n) allows only 50% of meals & entertainment deductions which, otherwise, would be allowable after passing the many rigorous tests of section 274. (Section 274 already imposes many rules to make certain that the entertainment is directly related to one's business.)

Let's look at an example of the complexity brought about by this law. Consider a small business with three traveling salespersons. One salesperson turns in the hotel invoice for $105. The invoice can be paid and classified as travel, right? Nope, not the case. The bookkeeper for the company has to get a detailed listing and separate out meals into a separate account. This is only because the meals are only 50% deductible, while the hotel room is 100% deductible. What if the hotel room includes a breakfast? Must we secure a letter from the hotel allocating the overnight cost? Now, if the three salespersons each stay in two hotel rooms per week, 50 weeks per year, our poor bookkeeper is analyzing 300 hotel bills to determine what portion is for meals.

Now, let's say our small business has a summer picnic or holiday party for all of its employees, we can just treat that the same as other meals, right? No! These meals are 100% deductible, not just 50%. Thus, the bookkeeping system needs to be revised to separate firm outings from other meals and entertainment. What if I put on a sales presentation to prospective customers? How do I handle the cost of meals served during the presentation? Do you know? You need a CPA/tax attorney like myself just to tell you about all of the instances in which the 50% rule does not apply. There are over 10 exceptions to the disallowance of section 274(n). Also, there is the relatively new category for truckers in which the disallowance is being phased from 50% down to 20% over ten years.

And, how many law firms and large corporations (many of which have internal chefs) are burying the cost of the meals served at work to other categories?

Any of you know what a schedule M-1 or M-2 is on a tax return? It is the place where you place the other 50% of meals & entertainment so you can tie into your balance sheet. Also, in New Jersey, we get to make an adjustment for the federally disallowed meals & entertainment because New Jersey found the section to be unfair to small business.

And why all of this complexity? Well, Congress needed to plug a hole in its budget! Rather than raise the tax rate, Congress decided to unfairly focus on legitimate business deductions.

So, why is this so particularly unfair to small businesses? First, is the recordkeeping burden as I have described above. It falls disproportionately upon firms that cannot afford in-house tax specialists. Second, small businesses expend a higher percentage of their promotional budgets than big businesses for meals and entertainment. Think about it. How many $300,000 per minute commercials do you think I can buy on prime time television to advertise my business? Larger businesses rely more on print & media promotion. Whereas many small businesses are selling personal relationships. They do this over a round of golf (already limited) or a lunch. Look at me! (For those not seeing me in person, I am about 40 pounds overweight.) Do you think I really need to have lunch at a fancy place just to get the tax deduction? I would just as soon have a non-deductible soup and sandwich from the Wawa down the street and use the extra time to get myself to the gym. However, that is how we sell our services. Through intimate one-on-one meetings, which are enhanced over a meal.

The 1995 White House Conference on Small Business chose the repeal of section 274(n) as its number 2 issue and endorsed the following proposal:

> *"Small businesses typically rely on close personal relationships and customer service to compete for sales rather than on expensive advertising campaigns. Expenditures for meals and entertainment are often an important part of this effort. The recent changes in the tax laws to disallow 50 percent of these expenditures for tax purposes has disproportionately increased the selling costs for many small businesses. Accordingly, Congress and the President shall enact legislation that will allow a tax deduction for 100 percent of the expenditures for meals and entertainment."*

III. ELIMINATE SECTION 179 ELECTION TAX TRAP

In the year 2000 businesses may, generally, take a current year deduction for up to $20,000 of capital assets. The trap is that an election under the Treasury Regulations governing section 179 (using form 4562) is required. I urge Congress to revise the law so as to deem the election as having been made if the taxpayer takes the deduction.

Here is the problem. Taxpayer X knows that he can write-off up to $20,000 of capital assets in year 2000 pursuant to section 179. Accordingly, he purchases a computer and a photocopier for a total of $4,500 and classifies those items as office supplies when he prepares his/her return. On audit, the IRS auditor correctly disallows the $4,500 and allows only a depreciation deduction of $900 in year 2000. The auditor points out that an election using form 4562 was not made. Also, because of the manner in which the regulations are written (§1.179-5), the election may not be made on an amended return. (The normal rules for amending a return give a taxpayer 3 years from the normal due date. For section 179, the taxpayer is given only 6 months.)

The IRS position has been upheld under several tax court cases (see V.J. Genck, 75 TCM 1984, TC Memo. 1998-105 and R.C. Fors, 75 TCM 2221, TC Memo. 1998-158).

Congress can correct this unintended inequity by amending Section 179(c) by adding new subpart (3):

"(3) Election deemed made. --An election shall be deemed made by a taxpayer by the filing of a return which claims deductions for any section 179 property acquired during the year, whether or not such deductions are identified as section 179 property on the return."

With the amendment which I propose, the unfair results of Genck and Fors will be avoided. However, the taxpayers will still have the burden of proving the expenditure and that the property acquired is, indeed, section 179 property.

IV ESTIMATED TAX REFORM

If a taxpayer's tax obligation is not satisfied by income tax withholding, such taxpayer is, generally, required to make estimated tax payments. Failure to do so would subject a taxpayer to a penalty which is, in essence, a reimbursement to the U.S. Treasury for the taxpayer's use of funds. Throughout the 1980s, there were two safe havens frequently available and used by most taxpayers

making estimated tax payments:

A. Pay in an amount equal to 90% of the current year tax liability; or

B. Pay in an amount equal to 100% of the prior year tax liability.

Due to increasing income and simplicity, most taxpayers adopted alternative B above when determining how much to pay in estimated taxes. It was simple. In the early 1990s, Congress attempted to take away alternative B for taxpayers with over $150,000 of adjusted gross income. This was simply a move to raise revenue. However, the burden on taxpayers, particularly small business, was so outlandish, that Congress agreed on a compromise with the tax professionals. That compromise was to require the high income individuals to pay 110% of the prior year tax liability to get the safe harbor.

The 110% safe harbor worked very well until new legislation was adopted in 1997 to be effective for 1998. That legislation (P.L. 105-34) adopted a 105% safe harbor for 1998 through 2000, a 112% safe harbor for 2001, and returned to the 110% safe harbor thereafter. In 1998 Congress again amended the safe harbor with P.L. 105-277 by increasing the safe harbor for 1999 and 2000 to 106%. Not wanting to make life simple, Congress again amended (P.L. 106-170) the safe harbor to 108.6% for 1999 and 110% for 2000. This is unconscionable! The table below clearly reflects Congress' insanity:

Tax Year	Pre-1998	P.L 105-34	P.L 105-277	P.L. 106-170
1997	110%	110%	110%	110%
1998	110%	105%	105%	105%
1999	110%	105%	106%	108.6%
2000	110%	105%	106%	110%
2001	110%	112%	112%	112%
2002	110%	110%	110%	110%

This is simply bad tax policy no matter how you look at it. However, it allows you to move revenue from one year to another without really letting the American public know about it. This is "smoke & mirrors" legislation at its worst! Keep it at 110% going forward and never again change it. You should, however, adjust the threshold level for inflation. I also recommend that the $150,000 threshold be adjusted upward (rounded to the nearest $10,000) to reflect inflation once a decade.

The high income safe harbor problem, along with other complexities inherent in estimated taxes, is well documented in the June 5, 2000 Annual Report from the Commissioner of the Internal Revenue Service on Tax Law Complexity at pages 36 through 38.

Currently, estimated taxes are paid on the 15th day of April, June, September and the following January for each year. The Commissioner recommends, and I agree, that estimates should be made by the 15th day following each calendar quarter (April, July, October, and the following January). For small businesses, this would tie into the natural reporting which they normally do for payroll. It would allow more businesses to look at the current year safe harbor for avoiding estimated tax penalties. I understand that this would shift one payment (the September 15th/October 15th) from one fiscal year to another. However, in light of our budget surpluses, this would be the time to make the move....a time when the country can afford a one-time deferral of approximately $50 billion.

Consideration should also be given to simplifying estimated taxes (for example, by the enactment of a meaningful safe harbor) for all corporations. This proposal was made earlier this year by the AICPA Tax Division in conjunction with the ABA Section on Taxation and the Tax Executives Institute.

V. TAX EQUITY NOW! ALLOW 100% MEDICAL INSURANCE DEDUCTION TO SMALL BUSINESSES FOR BOTH INCOME AND FICA TAX PURPOSES

Over the past 20 years, many portions of the tax law have been changed so as to place those working in small businesses as owners at a disadvantage to those providing similar services for large corporations. Issue #385 of the 1995 White House Conference sought to bring small business back to equity.

Under current law, a regular "C" Corporation can fully deduct certain fringe benefits, e.g. medical insurance premiums and dependent care benefits, paid for its employees, including shareholders. Such benefits are also excluded from the income of "C" Corporation employees. If one is an owner, partner, shareholder, or member of a sole proprietorship, partnership, S Corporation, or Limited Liability Company, respectively, such exclusion is not available. Instead, one must personally report as income amounts paid on his or her behalf for such benefits, and then try to deduct them at a personal level if the law permits it. The exclusion of such benefits should not be based upon the type of entity chosen for the business. Why should the William Gates & Michael Eisners of the world get to exclude their fringe benefits, while the owners of many small businesses cannot?

Relative to the issue above, Issue #385 as reported by The White House Conference is stated as follows:

> *Tax Equity Now! Congress & the President shall enact legislation which shall place large and small businesses on a level playing field for tax purposes... that is provide tax equity... in situations where small businesses are currently at a disadvantage. This should be done by uniformly applying the tax law to all forms of business (e.g. proprietorships, partnerships, C Corporations, S Corporations, limited liability companies) with regard to tax rates, deductions, and exclusions as follows:*
>
> - *That all forms of business entities be allowed to take deductions for 100% of the medical insurance premiums, dependent care, and other fringe benefits not currently deductible by self-employed individuals, partnerships, S Corporations, and Limited Liability Companies on behalf of all of their employees who are owners, partners, shareholders, and/or members. As long as fringe benefits continue to be excluded from the income of employees of large C Corporations, then such benefits should be excluded from the income of employees of all small businesses, regardless of form, as well as from the income of self-employed individuals.*
>
> ...
>
> ...
>
> *The privilege of deducting legitimate business expenses should no longer be based upon the entity chosen to operate such business. The choice of an entity within which one will operate a business should be a legal issue, not a tax issue.*

The essence of the proposal was to allow the deduction for both income tax and FICA tax purposes. Current law phases in a deduction for medical insurance premiums only for income tax purposes. Even when fully phased in, it will provide only half a loaf. Medical insurance premiums for self-employed individuals should be deducted in computing one's self-employed income for FICA/Medicare tax purposes as well as income tax purposes.

By adopting such a law, Congress would not only resolve the inequity of current law, it would reduce the compliance burden on small business. The current need to segregate the health insurance premiums of the self-employed from the premiums of his/her employees would be eliminated in that all such premiums could then be reported on the face of Schedule C, form 1065, or form 1120S.

Under current law, an individual making $50,000 per year at a large corporation, along with a $5,000 medical package, pays taxes only on $50,000. One who is self-employed and receiving the same compensation pays income taxes on $52,000 ($50,000 plus 40% of $5,000) and social security taxes on $55,000. This is patently unfair.

I urge Congress and this committee to take the lead in allowing small business owners to take a full deduction of medical insurance premiums on their business returns which will be effective for both income tax and FICA/Medicare tax purposes.

VI. REPEAL/REFORM THE ALTERNATIVE MINIMUM TAX ("AMT")

On pages IV-42 and IV-43 of his FY 1999 Report to Congress, the National Taxpayer Advocate set out excellent reasons for repealing and/or reforming the AMT. The need for the AMT was largely eliminated by the Tax Reform Act of 1986 and the implementation of the Passive Loss rules. It is complex and no longer required to ensure equity.

However, if Congress decides to retain the AMT, certain reforms are absolutely necessary:

A. Index the AMT rate bracket and exemption amount. Congress gets kudos for eliminating hidden tax increases in the regular tax by indexing rates. However, the failure to index the AMT rates has brought it into play with ever-increasing frequency to taxpayers it was never intended to cover.

B. Eliminate the phase-out of the exemption amount. Remember, this is merely a hidden tax bracket increase (see my discussion above regarding phase-outs).

C. Eliminate the adjustment for state income taxes. The payment of state income taxes reduces one's ability to pay federal taxes, and is an appropriate deduction for both computing one's regular and alternative tax. Recently I had a client who incurred a $100,000 tax liability to New York State and New York City as a result of the sale of their home. The bulk of their life savings were tied up in this home. We were unable to structure the payment of the State and City taxes to avoid the impact of the alternative minimum tax. In addition, the State of New York does not provide a lower tax rate for capital gains. Accordingly, these taxpayers are facing a full rate of 32% on the gain from the sale of their home. Without the alternative minimum tax deduction for state taxes, these taxpayers paid an additional $28,000 in federal tax.

D. Allow deductions for purposes of alternative minimum tax with respect to home equity loans which are deductible under the regular tax computations. Most people are unaware of this difference and compute it incorrectly anyway. In addition, the same policy reasons for allowing interest on a $100,000 equity loan would seem to apply at the alternative minimum tax level also. You should note that there are other minor differences in a deductibility of home mortgage interest when one compares the alternative minimum taxable income base with the regular taxable income base. In the interest of simplification, these differences should also be eliminated.

VII. CASH METHOD OF TAX ACCOUNTING/INSTALLMENT METHOD DEBACLE

Currently, small businesses may use the cash method of tax accounting as long as annual gross receipts do not exceed $5 million. This method of accounting is less burdensome on small businesses and should be used as long as it is reasonable to do so.

In 1986, Congress made a judgment as to how large a business should be before it should be required to adopt the accrual method. I am assuming that your judgement was sound at that time. If that is true, a business doing $6 million today was likely doing less than $5 million in 1986 and should not be required to adopt the accrual method. Accordingly, I am requesting that the $5 million threshold be adjusted now for any inflation which has taken place since 1986 and to adjust the threshold each decade to the nearest $100,000.

Finally, the 1999 legislation eliminating the installment method for the sales of businesses must be reversed. That legislation represents another narrow attempt by Congress to avoid telling constituents that it is raising taxes. It should be reversed. If additional tax revenue is needed, you need only go to the tax rates and adjust them.

Rule XI, clause 2(g)(4) statement:

My curricula vitae is enclosed. I have not received any federal grants, contracts or subcontracts at any time.

Respectfully submitted,

E. Martin Davidoff

E. Martin Davidoff, CPA, Esq.

[Excerpts from July 12, 2000 letter to W. Val Oveson, National Taxpayer Advocate]

I have read your 1999 Annual Report to Congress. What a terrific job! I loved your rationales for eliminating the phase-out of itemized deductions and exemptions. Your quote "this puts the government in the awkward position of mandating tax rates that are effectively regressive at certain levels of income" is an argument that I have made ever since the phase-out of itemized deductions was first introduced. You have certainly hit the nail right on the head here. You know as well as I do that the real rationale for the phase-out of the itemized deductions and exemptions was the fact that Congress did not want to raise the highest tax rate above 40%. So, instead of a straightforward tax increase, Congress followed a duplicitous path of complexity, with the hope of misleading taxpayers. Keep up the good work in your advocacy for this change.

I would like to provide you my views on some of the legislative proposals which you have discussed. Some of the views below hopefully enhance your proposals, while a few others may disagree with your proposals. In any event, here are my comments:

#50 Alternative Minimum Tax

In addition to your three excellent proposals, I would propose adding the following two additional proposed changes:

D - *Eliminate the adjustment for state income taxes.* The payment of state income taxes reduces one's ability to pay federal taxes, and is an appropriate deduction for both computing one's regular and alternative tax. Recently I had a client who incurred a $100,000 tax liability to New York State and New York City as a result of the sale of their home. The bulk of their life savings were tied up in this home. We were unable to structure the payment of the State and City taxes to avoid the impact of the alternative minimum tax. In addition, the State of New York does not provide a lower tax rate for capital gains. Accordingly, these taxpayers are facing a full rate of 32% on the gain from the sale of their home. Without the alternative minimum tax deduction for state taxes, these taxpayers paid an additional $28,000 in federal taxes.

E -*Allow deductions for purposes of alternative minimum tax with respect to home equity loans which are deductible under the regular tax computations.* Most people are unaware of this difference and compute it incorrectly anyway. In addition, the same policy reasons for allowing interest on a $100,000 equity loan would seem to apply at the alternative minimum tax level also. You should note that there are other minor differences in a deductibility of home mortgage interest when one compares the alternative minimum taxable income base with the regular taxable income base. In the interest of simplification, these differences should also be eliminated.

#16 Internal Revenue Code Section 179 Property

Many small businesses take deductions for office supplies which include property that probably should be capitalized. This includes fax machines, small photocopiers, etc. These are individuals who are well under the $18,000 cap for Section 179 Property and would have easily been able to make the election on these items. What frequently transpires is a revenue agent will find these items on an audit improperly classified. The taxpayer then no longer has the right to make the election under Section 179 and faces the burden of paying the taxes along with amending tax returns for the intervening years to claim the depreciation adjustment. The law should be amended to allow the election of Section 179 at any time within the three year statute of limitations, as may be extended by the IRS for purposes of audit.

E. Martin Davidoff, CPA, Esq.
[Excerpts from July 12, 2000 letter to W. Val Oveson, National Taxpayer Advocate]

#52 Repayment Previously Reported

You are right on point with this issue and it is similar to other inequities which are in the Internal Revenue Code. One such example is the reporting of gambling winnings and losings (remember, I am from the great state of New Jersey, the home of Atlantic City). One has to report all of the gambling income "above the line", while losses are only allowable (the extent of winnings) only as an itemized deduction. Accordingly, if one does not itemize (am I correct in that most people do not itemize?), then one does not get the benefit of the deduction. Technically, under the law, if one were playing Blackjack, he would have to report each winning hand as income "above the line" and each losing hand on Schedule A.

Clearly, the law is inequitable and difficult to enforce. Gambling winnings should be taxable only to the extent that they exceed gambling losses within any given year.

#20 Limit Interest On Tax Liability

I oppose this proposal in that it penalizes compliant taxpayers. There is little economic incentive for one to pay their taxes once they have reached the 200% threshold. Interest is a legitimate charge imposed for the time value of money. Capping that seems to send the wrong message to non-filers.

#18 Fixed Rate of Interest for Installment Agreements

The fixed rate proposal would seem to serve relatively smaller taxpayers. I suspect your concern for an exact payoff amount and exact payoff dates are most common for taxpayers who owe an amount below a certain level. Let's say, for example, that level is $25,000.

I propose that you modify your proposal to fix the interest rate at the *option of the taxpayer* where the total amount of tax is less than $25,000. This provides simplicity. It avoids the need to recalculate if rates go lower (which would be an administrative nightmare), and it gives the taxpayer a choice between a fixed and floating interest rate. For cases under $25,000, reductions in the interest rate would end up having a minor impact on the overall installment plan.

For larger taxpayers, fairness seems to override complexity in my mind. I would not want a $1,000,000 debtor to the IRS using IRS fixed rates as a hedge.

#15 Employee Business Expenses

In order for one to compute, "above the line" employee business expenses as you propose, it would appear to necessitate the computation of a modified adjusted gross income. This is somewhat complex.

However, my greater concern is both the revenue loss and added complexity by including this provision. Simply stated, the bulk of taxpayers do not itemize their deductions. I guarantee that if you had a provision for "above the line" unreimbursed business expenses, every storefront preparer would be advocating an additional way for them to save taxes for their clients. It is a haven for abuse.

In the case where there is a legitimate need for taxpayers to expend money on behalf of their employers, most employers will provide the reimbursement, occasionally coupled with a reduction in pay to put all things equal. Believe me, this proposal opens Pandora's box and will greatly add to its complexity.

E. MARTIN DAVIDOFF & ASSOCIATES

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E. MARTIN DAVIDOFF, CPA, Esq.

PROFESSIONAL STATUS

Certified Public Accountant	
Licensed in New York State	November 28, 1980
Licensed in New Jersey	August 7, 1981
Attorney and Counsellor at Law	
Admitted to the New York State Bar	March 19, 1979
Admitted to the New Jersey State Bar	December 17, 1981

EDUCATION

Massachusetts Institute of Technology

Received a Bachelor of Science (S.B.) from the Sloan School of Management, Class of 1974.

Honors: Selected to be listed in Who's Who of American Colleges and Universities. Received two American Legion awards for leadership in student government.

Alumni Activities: Class Treasurer (1979 - Date), Alumni Fund Board (1978 - 1981), Alumni Fund Class Agent (1974 - 1982), and Educational Counselor (1985 - Date).

Boston University Graduate School of Management

Received M.B.A. with honors in September, 1975
Concentration in general management and finance

Washington University School of Law - St. Louis, Missouri

Received J.D. in May, 1978.
Elective courses taken in corporations, estate planning, trusts, corporate finance, securities regulation, and taxation of individuals and business associations.

Congressional Clinic:
Worked on extensive legislative projects for U.S. Senator Hathaway during final semester. Completed 200-page analysis entitled "The Economic Cost of Alcohol Abuse".

WHITE HOUSE CONFERENCES ON SMALL BUSINESS

Appointed by Governor Whitman to the 1995 White House Conference. Elected as a delegate to the 1986 White House Conference on Small Business. Served as the New Jersey Delegations' Tax Issues Co-Chair and Treasurer for both conferences.

PUBLIC ACCOUNTING WORK EXPERIENCE

My work experience prior to establishing the firm of E. Martin Davidoff & Associates Certified Public Accountants on December 1, 1981 began at the firm of Richard A. Eisner CPAs in New York City. After two years working there as a Tax Senior, I joined the firm of Leonard C. Green & Co. of Woodbridge, New Jersey as a Tax Manager. During my career, I have had numerous interesting engagements which demonstrate my skills. A small sampling of those engagements follows:

- Frequently have negotiated with the IRS to release levies and liens in exchange for payout terms which are within our clients' ability to pay.
- Successfully completed over a dozen offers in compromise and closing agreements with the Internal Revenue Service, New Jersey Division of Taxation, and the New York Division of Taxation & Finance. Liabilities ranged from $12,000 to over $1,000,000 with payouts ranging from 4% to 62% of the total amount due.
- On a Pro Bono matter, convinced the IRS to reverse an assessment in excess of $10,000. I succeeded even though the time to appeal the assessment to the U.S. Tax Court had expired prior to my first meeting with my client.
- On many occasions, have secured the waiver of thousands of dollars of penalties assessed by the IRS and state tax agencies for the late payment of payroll or income taxes. Frequently, this has been accomplished only after the client and their accountant (who required my assistance) had attempted but failed to do so.
- We have guided one of our clients from a 'startup", operating out of one of the shareholder's homes, to a service business of over $10 million annually with over 110 employees.

PROFESSIONAL ASSOCIATIONS

American Institute of Certified Public Accountants, Tax Division Member
- Tax Legislative Liaison Committee (1991 - 1993)

New Jersey Society of Certified Public Accountants
- State Officer - Vice President (1994 - 1995)
- State Officer - Secretary (1993 - 1994)
- Chairperson of the Membership Committee (1992 - 1993)
- President of Middlesex-Somerset Chapter (1991 - 1992)
- Trustee of the Society (1990 - 1992)
- Chairperson of the Committee of Federal Taxation (1988 - 1990)

American Association of Attorneys - Certified Public Accountants
- Chairperson and founder of IRS National Tax Liaison Committee (1997 - 2001)
- Treasurer of New York chapter (1986 - 1990)

New Jersey State Bar Association - Section on Taxation

HONORS

★ 1998/1999 NJSCPA Service Award presented by The New Jersey Society of Certified Public Accountants for dedicated service and commitment at both state and chapter levels. A scholarship was awarded in the name of E. Martin Davidoff to a New Jersey college that offers an accounting curriculum.

HONORS (continued)

- ★ 1997 Accountant Advocate of the Year, awarded by the U.S. Small Business Administration, for New Jersey and for Region II (New York, New Jersey, Virgin Islands and Puerto Rico)
- ★ Nicholas Maul Leadership Award for 1998, awarded by the Southern Middlesex County Chamber of Commerce
- ★ Listed in Who's Who in the East and Who's Who in American Law (various editions)

PUBLIC SERVICE ACTIVITIES

Small Business Advocacy

Governor's Conference on Small Business - Chairperson of Taxes and User Fees session (1994)

National Federation of Independent Business Leadership Council; Tax Issues Committee Chairperson for New Jersey

New Jersey Association of Women Business Owners, Inc., Associate Member (1997 - Date)

Middlesex Regional Chamber of Commerce (1993 - Date)
- Legislative Committee (1997 - Date)

Coauthor of New Jersey S Corporation Legislation (1992 - 1993)

Community Service

Office of Attorney Ethics Middlesex County Fee Arbitration Secretary (1992 - 1994); Successfully reduced case age by over 80% and case backlog by nearly 60%.

East Brunswick Recreation and Parks Advisory Board (1992 - 1998)
- Principal proponent and advocate for 1998 Crystal Springs expansion
- President (1996 & 1997)

East Brunswick Soccer Club
- Life Member
- Girls Recreational Coach (1986 - 1995)
- Girls Instructional Division Director (1989 - 1990)

East Brunswick Rescue Squad LifeSavers' Party Committee; Chairman of 2/29/2000 event which raised $15,000 for the East Brunswick Rescue Squad

East Brunswick Long Range Finance and Budget Advisory Committee (1993)

New Jersey Commission on Capital Budgeting and Planning - Public Member (1996 - 2000)

East Brunswick Public Schools Thorough & Efficient/Curriculum Committee (1987 - 1989)

Charitable Involvement

Milltown Jaycees (1981 - Date)
- Chair, Children's Holiday Shopping Spree project (1982 - Date)
- Jaycee of the Year (1991 - 1992)

Hugh O'Brian Youth Foundation New Jersey Seminars, Inc., Director (1991 - Date)

State of Israel Bonds, Executive Committee member for the Accounting & Financial Services Division

Mens Club of The East Brunswick Jewish Center
- Vice President (1994 - 1995, 1998 - 1999)
- Treasurer (1995 - 1998)
- Man of the Year (1995)
- Financial Secretary (1993 - 1994)

Woman Helping Woman 25th Anniversary Dinner Committee Member

Testimony of the Honorable W.J. "Billy" Tauzin (R-LA)
before the House Small Business Committee,
Subcommittee on Tax, Finance and Exports

The Impact of the Complexity of the Tax Code on Small Businesses:
What Can Be Done About It?
September 7, 2000

Mr. Chairman, it is my honor to address the Subcommittee on the benefits of a national retail sales tax and my proposal, H.R. 2001, the National Retail Sales Tax Act of 1999. I first introduced this legislation, along with my friend, former Congressman Dan Schaefer in the 104th Congress. Since then I have been joined in this effort by Congressman James Traficant and others, that understand the economic benefits of a national retail sales tax. I look forward to working with you and the members of the Subcommittee to overhaul our current system and lift the burden of the income tax from the shoulders of small businesses and all Americans.

The federal government's outdated, flawed and unfair income-tax system has become a nightmare for all Americans. It has grown from 14 pages in 1914 to more than 2,000 pages of law, 6,000 pages of regulations and hundreds of thousands of rulings and interpretations. Tax preparers and income tax experts who routinely testify before Congress admit that even they do not fully understand all of the provisions and ramifications of the Internal Revenue Code.

Unfortunately, small businesses can not escape the harmful and detrimental effects of the income tax code. In fact, the National Federation of Independent Businesses (NFIB) calls the federal income tax code the "small-business owner's most feared adversary." Unlike large corporations, small businesses often do not have the resources necessary to hire tax accountants and attorneys to help them navigate the income tax code.

As this subcommittee is well aware of, small businesses are disproportionately affected by the death tax. Too many small businesses and family farms have been forced out of business because of the confiscatory power of the death tax. The House of Representatives is scheduled to vote this week to override President Clinton's recent veto of legislation to abolish this anti-family, anti-small business tax.

The death tax is just one of the punitive portions of the federal income tax code. While I strongly support the repeal of the death tax and other legislation to reduce the complexity of, and the burden created by, the federal income tax code, I believe a fundamental modernization of our federal tax system is required to restore freedom, fairness and simplicity to the federal tax system.

Majority Leader Dick Armey, who supports a flat income tax, and I have taken our message of tax reform to tens of thousands of people in over thirty cities on the "Scrap the Code" tour. At every stop on our tour we have been met by hundreds and sometimes thousands of Americans yearning to learn more about the major alternatives to the current code. I am pleased that Congressman John Sununu is here today to testify on behalf of the flat tax.

While Congressmen Sununu and Armey, and I differ on which tax-reform bill is best for America, we agree that Americans work too hard for their money, have too little to show for it and should not have to tolerate our inherently-unfair and overly-complex federal income tax code. What's worse is that the federal income tax code tells Americans how to live their lives – encouraging some types of actions and discouraging others.

Let me briefly explain my proposal, H.R. 2001, the Tauzin-Traficant National Retail Sales Tax Act of 1999 (NRST). My legislation would eliminate the personal and corporate income tax code – including taxes on capital gains and savings, inheritance and gift taxes, and all non-trust fund dedicated excise taxes, abolish the Internal Revenue Service and replace them with a 15 percent national sales tax on the retail purchase of all goods and services.

Simplicity

Unlike the current income tax code or even the flat tax, the national retail sales tax requires no federal individual tax returns of any kind. Americans are forced to spend in excess of 5 billion hours trying to calculate the amount of income taxes owed to the federal government. This is absurd. Under my proposal, individual Americans will pay their taxes when they make purchases of retail goods and services. No receipts, no tax returns, no audits, no hassle.

All goods and services for consumption would be taxed at the same rate. If we exempted food, clothing, and housing – which represents a substantial amount of the American economy – the rate would have to be significantly higher. The broader the NRST base the lower the rate.

Freedom, Fairness

The NRST will empower all Americans by giving them the choice as to how much tax they pay. Our present income tax system takes our money through withholding before we even receive it. Most of us now consider that our wages are really the "take-home pay" that we get net of all the deductions. Under the present system, it doesn't matter if one of us is more frugal than the other because we all pay the same amount of tax. In fact, if we are more frugal than our neighbor we are actually going to pay more and more tax because our earnings on our savings will be taxed each year.

With the national retail sales tax we receive all of the money we earn. Our checks are increased by the amount previously deducted for federal income tax. With this money in hand, we have the power to determine the amount of federal tax we pay based on how much we choose to spend. The more you consume the more you will pay in taxes. The less you consume the less you will pay in taxes. The American people, not Congress or the IRS, will have the power.

Eliminating "Hidden" Taxes

Also, because of the way that the present income tax system hides the amount of taxes we pay in the price of goods and through withholding, I don't think any of us can really tell how much tax we are paying to the federal government.

Currently, Americans are in effect taxed twice by the IRS. Americans pay a federal tax on their income, and pay what amounts to a "hidden" sales tax (believed to be as high as 15 to 20 percent) on the retail purchase of all goods and services. The federal government calls this the "corporate income tax" -- as if it were really paid by corporations. But, in reality, consumers pay this tax in the price of goods they buy. So under the present code, American income is literally taxed coming and going.

This "hidden" sales tax makes it harder for American goods to compete overseas. Due to the income tax and its burdensome compliance costs, American products produced for export leave the U.S. at a 15-20 percent competitive disadvantage.

What's worse is that products imported into the United States enjoy a 15-20 percent competitive advantage over our American-made products. Most industrialized countries simply exempt products for export from most of their taxation. This exacerbates our trade deficit and translates into millions of lost American jobs. Mr. Chairman, that's unfair to American workers, products and businesses, both small and large.

No business would have to pay federal income taxes under the NRST. In addition, since the NRST is designed to only tax consumption, all purchases made for business purposes would NOT be subject to the 15 percent tax. The net effect of the NRST, is to eliminate two taxes and replace them with one clearly defined tax on goods and services sold at the retail level.

Under a NRST, no national sales tax will be placed on a product exported from the United States. As our country becomes more and more dependent on foreign markets for our goods and services it is becoming increasingly clear that we must fundamentally modernize our tax code to increase U.S. competitiveness around the world.

There will also be what some economists call the "sponge effect". The U.S. is the world's largest market and has the best infrastructure of any country on earth. When the income tax is replaced with the national retail sales tax, it will become the world's largest tax haven and a "sponge" for capital from around the world.

Enforcement

Enforcement is an serious issue for any tax plan. Will there be people who try to evade the national retail sales tax? Yes. There are always going to be people who refuse to pay any tax. The current code has become so complex that it makes it easier for people to cheat the system.

Under the NRST there will be dramatically fewer collection points to monitor. Instead of having to audit and collect information on 250 million taxpayers and millions of businesses, the government will have to watch a substantially smaller number of collection points.

All but five states levy state sales taxes (Alaska, Deleware, Montana, New Hampshire and Oregon do not). The other 45 states and the District of Columbia already have the mechanisms and experience in place to enforce the sales tax. Local administration and collection will translate into better compliance rates.

States will also have an incentive to enforce the tax because the more they collect, the more they receive to cover their administrative costs. Under the Tauzin-Traficant plan, States would collect the 15 percent national sales tax from the retailers within the state and remit the tax to the United States Treasury. Participating States may keep 1.0 percent of their collections to offset their collection expenses. Similarly, any business required to collect and remit the sales tax would be permitted to keep 0.5 percent of tax receipts to offset compliance costs.

The NRST would ensure that the underground economy, those individuals and businesses that currently don't file income taxes, would pay their fair share. The underground economy encompasses not only illegal sources of income, such as drug dealing, gambling, and prostitution, but also the ordinary citizen who accepts a lower price for cash payments and doesn't report the income or the businessman who keeps two sets of books and pockets a portion of the sales or takes improper deductions.

In closing, I believe that we should re-examine the basic ideas on which this government was founded. Our Founding Fathers insisted on the use of indirect taxes on individuals and specifically forbade direct taxes like the income tax. We have an opportunity to eliminate the income tax, the IRS, tax returns, audits, and the penalties on our work, savings and investments and replace them with a national retail sales tax. We must free Americans from the trappings of the income tax code.

The beauty of the national retail sales tax is its simplicity and fairness. Those who spend the most will pay the most. Those who spend the least will pay the least. No more income tax forms. No more compliance costs. No more hidden taxes. No more loopholes for the corporations and the rich.

What's important now is to begin a national dialogue and a dialogue within Congress, with the assistance of your Subcommittee, on tax reform. This debate isn't simply about a flat tax vs. a national sales tax. This is about fundamental tax reform vs. preserving the status quo. Revolutionary change, such as scrapping the federal income tax and abolishing the IRS, will never happen unless Americans demand it.

Mr. Chairman, thank you again for holding these hearings and for your initiative on this critical issue.

The Growth-Boosting Power of a Consumption Tax

DALE W. JORGENSON, CHAIRMAN,
DEPARTMENT OF ECONOMICS AND
FREDERIC EATON ABBA PROFESSOR
OF ECONOMICS, HARVARD
UNIVERSITY

This section will consider the economic impact of a tax on consumption for corporate and individual income taxes at federal, state and local levels. I will limit this discussion to a revenue-neutral submission—one that would leave the government deficit unchanged—and to the impact of this tax reform on economic growth. The benefits of such a tax are these:

1. An immediate and powerful impact on the level of economic activity;

2. A sharply higher tax rate on consumer goods and services;

3. Individuals would sharply curtail consumption of both goods and leisure, which would produce a dramatic jump in savings and a substantial rise in labor supply;

4. A radical shift away from consumption toward investment; real investment would leap upward by a staggering 80%;

5. Holding net foreign investment consistent, exports would jump to 29% while imports would rise only slightly; the initial export boom would gradually subside, while remaining around 15% higher than under the current tax system;

6. Since producers would no longer pay taxes on profits or other forms of income from capital and, since workers would no longer pay taxes on wages, prices received by producers would fall by an average of 20%; and industry outputs would rise by an average of 20% with substantial relative gains for investment-goods producers.

7. In the long run, producers' prices would fall by almost 25% relative to prices under an income tax. The shift in the composition of economic activity toward investment and away from consumption would dramatically redistribute economic activity. Production would increase in all industries, but the rise in production of investment goods would be much more dramatic.

Implementation of a Consumption Tax

In hearings on replacing the federal income tax held by the Committee on Ways and Means in June 1995, testimony focused on alternative methods for implementing a consumption tax. The consumption-tax base can be defined in three alternative and equivalent ways. First, subtracting investment from value added produces consumption as a tax base, where value added is the sum of capital and labor incomes. A second definition is the difference between business receipts and all purchases from other businesses, including purchases in investment goods. A third definition of the tax base is retail sales to consumers.

The three principal methods for implementing a consumption tax that correspond to these three definitions are:

1. The subtraction method. Business purchases from other businesses, including investment goods, would be subtracted from business receipts, including proceeds from the sale of assets. This method could be implemented within the framework of the existing tax system by integrating individual- and corporate-income taxes, as proposed by the U.S. Treasury in 1994. In this approach all businesses would be treated as partnerships or "subchapter S" corporations. The second step would be to allow full expensing of investment goods purchased in the year of acquisition. If no business receipts were excluded and no deductions and tax credits were permitted, the tax return could be reduced to the now familiar postcard size, as in the flat-tax proposal of Majority Leader Dick Armey and Senator Richard Shelby in 1995.[1] Enforcement problems could be reduced by drastically simplifying the tax rules, but the principal method of enforcement, the auditing of taxpayer records by the Internal Revenue Service, would remain.

2. The credit method. Business purchases would produce a credit against tax liabilities for value-added taxes paid on goods and services received. This method is used in Canada and all European countries that impose a value-added tax. From the point of view of tax administration, the credit method has the advantage that both purchases and sales generate records of all tax credits. The idea of substituting a value-added tax for existing income taxes is a novel one. European and Canadian value-added taxes were added to preexisting income taxes. In Canada and many other countries the value-added tax replaced an earlier and more complex system of retail- and wholesale-sales taxes. The credit method would require substantial modification of collection procedures, but decades of experience in Europe have ironed out many of the bugs.

3. National retail-sales tax. Like existing state sales taxes, national retail-sales tax would be collected by retail establishments, including service providers and real-estate developers. This method would also require a new system for tax administration, possibly subcontracting the actual collection to existing state agencies. Enforcement procedures would be similar to those used by the states, and the Internal Revenue Service could be transformed into an agency that would subcontract collections. Alternatively, a new agency could be created for this purpose and the IRS abolished.

The crucial point is that all three methods for implementing a consumption tax could be based on the same definition of the tax base. This concept greatly simplifies the tax economist's job, since the economic impact would be the same for all three approaches. The concept also leaves important issues to be resolved by other tax professionals, especially tax lawyers who would write the legislation and the implementing regulations in accounting practice and advise economic decision makers about their implications.

From an economic point of view, the definition of consumption is contained in the Personal Consumption Expenditures (PCE) defined in the U.S. national income and product accounts. However, the taxation of services poses important administrative problems, which were reviewed in a U.S. Treasury monograph (Jorgenson and Yun 1984) on the value-added tax. First,

PCE includes the rental-equivalent value of the services of owner-occupied housing, but does not include the services of consumers' durables. Both are substantial in magnitude, but could be taxed by the prepayment method described by David Bradford (1986). In this approach, taxes on the consumption of the services would be prepaid by including investment rather than consumption in the definition of the tax base.

The prepayment of taxes on services of owner-occupied housing would remove an important political obstacle to the substitution of a consumption tax for existing income taxes. At the time the substitution takes place, all owner-occupiers would be treated as having prepaid all future taxes on the services of their dwellings. This is equivalent to excluding not only mortgage interest from the tax base, but also returns to equity, which might be taxed upon the sale of a residence with no corresponding purchase of residential property of equal or greater value. Of course, this argument is open to the criticism that home owners should be allowed to take the mortgage-interest deduction twice—once when the substitution occurs and again when consumption-tax liabilities are assessed.

Under the prepayment method, purchases of consumers' durables by households for their own use would be subject to tax. These would include automobiles, appliances, home furnishings, and so on. In addition, new construction of owner-occupied housing would be subject to tax, as would sales of existing renter-occupied housing to owner-occupiers. These are politically sensitive issues and it is important to be clear about the implications of prepayment as the debate proceeds. Housing and consumers' durables must be included in the tax base in order to reap the substantial economic benefits of putting household and business capital onto the same footing.[2]

Other purchases of services especially problematical under a consumption tax would include those provided by nonprofit institutions such as school and colleges, hospitals, and religious and eleemosynary institutions. The traditional tax-favored status of these forms of consumption would be defended tenaciously by recipients of the services and even more tenaciously by the providers. Elegant and, in some cases, persuasive arguments should be made that schools and colleges provide services that represent investment in human capital rather than con-

sumption. However, consumption of the resulting enhancements in human capital often takes the form of leisure time, which would remain as the principal untaxed form of consumption. Taxes could, however, be prepaid by including educational services in the tax base.

Finally, any definition of a consumption-tax base will have to distinguish between consumption for personal and business purposes. Ongoing disputes over exclusion of home offices, business-provided automobiles, equipment, and clothing, and business-related lodging, entertainment, and meals would continue to plague tax officials, the entertainment and hospitality industries, and holders of expense accounts. In short, substitution of a consumption tax for the federal income-tax system would not eliminate all the practical problems that arise from the necessity of distinguishing between business and personal activities in defining consumption. However, these issues are common to both tax systems.

Next Steps

Under any one of the three approaches, the substitution of a consumption tax for existing individual and corporate income taxes would be the most drastic change in federal-tax policy since the introduction of the income tax in 1913. It should not be surprising that the dimensions of the economic impact would be truly staggering. As Americans become more fully apprised of the manifold ramifications of fundamental tax reform, it is easy to forecast that Gucci Gulch[3] will be transformed into the political equivalent of the Grand Canyon.

The coming debate over tax reform is both a challenge and an opportunity for economists. It is a challenge because the impact of fundamental tax reform will involve almost every aspect of economic life. Economists who have spent their lives preoccupied by the latest debating points in professional journals read only by other economists will suddenly find themselves swept up in the journalistic maelstrom of American political life. The fine points that dominate scholarly discussions will be subjected to the fire of media exposure and public scrutiny. While translation of professional debating points into sound bites requires

considerable talent and experience, a substantial number of economists have acquired the requisite skills.

The debate will nonetheless be a wonderful opportunity for economists because economic research has generated an enormous amount of valuable information about the impacts of tax policy. Provided that the economic debate can be properly focused, economists and policy makers will learn a great deal about the U.S. economy and its potential for achieving a higher level of performance. I am personally very gratified that the Joint Committee on Taxation has convened a group of leading tax economists to began serious work on shaping the professional discussion. I will close this section with the recommendations I will make at the beginning of this landmark debate.

The first issue that will surface is progressivity or use of the federal tax system to redistribute resources. My recommendation is that this issue be set aside at the outset. Fiscal economists of varying persuasions agree that progressivity or the lack of it should be used to characterize all government activity, including both taxes and expenditures. Policies to achieve progressivity could and should be limited to the expenditure side of the government budget. This initial policy stance would immeasurably simplify the debate over the economic impact of fundamental tax reform. I view this radical simplification as essential to intellectual progress, since there is no agreed-upon economic methodology for trading off efficiency and equity in tax policy or anything else.

The second issue to be debated is fiscal federalism or the role of state and local governments. Since state and local income taxes usually employ the same tax bases as the corresponding federal taxes, it is reasonable to assume that substitution of consumption at the state and local level will have the same impact as on the federal level. For simplicity, I propose to consider the economic impact of substitution at all levels simultaneously. Since an important advantage of fundamental tax reform is the possibility, at least at the outset, of radically simplifying tax rules, it does not make much sense to assume that these rules would continue to govern state and local income taxes, even if the federal income tax were abolished.

The third issue in the debate will be the economic impact of the federal deficit. Nearly two decades of economic dispute over

this issue has failed to produce resolution. No doubt this dispute could continue well into the next century and preoccupy the next generation of fiscal economists, as it has the previous generation. An effective rhetorical device for insolating the discussion of fundamental tax reform from the budget debate is to limit the consideration to deficit-neutral proposals. This device was critical to the eventual enactment of the Tax Reform Act of 1986 and is, I believe, essential to progress in the debate over fundamental tax reform.

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NOTES

1. Economists will recognize the flat-tax proposal as a variant of the consumption-based value-added tax proposed by Robert Hall and Alvin Rabushka (1995).

2. See, for example, my testimony before the Committee on Ways and Means of June 6, 1995.

3. A colloquial expression for the corridor outside the hearing room of the Committee on Ways and Means, it appeared in the title of the definitive journalistic account of the Tax Reform Act of 1986, by Jeffrey H. Birnbaum and Alan S. Murray (1987).

Complexity of the Tax Code as it Impacts Small Business

Statement of

W. Val Oveson

National Taxpayer Advocate

Before the

Subcommittee on Tax, Finance and Exports

House Committee on Small Business

September 7, 2000

IRS Department of the Treasury
Internal Revenue Service
www.irs.ustreas.gov

TAXPAYER ADVOCATE SERVICE Taxpayer Advocate Service

Statement of
W. Val Oveson
National Taxpayer Advocate
Internal Revenue Service
Before the Subcommittee on Tax, Finance and Exports for the
House Committee on Small Business
September 7, 2000

Mr. Chairman and Distinguished Members of the Subcommittee:

I am pleased to be here today to address the Subcommittee on the subject of complexity of the tax code as it impacts small business. For the past two years, I have reported that complexity of the tax law is the most serious problem facing taxpayers. This conclusion was stated in my Annual Report to Congress as claimed by several groups -- individual and small business taxpayers, tax practitioners and professional associations, and Taxpayer Advocates. As the National Taxpayer Advocate, I have witnessed two types of complexity with respect to the tax laws. First is the legal complexity that deals with complicated statutes and the even more complicated regulations they require. Second is the administrative complexity that deals with the systems, procedures and processes required for the public to comply with the law and the Internal Revenue Service to administer the law.

The issue is further complicated because many provisions have very good intentions. A number of statutes were enacted either to make the tax system more equitable or to provide targeted relief. The Alternative Minimum Tax was enacted to make sure wealthy taxpayers paid their fair share of taxes, yet it adds tremendous complexity for all types of taxpayers, including small business owners. The varying FICA Deposit Requirements were implemented to eliminate some of the burden for small businesses yet, because those requirements are varying, the complexity and burden, as well as the opportunity for error, actually increased.

I congratulate Congress for trying to get a handle on complexity, as demonstrated by section 4022 of RRA 98, which calls for complexity studies to be conducted by the IRS and the Joint Committee on Taxation. I hope you can use the information from these reports to slow down the frequency of changes to the tax laws and focus on changes that will reduce complexity and burden.

I appreciate this opportunity to testify before you. My role is to be the voice of the taxpayer and advocate for a more equitable, balanced approach to tax administration. Based on the cases that come into the Taxpayer Advocate Service and input from a variety of practitioner and stakeholder groups we have identified several areas that add to the compliance burden and costs faced by small business taxpayers.

I. Penalties

The number of administrative penalties is staggering. This is particularly true for small business. We have seen numerous examples where the application of penalties has overwhelmed small business taxpayers. A good example would be a late filed and late paid employment tax return. That return would be subject to the failure to deposit penalty, late filing penalty, and failure to pay penalty as well as compounded interest on the total tax and penalties.

Penalties are supposed to function in our tax system by punishing noncompliant taxpayers and deterring compliant taxpayers from noncompliant behavior. In my opinion, the system of penalties has become so complex and so burdensome that it may be driving taxpayers toward noncompliance rather than toward compliance. In the Taxpayer Advocate Service, we see many cases in which a taxpayer understands why penalties and interest have been assessed and would like to comply with the laws. In a large number of those cases, however, the taxpayer cannot reasonably expect to pay off the liabilities over time with the amount of penalties assessed and with further penalties and interest continuing to accrue.

I support the complete repeal of the failure to pay penalty. We do not need to replace the penalty with some alternative system. By setting the interest rate slightly above the market rate, we compensate the government for the use of the money and provide taxpayers with an incentive to pay. In my experience, few taxpayers are aware of the failure to pay penalty and, thus, it does not effectively motivate taxpayers to comply. In fact, when a taxpayer is in financial trouble or has not filed returns for several years, the failure to pay penalty becomes a barrier to compliance rather than an inducement.

In addition, I believe that Congress should restructure the application of the failure to file penalty. This penalty is currently structured such that it loses it's incentive after only five months. The penalty should be restructured to provide a continuing incentive yet not be so substantial as to deter compliance. For example, a penalty equal to 0.5 percent per month that escalates to a maximum of 24 percent at 48 months would provide a continuing incentive yet not be so burdensome as to deter compliance.

II. Employment Tax Deposits

One way to reduce tax burden for small business is to have consistent rules that do not change as a business expands or contracts. This results in a better understanding of the requirements and less time spent trying to understand changing requirements. The rules relating to depositing employment taxes provide a good example. These rules vary significantly based on the number of employees and the wages paid to them and businesses continually have to evaluate when they are required to deposit employment taxes.

There are many ways to simplify the rules for employment tax deposits. Each approach has benefits and drawbacks and before any change is enacted, thorough research and analysis needs to be conducted. However, the key to reducing the burden in this area is not the particular method, the key is ensuring that the method selected is simple and the rules do not change. Examples of simplified employment tax deposit rules include:

a. Require the withheld tax to be deposited monthly regardless of the amount. This would put all businesses, regardless of size, on the same simplified deposit system. However, this system has a cost to the government, as it would lose the use of large sums of money.

b. Require that all deposits be made within 5 days of the payroll date, regardless of the size of the payroll. This would require some businesses to make more deposits but the requirement would be constant and all parties would understand the rules.

c. Require that deposits are due within 5 days when the payroll tax liability has reached $10,000. This would result in fewer deposits for small businesses and continue the rapid depositing for large businesses yet the rule would be the same for all.

III. Depreciation

The depreciation section of the Internal Revenue Code has been altered numerous times over the years and depreciation is consistently among the most litigated issues. I believe it is time to revise the depreciation rules and replace them with simple rules that are consistent for all taxpayers. There are many ways to simplify depreciation rules, following are two alternate proposals for your consideration.

a. Allow a section 179 expense to be claimed on all capital asset purchases. This is a bold proposal that would significantly cut the costs of compliance for small businesses. This would eliminate all decisions and record keeping for capitalization and depreciation. Since decisions to capitalize and/or depreciate are timing issues, over time the revenue to the government would even out.

b. Allow a system that mixes the Section 179 deduction with the depreciation rules. A new system could require all businesses to expense all assets that cost less than $10,000 per asset. Other expenses could be depreciated using a straight line method for 5 years for each depreciable asset costing under $100,000, 10 years for each depreciable asset over $100,000, and 25 years for all real estate. The amounts and years stated here are not important. What is important is to have one simple set of rules for all assets.

IV. Due dates and payment dates

The IRS publishes a Tax Calendar for small businesses (Publication 1518) that lists the daily tax obligations for all different types of taxes that potentially affect small businesses. According to that calendar, some tax compliance action is potentially necessary on over 50 percent of the business days of the year.

To address this burden, I believe that the filing dates for as many tax obligations as possible should be synchronized. This should include Income, Gift, Excise and Employment taxes. The deposit dates for Employment and Excise taxes could all be required to be made on the 5th day after the end of the month. The due date for all returns could be 3 months and 15 days after the end of the taxable period. Once again the actual dates are not important, it is important that the dates be the same.

Further, administrative requirements could be standardized. Requests for extension of time to file tax returns provides an example of differing administrative requirements. Individual returns have a four-month automatic extension (Form 4868) that does not require a signature. This can be followed by an additional two-month extension (Form 2688) that needs to be signed by the taxpayer and approved by the IRS. In contrast, corporate return filing dates are extended for 6 months by filing Form 7004 which requires a signature. These different types of extensions, different due dates and different signature requirements serve little purpose and continually confuse even seasoned tax professionals.

V. Employee vs. Independent Contractor

This has long been a thorn in the side of small business. Small businesses have to weigh the "20 Common Law Requirements" and "Section 530 Safe Harbor" to determine whether individuals doing work for them should be treated as employees or as independent contractors. If employers make the wrong decision, and treat individuals as independent contractors rather than employees; they face potentially huge delinquent employment tax obligations. The inequity in this area also creates distinct competitive advantages for some companies that are not complying with the law over those that are complying. I encourage you to pass legislation that is easy to understand and administer. For example:

> "Individuals who receive payments for services are deemed to be employees unless they meet both of the following standards:
>
> 1. The individual signs a statement that they agree to be considered an independent contractor and acknowledge the requirement to file Schedule C and Schedule SE or other appropriate forms (1120, 1120S, or 1065), and

2. The individual performs similar work for multiple businesses or is under a signed contract to the one business for either a specified period of time or contractual amount."

The benefits of this solution are that the parties have the ability to structure the agreement to meet their needs and independent contractors sign to acknowledge their individual filing requirements.

VI. Alternative Minimum Tax and Adjusted Gross Income Phaseouts

I have testified on several occasions on the complexity that both of these provisions add to the tax code. Many would classify the phaseouts of items such as the child tax credit, child and dependent care credit, the education credits and the earned income tax credit as individual provisions. However, these provisions add to the complexity for small business taxpayers as well. These phase outs are equivalent to marginal rate increases and require a taxpayer to perform additional calculations on a separate worksheet, rather than simply entering a standard credit amount on a tax form.

The combination of these credits, along with exemptions and deductions, can also cause unintended consequences and major difficulties for taxpayers if they become subject to the Alternative Minimum Tax. I have testified on this issue before and continue to support the elimination of the Alternative Minimum Tax and the Adjusted Gross Income phaseouts.

In addition to commenting on the complexity of the tax code as it impacts small business, you asked me to highlight the role that my office can play in helping resolve complex tax problems for small business owners.

I. Advocate change.

The Taxpayer Advocate Service can advocate change in tax law and IRS procedures. We work to help taxpayers resolve problems with their tax accounts every day. We also meet with practitioner groups and listen to their input. This testimony and my Annual Report to Congress serve as examples of how we can gather information and recommend solutions to problems.

II. Advocate for educational programs.

The Taxpayer Advocate Service needs to be a partner with IRS and the tax preparation community to ensure that interested small businesses have tax compliance educational opportunities. All new businesses should be invited to attend local training sessions where their tax compliance obligations are thoroughly discussed.

III. Advocate for small business owners related to problems they have encountered.

This is a major service that we now perform for small business. Business owners should contact the Local Taxpayer Advocates if they are concerned about any tax issue they are facing. Taxpayer Advocates will either correct the problem or act as an advocate for the taxpayer in their dealings with the other IRS divisions. While we can not always guarantee a favorable result, we can guarantee that the problem will be addressed.

IV. Advocate system changes within the IRS.

When we see systems that are not working inside the IRS we are able to influence how the system can be corrected and how the Service treats those affected by the error. We are also able to advocate for new ideas in tax administration.

Conclusion

Mr. Chairman, it has been my pleasure to serve as the National Taxpayer Advocate for the past two years. I am passionate about reducing the complexity of the tax law. I applaud your efforts to simplify the tax code and made the system better for the small business owners of this country. Thank you for the opportunity to offer some of my ideas.

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STATEMENT

of

PAMELA F. OLSON

on behalf of the

AMERICAN BAR ASSOCIATION
SECTION OF TAXATION

before the

SUBCOMMITTEE ON TAX, FINANCE, AND EXPORTS

of the

COMMITTEE ON SMALL BUSINESS

of the

U.S. HOUSE OF REPRESENTATIVES

on the subject of

THE IMPACT of COMPLEXITY in the TAX CODE
on SMALL BUSINESSES

September 7, 2000

Mr. Chairman and Members of the Subcommittee:

My name is Pamela F. Olson. 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.

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

The ABA and its Tax Section have long been forceful advocates for simplification of the Internal Revenue Code. In resolutions proposed by the Tax Section and passed by the full ABA in 1976 and 1985, the ABA went on record urging tax law simplicity, a broad tax base and lower tax rates. We have reiterated this position in testimony before the House Ways and Means and Senate Finance Committees on numerous occasions. Over a year ago, the Section of Taxation testified before the House Ways and Means Oversight Subcommittee and the Senate Finance Committee on simplification of the Internal Revenue Code. Our testimony included a number of recommendations important to the small business community. On February 25, 2000, the Section of Taxation, the AICPA Tax Division, and Tax Executives Institute released identical simplification proposals. We are pleased the Subcommittee has chosen to address this issue.

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 Tax Section can attest to the widespread disaffection among taxpayers with the current Code. The willingness and ability of taxpayers to keep up with the pace and complexity of changes is now under serious stress.

We do not claim to have all the answers. The Tax Section will continue to point out opportunities to achieve simplification whenever possible, including several ideas that we will discuss later in this testimony. However, it is also necessary that we point out that simplification necessitates hard choices and a willingness to embrace proposals that are

often dull and without passionate political constituencies. Simplification also requires that easy, politically popular, proposals be avoided if they would add significant new complexity. Simplification – and preventing greater complexity – may not garner political capital or headlines, but it is crucial.

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 small business, alternative minimum tax, administrative, and individual items.

1. Small Business Tax Provisions.

a. Permit Accrual Method Taxpayers to Use the Installment Method.

Following a proposal set forth in President Clinton's Fiscal Year 2000 Budget Proposal, Congress repealed the installment method of tax accounting for accrual method taxpayers in the Tax Relief Act of 1999 (Title V, Subtitle C, Section 536), enacted as part of the "Ticket to Work and Work Incentives Improvement Act of 1999" (H.R. 1180). The repeal of installment sales treatment for accrual method taxpayers adversely affects businesses attempting to sell business assets because they are taxed immediately even when payments are received years later. Immediate taxation of business sellers, and its chilling effect on the marketplace, simply does not represent sound tax policy. For these and other reasons that we have previously outlined,[1] we respectfully request that Congress reenact prior law which, for over eighty years, has permitted accrual method

[1] *See* Letter from Paul J. Sax, Chair, ABA Section of Taxation to Senator William V. Roth, Jr., Chairman, Senate Comm. on Finance (February 24, 2000) (on repeal of installment method of accounting); Letter from Paul J. Sax, Chair, ABA Section of Taxation to Congressman Bill Archer, Chairman, House Comm. on Ways and Means (February 24, 2000) (on repeal of installment method of accounting); Repeal of the Installment Method of Accounting for Accrual Basis Taxpayers: Hearings Before the Subcomm. on Oversight of the House Comm. on Ways and Means, 106th Cong. 2d Sess. (February 29, 2000) (statement of Pamela F. Olson, Chair-Elect, ABA Section of Taxation); Small Business Use of the Cash Method of Accounting and Repeal of the Installment Method of Accounting: Hearings Before the House Comm. on Small Business, 106th Cong. 2d Sess. (April 5, 2000) (statement of Pamela F. Olson, Chair-Elect, ABA Section of Taxation).

taxpayers to sell business assets for installment payments and report the gain in the year cash is actually received.

In response to concerns expressed about the repeal of the installment method, 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. Although we applaud the Treasury Department for taking this step, we do not believe it resolves the concerns caused by the repeal of installment sales reporting and we do not believe $1 million in gross receipts provides sufficient relief from the complexity the accrual method of accounting creates.

b. 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.

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.

c. 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.

d. Simplify the Minimum Distribution Requirements.

The tax rules concerning retirement plan distributions (especially the minimum distribution requirements of section 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 evergrowing 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 section 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.

e. Eliminate the Half-Year Age Conventions.

Section 401(a)(9) provides that retirement plan benefits must commence, with respect to certain employees, by April 1 of the calendar year following the calendar year in which the employee attains 70½. Section 401(k) states that plan benefits may not be distributed before certain stated events occur, including attainment of age 59½. Further, section 72(t) provides that premature distributions from a qualified retirement plan, including most in-service distributions occurring before an employee attains age 59½, are subject to an additional ten percent tax. The half-year age conventions complicate retirement plan operation because they require employers to track dates other than birth dates. Changing the age requirements to 70 from 70-1/2 and to 59 from 59-1/2 would have a significant simplifying effect.

f. 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).

g. 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.

h. 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.

i. 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).

j. 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.

k. 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.

l. 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.

m. 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.

n. 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).

o. 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.

p. 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.

q. 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.

r. 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.

s. 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.

t. 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, particularly for small businesses.

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.

u. 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.

v. 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.

2. Alternative Minimum Tax.

a. Repeal the Individual AMT.

The individual AMT no longer serves the purpose for which it was enacted, produces enormous complexity, and has unintended consequences for many taxpayers including many small business owners.

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 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.

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.

3. 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 Tax Section 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 Tax Section 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.

4. Individual Tax Provisions.

In previous testimony before the House Ways and Means Oversight Subcommittee and the Senate Finance Committee on simplification of the Internal Revenue Code and in the identical simplification proposal released by the Section of Taxation, the AICPA Tax Division, and the Tax Executives Institute on February 25, 2000, the Tax Section discussed a number of simplification proposals for individual taxpayers.[2] Some individual simplification proposals that are particularly relevant to small businesses and their owners are discussed below.

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[2] The individual simplification proposals discussed included elimination or rationalization of phase-outs and family status issues including the earned income credit. *See* Letter from Paul J. Sax, Chair, ABA Section of Taxation to Senator William V. Roth, Jr., Chairman, Senate Comm. on Finance (February 25, 2000) (on simplification of the tax laws); Letter from Paul J. Sax, Chair, ABA Section of Taxation to Congressman Bill Archer, Chairman, House Comm. on Ways and Means (February 25, 2000) (on

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

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

b. 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.

c. 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

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simplification of the tax laws); The Impact of Complexity in the Tax Code on Individual Taxpayers and Small Businesses: Hearings Before the Subcomm. On Oversight of the House Comm. on Ways and Means, 106th Cong. 1st Sess. (May 25, 1999) (statement of Stefan F. Tucker, Chair, ABA Section of Taxation); Complexity of the Individual Income Tax: Hearings Before the Senate Comm. on Finance, 106th Cong. 1st Sess. (April 15, 1999) (statement of William J. Wilkins, Director of External Relations, ABA Section of Taxation).

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.

d. Increase the Estate and Gift Tax Unified Credit.

The Code requires the estates of decedents with gross estates in excess of the exclusion amount ($675,000 in 2000 and 2001) to file estate tax returns. In 1997, Congress put in place a gradual phase-up of the exclusion amount to $1 million in 2006, which will eliminate the filing requirements for a substantial number of estates otherwise required to file returns and reduce to zero the tax owed by many of those estates. An additional increase in the unified credit (beyond $1 million) would further relieve an additional significant number of decedents' estates from the burden of filing returns and paying estate tax without a significant decrease in Federal revenue. More importantly, such a change would relieve many such individuals during their lifetimes of the burden of estate planning oriented almost entirely toward minimizing their estate tax liability, rather than family and business succession considerations.

e. Repeal of the Estate Tax

The manner in which a repeal of the estate tax is accomplished and the replacement regime adopted may reduce the simplification resulting from the repeal. Under the Death Tax Elimination Act, H.R. 8, recently passed by the House and Senate, the estate tax would not fully phase out until 2010. Some delay in effective date or a limited phase-out period is helpful in the estate tax context to enable state legislatures to make any necessary changes in state death taxes. During any phase-out period, however, taxpayers must take into account in their estate planning the potential effects of two different tax regimes. Thus, shortening the more than nine-year phase-out period in the Death Tax Elimination Act would reduce complexity.

f. Reexamination of Sections 2032A and 2057.

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

these provisions encourage extensive tax planning and invite manipulation of ownership interests and asset use.

* * *

We appreciate your interest in these matters. The Section would be pleased to work with the Committee and its staff on these important issues, as well as other tax issues of significance to small businesses.

* * *

Disclosure

Pursuant to the U.S. House of Representatives "Truth in Testimony" rule, non-governmental witnesses appearing before the House are required to include as part of their written testimony both a biographical sketch and a disclosure by source and amount of federal grants and contracts received by them and any organization represented by them in the current and preceding two fiscal years.

Neither the American Bar Association nor the Section of Taxation has received any grants relevant to this hearing.

Curriculum Vitae

PAMELA F. OLSON is a partner in the Washington, D.C. office of Skadden, Arps, Slate, Meagher & Flom, LLP. She is currently the Chair of the American Bar Association Section on Taxation, and previously served as Vice President (Committee Operations), Council Director, as Chair of the Employment Taxes Committee of the Section. Prior to joining Skadden, Arps, Pam spent over five years in Chief Counsel's Office, serving as a trial attorney in San Diego, attorney advisor in the now defunct legislation and regulations division, and as Special Assistant to Chief Counsel Fred Goldberg. Pam holds a B.A., M.B.A., and J.D. from the University of Minnesota, and is a member of the D.C. Bar and the Bars of the United States Tax Court, and the United States Supreme Court. She is a Fellow of the American College of Tax Counsel and the American Bar Foundation and is a trustee of the American Tax Policy Institute. She is a frequent speaker and writer on Federal tax matters, particularly relating to tax controversy matters, particularly relating to tax controversy matters.

TAX DIVISION

OF THE

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

STATEMENT OF

DAVID A. LIFSON

TO

THE HOUSE OF REPRESENTATIVES

SUBCOMMITTEE ON TAX FINANCE AND EXPORTS

HOLDING HEARINGS ON

THE IMPACT OF COMPLEXITY OF THE TAX CODE

ON SMALL BUSINESS

SEPTEMBER 7, 2000

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Introductory Comments

Mr. Chairman, and members of this distinguished subcommittee, my name is David A. Lifson, 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 who 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.

The AICPA has long been an advocate for tax law simplification. Small business in particular needs advocates to collect and voice their concerns about the burdens imposed on them. We are committed to helping make our tax system as simple and fair as possible. Unfortunately, we believe that the law's complexity in certain key areas may be strangling voluntary compliance. The lack of deliberation in the legislative process, the frequent law change in recent years, and the increasing magnitude and complexity of the Internal Revenue Code are serious concerns for all tax professionals.

Because of this shared concern, we were pleased to join with the American Bar Association Section of Taxation and the Tax Executives Institute over the past year-and-a-half to work toward the common goal of suggesting ways to make the tax system simpler and more rational for a broad range of individual and business taxpayers. In collaboration with our professional colleagues, we developed a package of tax simplification recommendations that we submitted to Congress on February 25, 2000.

The AICPA sees significant problems arising from the increasing complexity of the tax law. For example:

- a growing number of taxpayers perceive the tax law to be unfair;
- it greatly impedes the continuing efforts of the Internal Revenue Service to administer and enforce the tax law;
- the cost of compliance for all taxpayers is increasing (of particular concern are the many taxpayers with unsophisticated financial affairs who are forced to seek professional tax return preparation assistance); and,
- complexity interferes with economic decision making.

The end result is erosion of voluntary compliance. By and large, our citizens obey the law, but it is only human to disobey a law if you do not or can not understand the rules. The dynamic American economy is changing and moving rapidly against an unnecessarily cumbersome and, in some areas, outdate income tax system.

There are various types of simplification that if enacted would update the existing tax system, such as: (1) simplification that reduces calculation complexity; (2) simplification that reduces the filing burden; and, (3) simplification that reduces the chances of a dispute between the IRS and the taxpayer. The first two types of simplification are sometimes the easiest to identify and fix, although sometimes the repairs involve hard choices. Computers help. Forms help. But this is not just about math. The last type of problem, adding certainty to the law and thereby reducing

the likelihood of disputes, is the most difficult to effectuate yet, perhaps, the most important. Clarifying law that is hard to understand must be a priority if we are to achieve a simpler system.

AICPA Blueprint for Tax Simplification and Complexity Index

The AICPA in the *Blueprint for Tax Simplification*, issued in 1992, identified four elements necessary to create a simpler tax system: (1) a visible constituency to communicate the need for simplification to Congress and the Administration; (2) identification of guiding principles for tax simplification; (3) identification of factors that contribute to complexity to be used in the development of a framework for analyzing the balance among equity, policy, revenue, and simplification objectives; and, (4) consideration of simplification at all stages of the legislative and regulatory process.

The Blueprint also outlined guiding principles in pursuing a simpler tax law. These are:

- the legislative process should consider the objectives of equity, efficiency and revenue needs, balancing them with simplification;
- once tax policy objectives have been identified, alternative approaches to implementing the policy should be considered to provide the simplest possible design and administration;
- the long-term benefit of any change made to simplify the tax law should more than offset any transitory complexity that results by a change;
- the law and regulations should be drafted within a rational, consistent framework;
- there should be a balance between simple general rules and more complex detailed rules;
- the benefit of a provision should be weighed against the cost of compliance; and
- tax rules should build on common industry record keeping and business practices.

The Blueprint concluded with the identification of the leading factors that create complexity: the effects of change; subjectivity; lack of consistent concepts; structural complexity; the effect on taxpayers not targeted by a particular provision; communication complexity; computations; complexity of forms; administrative issues; legal complexity; transactional application and business dynamics; diffusion of responsibility; inconsistent application of rules; and the legislative process.

From these factors, the AICPA then developed and released the *Complexity Index*. The Index is a tool for measuring complexity factors to assess the complexity, or simplification, of proposed tax law changes relative to existing law or competing legislative proposals. The Index is used by AICPA committees when developing legislative proposals and comments. Although we understand that complexity is a multidimensional concept and acknowledge that no single index can measure complexity in an absolute sense, the AICPA has encouraged over the years congressional tax writing committees and staffs to use the same or a similar index when considering and drafting proposed legislation.

There has been much talk about simplification since then, but simplification still has a difficult time finding its way into enacted legislation. Nevertheless, the basic principles outlined above still apply and should be used in today's tax legislative environment.

Internal Revenue Service Restructuring and Reform Act of 1998 and The National Taxpayer Advocate Annual Report to Congress

The AICPA was greatly pleased when many of the concepts and factors contained in the Blueprint and 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 Office of the Taxpayer Advocate was strengthened and enhanced as a result of the 1998 Act. This office has demonstrated that concern about the critical need for simplification is not limited to tax professionals. In the National Taxpayer Advocate's Annual Report to Congress for fiscal year 1999, Val Oveson confirms that complexity of the tax law "continues to be the most serious and burdensome problem facing America's taxpayers." The heavy burden of complexity affects the entire spectrum of taxpayers, from individuals to small businesses to large corporations. The report provides highly useful information on the complexity issue. Among the topics covered are: the twenty most serious problems facing taxpayers; information on areas of the law that impose significant compliance burdens on taxpayers and the IRS; and proposals to simplify the tax code and ease the burden on taxpayers.

The 1998 Act established the framework for analyzing complexity. As a result the tools to measure a proposal's effect on the complexity of the law are being developed. Now we must take the steps to ensure that the tools are used. The information obtained must be formally considered in the legislative and regulatory process. This final element is critical to achieving a simpler tax system for many taxpayers.

Recent Legislative Proposals

In recent years, tax legislation has increasingly included complex thresholds, ceilings, phase-ins, phase-outs, effective dates, and sunset dates in an effort to provide benefits to numerous specific groups within the limits of revenue neutrality. The Administration's Fiscal Year 2001 Budget tax proposals, as drafted, continue this trend of complicating our tax structure through numerous, additional targeted credits. While these credits are well-intentioned, simplification is sacrificed. Cumulatively these provisions if enacted would further weigh down our tax system with complexity. As suggested in the comprehensive package of comments on the Administration's proposal submitted by the AICPA, simpler solutions for accomplishing the desired policy goals than the ones being suggested are available.

Simplification must be given a prominent position in the tax process on an on-going basis. Although it should not take precedence over revenue and tax policy objectives, simplification must be an integral part of the tax legislative, regulatory and administrative process. We recognize that a tax system that is "simple" for all taxpayers may never be designed, but we do believe a "simpler" system is attainable. It will, however, require both a complexity analysis of new legislative proposals and simplification review of existing tax law.

ABA, AICPA and TEI Joint Effort to Simplify Existing Tax Law

As noted in the February 25, 2000 submission of the ABA/AICPA/TEI, complexity is manifested by Internal Revenue Code provisions which contain either vague or highly technical

requirements. These requirements are 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 encouraged Congress to change fundamentally the way it considers tax legislation and tax simplification. We recognized that most complex provisions of the Internal Revenue Code have had behind them laudable goals. In many cases, however, the burdens the complex provisions impose on taxpayers and the Internal Revenue Service quite simply outweigh the benefits of attaining those goals. Also, 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 provisions remain in the law.

The jointly developed package of recommendations for reform include 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. The effort does not purport by any means to have compiled an exhaustive list of all areas in need of simplification. Indeed, it no more than touches the tip of the iceberg. The order listed is not intended to suggest any particular order of priority among the various recommendations made. The three organization do agree, 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.

ABA, AICPA and TEI Specific Recommendations

Attached as Appendix A is the full text of the ABA, AICPA and TEI package of simplification recommendations that was submitted to Congress on February 25, 2000. It specifically addresses a number of proposals that greatly affect small business:

Worker Classification

One obvious example of an area in need of clarification is that of worker classification. The costs and paperwork burden associated with having employees (ex. income tax withholding, unemployment tax, benefits, etc.) often pushes small businesses towards the use of independent contractors. Yet subsequent determination that workers should have been considered employees,

rather than independent contractors, leave many small businesses with an even greater burden. In our package of recommendations, we suggest that the current 20-factor common law test for deciding whether workers are employees or independent contractors should be replaced with a more objective test. The current test contains factors that are subjective, given to varying interpretations, and offers precious little guidance on how or whether to weigh the factors. An objective test provides certainty, while balancing the needs of service recipients and the rights of service providers. If such a change to an objective measure is not possible, Congress should at least reduce the differences in tax treatment of employees and independent contractors.

Capitalization, Expensing 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 business expenses – and are therefore deductible in the current year – or capitalized, in which case they are either deducted over time as the asset depreciates or when it is sold. The classification depends on whether the expenditure produces a "future benefit." But, that determination is rarely obvious or easy. It is imperative that the enormous drain on both government and taxpayer time and resources in making these determinations be alleviated. This could be accomplished by the development of objective, administrable tests governing the deduction of recurring and routine business expenses or the capitalization of clearly defined categories of expenditures.

Capital Gains Provisions

The capital gains regime applicable to individuals is excessively complex. The system imposes difficult record-keeping burdens on small business taxpayers who may recognize the sale of business assets on their personal tax returns (ex. Schedule C sole proprietor). It is a system where each special rule has been developed in isolation for a specific, defensible goal, yet the cumulative effect has been the creation of 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.

Alternative Minimum Tax

The corporate AMT requires corporations to keep at least two sets of books for tax purposes; imposes a myriad of 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. The corporate AMT should be repealed. If repeal leaves specific concerns unaddressed, those concerns should be addressed directly by amending the Code provisions causing the concerns, not by preserving a system that requires all taxpayers to compute their tax liability twice.

Likewise, the individual AMT should also be repealed. It no longer serves the purpose for which it was enacted, produces enormous complexity, and has unintended consequences. But for temporary relief carved into the law last year, the individual AMT would prevent many middle-

income taxpayers from taking advantage of credits intended to benefit them. Unchecked, it will prevent millions of middle-class Americans from taking routine deductions for state and local income taxes within a few years. The AMT continues to spin a web of mind-bending complexity.

Estimated Tax Safe Harbors

Our recommendations also include proposals to rationalize estimated tax safe harbors. In order to avoid interest on underpayments of tax, individual taxpayers, who are generally self-employed small business owners, make quarterly estimated tax payments based on a percentage of the prior year's tax liability -- a "safe harbor" amount. The availability and computation of the prior year safe harbor has been adjusted by Congress repeatedly during the past decade, thus making it difficult for a taxpayer to know what they must pay during the year. We recommend that an appropriate safe harbor percentage, perhaps 100 percent, should be established and applied for all years. In addition to rationalizing the individual safe harbor, we recommend that consideration be given to simplifying estimated taxes for all corporations.

The AICPA is continuing its efforts with the ABA Section of Taxation and TEI to develop additional simplification recommendations and to refine the attached recommendations.

Additional Areas Affecting Small Business in Need of Simplification

In addition to the above suggestions, the AICPA would like to suggest a number of other areas where simplification is greatly needed for small business taxpayers.

Installment Sales

Section 536 of the *Ticket to Work and Work Incentives Improvement Act of 1999*, which passed last year, effectively eliminates the use of the installment method of accounting for most accrual method taxpayers (most businesses, and all with inventories). It is having a devastating effect on the sale of small businesses. CPAs have directly seen many negotiated transactions for the sale of all or part of a small business fall through as a result of this law change. Purchasers now find it uneconomic to pay the full purchase price up front. Sellers find that they will have to produce funds from sources outside the business to pay the full tax on the sale which is now immediately due. Sellers are frequently faced with the alternatives of cutting the sales price in order to persuade the buyer to accelerate the payments in the year of sale, or to abort the transaction completely.

A legislative solution is needed to provide a comparable measure of relief for the level of hardship currently being suffered by small business owners contemplating the sale of a business. Congress needs to make it simple and fair for all business owners to pay the often substantial tax due from the successful sale of their business when the sales price is received in installments over many years.

Savings, Retirement Security and Portability

Small businesses are frequently discouraged from establishing and maintaining pension plans because of the cost and complexity involved. This is an area ripe for simplification. We believe that it is possible to substantially reduce the complexity of current law while still achieving virtually all of the current policy objectives.

In the qualified plan arena, as in other areas of tax policy, a balance must be struck between simplicity and equity. Equity usually comes in the form of nondiscrimination benchmarks. In reducing the complexity implicit in some of the current pension rules, some equity of current law will be lost. In simplifying other areas of the pension rules, however, equity will be enhanced. The right balance between striving to prevent discrimination while utilizing rules that can be broadly understood and implemented, and which encourage employers to establish and maintain qualified pension plans, is a desirable goal.

For example, simplification could be achieved through provisions to conform the definition of compensation for purposes of deduction limits and simplifying the definition of highly compensated employee. We welcome the opportunity to work with you to simplify the tax rules governing the treatment of private pension plans and to increase access to pension plans by small business owners and workers.

Congress should also consider proposals to reduce the costs to small businesses to establish and maintain pension plans. For example, small businesses could be encouraged by tax credits for qualified retirement plan contributions and start-up expenses that lower the cost to set up plans. Elimination of IRS user fees for initial determination letters for small businesses adopting a qualified retirement plan for the first time would also be beneficial.

Safe Harbors

The burden imposed on small businesses that are currently subject to complex areas of law could be greatly alleviated through the creation of safe harbor provisions. For example:

Transfer Pricing (IRC Section 482) -- For smaller businesses the regulations regarding transfer pricing are burdensome and largely honored by taxpayers through "reasonableness" approaches. As it is in the government's best interest to promote exports of goods and services, safe harbor rules (ex. pricing, contemporaneous documentation) should be considered.

Indopco -- This is a real concern for many practitioners. The Service has made it clear that it is working on the issue. For small businesses a safe harbor may be in order. Rules which are pertinent to larger corporations are frequently impractical for smaller ones.

Cash Basis of Accounting – The cash method of accounting presents simpler record-keeping for small and start-up businesses. The ceiling for use of the cash method should be increased (ex. sales of up to five or ten million) to permit more small businesses to use this method.

Subpart F – Many small businesses are engaging in international activities that then require them to comply with the time consuming requirements established by US international tax rules

which are more suited for large business. This too is an area where small businesses would benefit from a safe harbor rule. A dollar cutoff could be established below which it would not be necessary for small businesses to determine the Subpart F deemed dividend inclusion amount.

Expensing versus Capitalization – The rules in this area are complex even for relatively small dollar items. A realistic safe harbor rule for repair/improvement expenditures could eliminate this problem for many small businesses (ex. expense items of $10,000 or less in businesses with sales of $10 million or less).

Enhanced Guidance

Small and start-up businesses face many rules that they may not be aware of or they do not understand, both in the tax law and other areas of law. The IRS does a very good job developing its publications, but there is greater need for "user friendly" tax guidance. This is also true for other government agencies where federal rules impose requirements on small businesses. This guidance would be most useful if consolidated into a single resource, such as a chart of all federal requirements based on the number of employees of the business. From such a chart the small business owner could easily determine that from the first employee on they are subject to some basic requirements (i.e., W-2, Form 941, Form 940, etc.), then they could easily determine at what number of employees other requirements are imposed (ex. COBRA, American Disability Act, OSHA, etc.). The document could also provide the business with references to more detailed guidance and agency contact information. This is just one example of the type of instructions Congress could communicate as part of a small business simplification act to convey the need for greater guidance and education concerning existing law to ease the compliance burden imposed on small businesses.

Conclusion

The AICPA greatly appreciates the opportunity to share its views and ideas. We stand ready to provide whatever assistance and support this subcommittee may find helpful in the critical task of simplifying the tax laws for small business.

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:

- 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).

- 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.

- 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).

- 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).

- 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).

- 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.

- 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.

- 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.

- 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).

- 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.

- 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 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 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

* 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.

Statement of

Scott Moody
Economist
Tax Foundation

Before the

Subcommittee on Tax, Finance, and Exports
Of the Small Business Committee
Of the U.S. House of Representatives

On

The Impact of Tax Complexity on Small Businesses

September 7, 2000

Mr. Chairman and Members of the Committee, my name is Scott Moody and I am an economist at the Tax Foundation. It is an honor for me to appear before your committee today on behalf of the Tax Foundation to discuss the impact of tax complexity on small businesses.

The Tax Foundation is a non-profit, non-partisan research and public education organization that has monitored fiscal policy at all levels of government since 1937. The Tax Foundation is neither a trade association nor a lobbying organization. As such, we do not take positions on specific legislative proposals. The Tax Foundation does not receive any federal funds.

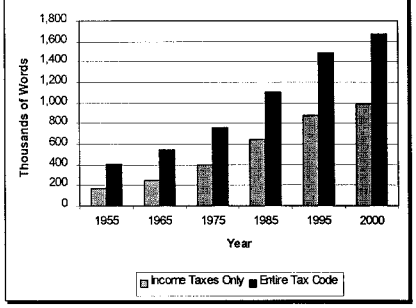
Our goal is to explain as precisely and as clearly as possible the current state of fiscal policy in light of established tax principles, so that you, the policy makers, have the information to make informed decisions. According to these principles, a good tax system should: 1) be as simple as possible, 2) not be retroactive, 3) be neutral in regard to economic activities, and 4) be stable.

Because complying with tax laws is a fixed cost for any business, it seems likely that smaller businesses will bear a greater relative compliance burden than larger companies. In fact, this is a common research finding, and all the studies the Tax Foundation has ever conducted on tax complexity demonstrate that economies of scale exist in tax compliance. In 1996, for example, small corporations -- those with less than $1 million in assets -- spent at least 27 times more on compliance as a percentage of assets than the largest U.S. corporations -- those with $10 billion or more in assets. This is especially important to consider because more than 90 percent of all U.S. corporations have assets of less than $1 million.

Ironically, all of their compliance effort is essentially for naught from a public finance point of view because the largest firms in asset size, with assets of more than $250 million, pay well over three-quarters of the corporate income tax take. Clearly, this disproportionate effort by small firms yields a poor cost-benefit ratio from a public policy viewpoint.

While some tax simplification for small businesses has occurred since 1996, most notably the Taxpayer Relief Act of 1997 (TRA 97), we believe our results remain illustrative of the magnitude in the tax compliance burden faced by small businesses. For instance, two important measures of tax complexity continue to climb—the size of the tax code and the instability of the tax code.

Figure 1. Growth in the Internal Revenue Code as Measured by the Estimated Number of Words



Size of Tax Code

Figure 1 reveals that the number of words in the tax code has been steadily increasing. In 1955, there were 409 thousand words in the Internal Revenue Code, and 40 years later in 1995 there were more than 1.4 million words. Today, there are more than 1.6 million words. The number of sections in the code has been rising even faster than the word count.

Table 1 shows that in 1954, there were 103 sections; today, there are 725. That's an increase of 604 percent. Clearly, the two mammoth volumes of the code must be daunting to a new small business that's trying to focus its talent on developing and marketing product.

Table 1
Comparison of 1954 Code and 2000 code

Subchapter of Income Tax Code	Number of Sections in Subchapter 1954	2000	Percent Growth
Determination of Tax Liability	4	50	1150%
Computation of Taxable Income	9	152	1589%
Corporate Distributions and Adjustments	14	35	150%
Deferred Compensation	2	31	1450%
Accounting Periods and Methods	6	33	450%
Tax-Exempt Organizations	4	19	375%
Corporations Used to Avoid Income Tax on Shareholders	4	27	575%
Banking Institutions	3	8	167%
Natural Resources	3	10	233%
Estates, Trusts, Beneficiaries, Etc.	7	32	357%
Partners and Partnerships	7	36	414%
Insurance Companies	5	30	500%
Regulated Investment Companies, Etc.	1	22	2100%
Tax Based on Income from Within or Without the United States	9	79	778%
Gain/Loss on Disposition of Property	7	40	471%
Capital Gains and Losses	4	56	1300%
Readjustment of Tax Between Years and Special Limitations	6	7	17%
Tax Treatment of S Corporations	0	14	NA
Other (a)	8	44	450%
TOTAL	103	725	604%

(a) Includes all subchapters not explicitly listed as well as Chapters 2-6 of Subtitle A of the Internal Revenue Code.
Source: Tax Foundation computations from Internal Revenue Code

Instability of Tax Code

In addition to the complexity associated with the sheer size of the tax code, small businesses must also contend with the instability of the tax code. In other words, it is not just a matter of learning the tax code a single time, rather it is an ongoing process of keeping up-to-

date with the latest legislative changes, regulatory changes and tax court rulings.

In terms of legislative changes, Tax Foundation research has found that, on average, every section of the Internal Revenue Code is amended once every four years. This is a direct result of the 32 significant federal tax enactments that have taken place since 1954—or approximately one every 1.4 years.

This legislative instability, however, does not take into account the fact that as tax laws change, so do the regulations that accompany such laws. As a general rule, surges in proposed IRS regulations occur in the first three years after significant tax legislation has been enacted. This is perhaps the most important reason why the jury is still out on TRA 97's effect on tax simplification. These surges in IRS regulatory activity add to the cost of planning and compliance for small businesses in several ways.

First, those small businesses affected by the proposed regulations must, either directly or indirectly through advisors, ascertain how the new tax law environment will alter their economic circumstances.

Second, many small businesses (or their advisors) will expend the resources necessary to comment on the proposed regulations.

Finally, once the proposed regulations become finalized, small business owners must learn how the new tax laws and regulations interact with the existing body of laws and regulations so that they can most advantageously rearrange their business affairs and portfolios. These rearrangements carry transaction costs in addition to the cost of tax compliance.

Between the changes in legislation and regulation, the tax code is almost always in a state of fluctuation. Such instability also spills over into the tax courts. And since it typically takes a taxpayer's dispute three years to appear on court dockets, small businesses are at an inherent disadvantage not only in terms of the necessary financial commitments but also in the necessary time commitments that such litigation entails.

Conclusion

The tax complexity due to the size and instability of the tax code creates two general types of economic costs. One is the overhead cost associated with the economically sterile exercise of tax planning, compliance and litigation. The second cost results from the economic opportunities that are foregone because of taxpayer uncertainty.

Even large businesses may not be able to obtain a reasonably certain conclusion about how taxation will affect a business plan or investment, but small businesses are even more in the dark. If small business owners cannot accurately predict the tax consequences of a particular economic activity, either because of the size or instability in

the tax code, then tax policy is handicapping the growth and dynamism of small businesses and of the entire U.S. economy.

In conclusion, the benefits of reducing the tax complexity burden would dramatically benefit small businesses since they currently bear a disproportionate amount of the burden. This could be done under a comprehensive revision of the tax code guided by established tax principles, such as those supported by the Tax Foundation. In addition, such tax reform would diminish the need for corrective tax legislation in the future and thereby increase the stability in the tax code and regulations.

TESTIMONY OF TODD MCCRACKEN

PRESIDENT OF

NATIONAL SMALL BUSINESS UNITED

Regarding the
Complexity of the Tax Code

Before the Subcommittee on Tax, Finance, and Exports of the House Small Business Committee

September 7, 2000

Mr. Chairman, Ms. Ranking Member, and Members of the Small Business Committee's Subcommittee on Tax, Finance, and Exports:

My name is Todd McCracken, and I am President of National Small Business United (NSBU), the nation's oldest national small business advocacy organization. I appreciate the opportunity you have granted me here today to speak for a few moments about the problems that small businesses have in complying with our complex tax code, and I would like to take time to discuss a simple tax proposal that I believe could streamline and revolutionize our existing system.

Mr. Chairman, NSBU was founded when the income tax was just 23 years old - with only two pages in forms and several pages of instructions. NSBU has not grown at the exponential rate of the income tax laws, but we now represent 65,000 businesses nationwide. We represent the varied tapestry of the America's entrepreneurs, from immigrants seeking a more fertile environments in which to grow their dreams to family businesses that have remained for generations. The average size of our membership is 12 employees. We are a bi-partisan organization; our goal is to work with Congress, business owners, and other groups not to advocate a particular party agenda, but to advocate ideas that just make good sense and help the broad-base of small businesses survive and thrive.

At the opposite end of the spectrum from common sense and good ideas, I think most people would agree that our current tax system is remarkably complex and unwieldy. As time has passed over the years, Congress has attempted to address new issues with raising revenue. While most of these attempts were born from good ideas, what has happened is that our tax code has become a collection of innovations, corrections, and other policies that the average person cannot wade through. In other words, the aggregate has become too much for the average person to deal with.

Recently, I was contacted by the National Taxpayer Advocate and asked to complete a survey which is designed to rank and highlight concerns businesses have with the Internal Revenue Service. It comes as no surprise last year that the number one complaint registered was the complexity of the tax code. This year, after speaking with the NSBU membership, we have decided to rank complexity of the tax code as the top problem businesses have in dealing with the IRS.

During the course of these discussions with NSBU members, I heard many examples and anecdotes concerning out tax code. I believe the comments of Grafton Willey, a certified public accountant from Rhode Island, expresses the frustration of the typical small business owner in dealing out tax code:

> *The last time Congress simplified the tax code, it seems as of the goal was to simplify it beyond all*

comprehension. Every time they attempt to simplify things my business as a certified public accountant goes up, so I have absolutely no confidence that the tax code will ever be simple.

Obviously the sheer size of the tax code is unwieldy. Even as a tax practitioner it is overly complex and ridiculous. Complexity is my friend because it makes me money, but it is inherently unfair that tax returns have become so complex that the average taxpayer is required to engage the services of a professional accountant to correctly comply with the law. Some of the blame can be placed on the IRS. There have been delays in publishing regulations and many of their regulations are overly complex running hundreds of pages.

Obviously, these are the comments of only one person, but if you asked ten small businesses to testify here today, statistics show at least nine of them would assert that they hire an outside tax expert to handle their returns and other matters.

I think we should take a close look at that number. We are all familiar with the phrase that "small business is the engine of our economy." Small businesses represent over 99% of all employers, employ 52% of the private workers, and employ 38% of the private workers.[1] In high-tech occupations, small businesses provide virtually all of the net new jobs. Small businesses are active in a great number of highly technical and complex sectors of our economy. Small businesses are responsible for new innovations in computer technology, laser and fiber optics, and building materials. Small businessmen

[1] Source: Small Business Administration Office of Advocacy website, located at http://www.sba.gov/ADVO.

are remarkably intelligent, capable, and dynamic. These business owners and remarkably talented and diverse. **Yet, despite all of the knowledge they apply day to day, most of them do not understand our tax code, and are unwilling to prepare their own taxes for fear of IRS penalties and punishments.**

Mr. Chairman, I think there is something desperately wrong with the system when there is only a small subset of people who understand how it works. Small businesses want to pay their taxes and be responsible citizens. I just don't think they necessarily believe that they should have to hire outside experts to do it; they should be able to handle their affairs themselves.

There are many quirks in our current tax code that seem to go against traditional conventions. For example, part of the American Dream is to build up a legacy to pass on to your heirs. If one works hard for the American Dream, chasing life, liberty, and happiness, which are our inalienable rights under the Declaration of Independence, it doesn't seem fair that the government gets a sizable portion of all of our efforts when you pass away. It seems only natural that your children should receive a proper inheritance, not a government that, in some cases, had little or no hand in the direct creation of your business. Most small businesspeople, when considering their estate affairs, are being asked to sell off their assets. Not only is that unfair, it almost seems in direct conflict with the America we all learned about in grade school.

Most entrepreneurs--that is unless they make a career of selling tax shelters--correctly see our system as punishing each step towards the American dream. At every stage of a business' life, it faces significant tax obstacles. At the start-up level savings are taxed, and start-up costs are not deductible. Capital investments are made from after-tax dollars and then taxed multiple times, when the income is earned and when the underlying asset that generates that income stream is sold. They are taxed when growing because the government takes an increasing share of income as more money is made. They are taxed when exporting, because U.S. taxes raise the price of our goods relative to foreign goods. They are taxed when they add jobs, because our extraordinarily high payroll taxes increase costs of hiring. Family businesses are discouraged because they are taxed when they are sold. And finally, the owner gets to meet the undertaker and the IRS on the same day as the government effects a leveraged buy-out of the businesses.

Some portions of the tax code simply don't make practical sense. For example, under the existing tax code, there is no equal treatment of all business types (such as C Corporations, S Corporations, and Limited Liability Companies) as it relates to employee benefits. Even business owners who are involved in their day to day business can not be defined as an employee for tax code purposes. Thus, they are unable to enjoy the benefits of their employee's health plans.

What is also problematic is that once something is added to the tax code, even if there is bipartisan and bicameral support for its removal, actually getting the issue addressed is a terrible task. For example, the Installment Tax Correction Act of 2000 which would

repeal revisions to the Code which repealed the use of the installment method of accounting for accrual method taxpayers and modified the pledge rules of installment obligations, is still mired in election year politics and has not become law.

I would like to call special attention to the current payroll tax (primarily FICA) burden that small businesses and their employees must endure. It is an enormous tax that receives relatively little attention given the share of revenues it accounts for. In fact, a survey by NSBU and Arthur Andersen found that small businesses cite payroll taxes as their most significant tax burden.

The U.S. has made a fundamental shift toward payroll taxes in the last 30 years. In 1995, 38 percent of all federal revenues came from payroll taxes, compared to just 14 percent (of a lower tax bill) 40 years ago. From 1970 to 1990, business received nine social security (FICA) tax increases totaling 60%, three unemployment (FUTA) increases totaling 94%, three FUTA base increases totaling 133%, and 19 FICA base increases totaling 677%.

At first glance, payroll taxes might seem to be an equitable form of taxation. The unemployed are not taxed, and larger businesses with more employees are taxed more than smaller businesses with fewer employees. However, most small businesses are much more labor intensive than their larger counterparts. Payroll taxes cause these small businesses to be taxed at a higher effective rate than larger, more capital-intensive firms. Moreover,

holders of corporations organized under Subchapter "S" (which are almost always small) have been forced to pay both sides of this tax, making for a substantial tax increase.

The fact that this huge tax must be paid regardless of the financial condition of the company creates substantial problems. First, it discourages new businesses. Most new businesses lose money in their early days, and payroll taxes amount to one more debt that must be somehow financed. Second, it discourages employment. The only way that a business in a financial bind can reduce payroll taxes is to reduce payroll; this means fewer jobs or lower wages. A payroll tax is really a tax on employment.

For its part, the IRS has tried to address some of the concerns of small businesses. They have developed a CD-ROM for small businesses designed to answer frequently asked questions. It seems to be well-done and user friendly – the problem is, most small businesses don't know about it.

The IRS, as a part of its restructuring efforts, has divided into four new divisions. The new Small Business/Self-Employed Division is scheduled to open this year. The agency claims that the new divisions will issue in a new era of prompt, courteous, and fair service for America's small-business taxpayers. While that remains to be seen, I would like to congratulate the IRS for all of their efforts.

Now that we have discussed a few problems with the tax code, I think we should also look at a possible solution.

In February of this year, a national survey conducted by American Express confirmed what NSBU already knew. The survey showed that 74 percent of entrepreneurs consider tax reform a top priority. But since the vast majority of Americans share a common dislike for our present system, it is easier to demagogue the current system than to reach consensus on what a new and more ideal system should look like.

NSBU leads entrepreneurial organizations not only by defining the principles on which tax reform should be based, but lending our full support for a specific proposal: the FairTax national sales tax plan. After a year-long process in which the current system and various alternatives--various flat tax plans and other forms of a sales tax among them--were held up and examined from all sides, our initially skeptical Board finally selected the FairTax as the best possible system for small businesses, without a single dissenting vote.

The FairTax is enlightened policy. Since the FairTax abolishes all federal income, FICA, estate, and capital gains taxes, it would allow small businesses to prosper as never before in this country. By instituting a 23 percent tax on all end-use goods and services, the FairTax would sweep away the burdens of the current tax system and create a new dawn for American entrepreneurship and economic growth.

The Fair Tax would allow businesses to begin with savings put aside with pre-tax dollars. It would allow them to grow unfettered by the income tax, and without an eye on the

capital gains tax. It would allow them to hire without discouragement from the payroll tax. It would allow them to export, unfettered by punitive American taxes on our exports. It would allow them to make capital investments unfettered by hidden costs in the capital assets. It would not penalize good years and bad by implementing the best of income averaging, a zero rate of tax. It would discontinue the charade of taxing income multiple times. Most importantly, it would repeal the self-employment taxes which are the most despised by entrepreneurs. The Fair Tax would tax Americans on income, but only at the point that they consume that income, not when they invest and save. Small business owners would have greater access to capital, the life-blood of a free economy. Small firm owners would be able to pass their business on to their children.

Compliance costs would diminish. Individuals not in business would never have to file a tax return again, and business returns would be vastly simpler. More than 7,000 incomprehensible sections of the Internal Revenue Code, would be exchanged for one simple question: how much is sold to consumers? This question is asked of retailers in 45 states of our Nation today, so the additional burden on these businesses would be negligible. Ninety percent of our $250 billion annual compliance bill would disappear.

As complexity disappears, we would reinstate the novel concept that Americans have a right to understand the law to which they are subject. Moreover, they will immediately see and understand the tax rates and any changes that occur. The mentality of "Don't tax you; don't tax me; tax that fellow behind the tree" would be gone. The current complexity of the code leaves most Americans, rightly or wrongly, feeling that they bear

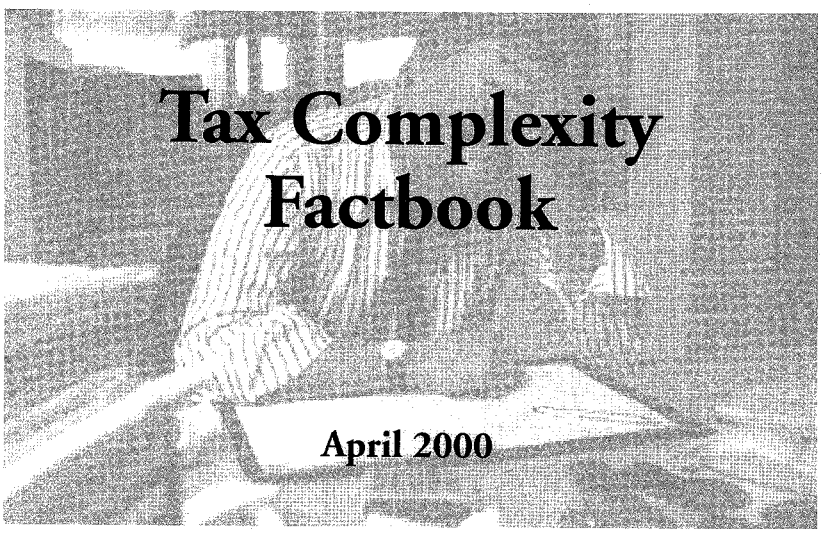
an unfair share of the tax burden. The poor believe that advantages must lie with those who are more well-off. The wealthy see their high marginal rates and eliminated deductions and feel singled out by the tax system. And the middle class assume that credits for the poor and loopholes for the wealthy mean that they alone should the country's tax burden. While there are both fallacies and accuracies in each group's assumptions, the unfortunate side effect is a polarization of the country and a universal feeling of victimization. And it should be clear to any rational observer that this feeling leads to tax avoidance and cheating on an unprecedented scale. If we can remove these hard feelings about the tax code, we can markedly improve compliance and give a boost to national comity at the same time.

The FairTax would do just that, by making visible the taxes now buried in goods and services. We would have a uniform tax for all the world to see and understand. How would the rich guy avoid some taxes? Only by saving and investing, which helps us all. But some day, he or his descendants will spend his profits, and taxes will be collected. At the same time, those less fortunate will receive a rebate lowering their total tax bill and effective tax rate, even if they don't save a nickel. This is a system all Americans can understand and be united behind—and voluntarily pay. The tax system would achieve greater enforceability with less intrusiveness. Today, more than $200 billion in income taxes, over 20 percent of the total collected, are not voluntarily paid.

Why should retailers support it? No single industry is more burdened by the multitude of state and Federal tax laws than retailers. Retailers are today both tax collectors and taxpayers. Under the FairTax, there will be no more uniform inventory capitalization requirements, no more complex government rules on employee benefits and retirement plans, no more tax depreciation schedules, no more tax rules governing mergers and acquisitions, and no more international tax provisions. Retailers will have "found" money in lower compliance costs.

While respected economists haggle over the dimensions of the economic benefits, they are unanimous in their view the FairTax would greatly enhance economic performance by improving the incentives for work and eliminating the current bias against saving and investment. Even the National Retail Institute's study by Nathan Associates shows that the economy would be one to five percent larger under a sales tax than in the absence of reform.

I appreciate the opportunity to speak before this subcommittee today, and I would be happy to answer any questions that you might have.



Tax Complexity Factbook

April 2000

Joint Economic Committee Staff Report
Office of the Chairman, Connie Mack
www.senate.gov/~jec

This staff report expresses the views of the author only. These views do not necessarily reflect those of the Joint Economic Committee, its Chairman, Vice Chairman, or any of its Members.

TAX COMPLEXITY FACTBOOK

BRIEF FACTS

- This year, a comprehensive volume of federal tax rules and regulations spans over 46,000 pages, more than twice the length of tax rules and regulations in the 1970s.
- The tax code itself fills 2,840 pages, and contains about 2.8 million words. In comparison, the Bible has 1,340 pages, and about 0.8 million words.
- The IRS estimates that Americans will spend 6.1 billion hours - over 3 million person-years - complying with the federal tax system in 2000.
- Over half of individual taxpayers now use a paid preparer for their income tax return, up from less than 20 percent in 1960.
- The costs of federal tax compliance are in the order of $200 billion, or at least 10 percent of total tax revenue collected by the government.
- Small businesses have particularly high tax compliance costs. One study found that small businesses face compliance costs that are more than three times larger than taxes paid.
- The IRS receives over 110 million phone calls each year for help by taxpayers. In 1999, the IRS was only able to answer 73 percent of the inquiries correctly.
- Individuals and businesses had to deal with 481 separate IRS tax forms in 1999, a rise of 20 percent from 403 forms in 1990.
- Between 1986 and 1998, Congress made about 6,500 changes to the tax code in 61 separate pieces of legislation.

Prepared by Chris Edwards, Senior Economist to the Chairman. (202) 224-0367.

TAX COMPLEXITY FACTBOOK

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1. INTRODUCTION

At the beginning of the 20th century, federal taxes accounted for less than 3 percent of the nation's gross domestic product (GDP), and the entire tax code and regulations filled just a few hundred pages. Today, federal taxes account for 20 percent of GDP, and a comprehensive set of federal tax rules spans over 46,000 pages.[1]

Americans spend an enormous amount of time filling out tax forms, keeping records, learning tax rules, and performing other tax compliance activities. In 2000, the IRS estimates that Americans will spend 6.1 billion hours – over 3 million person-years – complying with the federal tax system. As a consequence, the IRS National Taxpayer Advocate says that complexity of the tax laws is the "most serious problem facing taxpayers."[2]

The chief source of federal tax complexity is the income tax on individuals and businesses. Two-thirds of Americans think the income tax system is "too complex."[3] This may be an understatement, as former President Jimmy Carter in 1976 called the income tax "a disgrace to the human race."[4] Now, 24 years after that observation, the total number of pages of federal tax rules has doubled.[5]

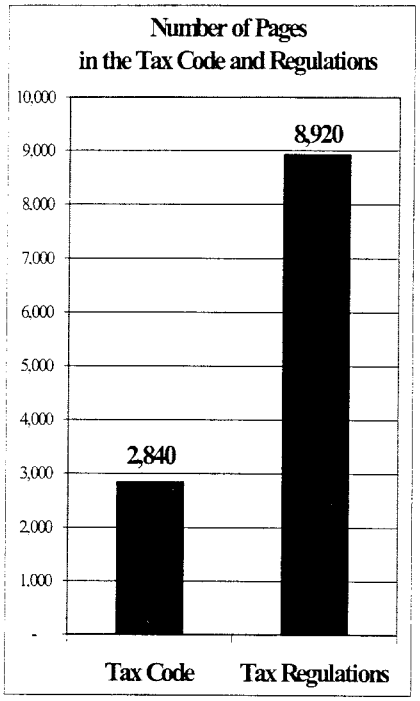
The complexity of the tax system has spawned huge federal and private "tax industries" to perform tax filing, administration, planning, enforcement, and other activities. The industry consists of hundreds of thousands of skilled workers in the IRS and private sector firms including tax preparers, accountants, lawyers, enrolled agents, and others. Currently, over half of individual taxpayers use a paid preparer for their income tax return, up from less than 20 percent in 1960.[6]

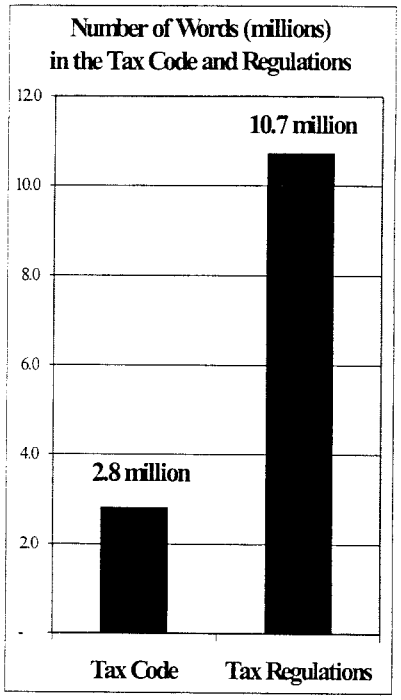
The problem with these compliance activities is that they do not add anything to the nation's economic output because they simply enable the transfer of money from some pockets to others. Estimates of the costs of federal tax compliance are in the order of $200 billion, or about 10 percent of revenue raised by the federal government. While even the simplest tax system would create some compliance costs, tax complexity increases these costs substantially. Tax complexity also leads Americans to view the system as unfair, contributes to high error rates, increases tax evasion, and creates taxpayer uncertainty which impedes economic decision-making.

2. HOW BIG IS THE FEDERAL TAX CODE?

Tax Code. The tax code contains the basic language created by legislation that promulgates the federal income, payroll, estate, and excise taxes. In 2000, the tax code fills a thick volume with 2,840 pages and contains about 2.8 million words.[7] In comparison, the Bible has 1,340 pages and 0.8 million words.[8] By far the most complicated tax is the income tax which accounts for 78 percent of tax code pages.[9]

Tax Regulations. Tax legislation is sometimes vague and wouldn't be operational without many additional pages of tax regulations adopted by the U.S. Treasury. Regulations are Treasury interpretations of the law that describe tax rules and procedures in great detail. Creation of regulations can be a complex and drawn-out process taking years after tax laws are passed, and can include proposed, temporary, and final versions. In 2000, federal tax regulations filled a hefty five-volume set with 8,920 pages and about 10.7 million words.[10] In total, the tax code and regulations span 11,760 pages and contain 13.5 million words.





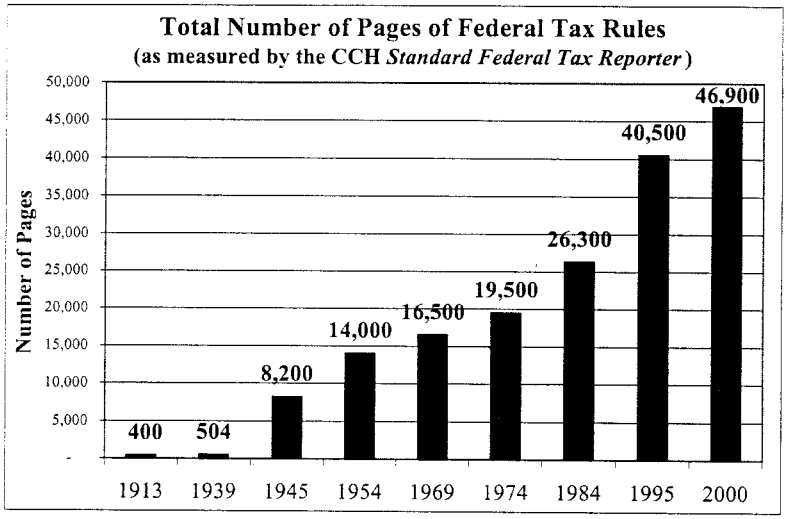
Source: JEC estimates based on page counts of RIA's current code and regulations.

3. THE GROWTH IN FEDERAL TAX RULES

A century ago, the federal government relied on excise taxes and customs dues for 91 percent of its revenue. As the demand for tax revenues rose, the government sought to tap other pools of money in the economy, and within a few decades enacted what quickly became the three largest sources of federal revenue – the individual income tax, the corporate income tax, and the Social Security payroll tax.

The most complicated federal tax, the corporate income tax, became effective in 1909 with a 1-percent rate.[11] The individual income tax followed soon after in 1913 with just 16 pages of laws and a basic rate of 1 percent.[12] The payroll tax to fund Social Security was added in 1937. By the late 1930s, the whole tax code still had only 100 pages, with a further 400 pages of regulations to guide taxpayers.[13] It was the huge tax expansion needed to finance World War II – fueled by the new idea of employer withholding in 1943 – that launched the income tax on a trajectory of seemingly continual growth. The federal payroll tax rose in tandem, expanding from a 1-percent rate when first enacted, to a 15.3-percent rate today.

CCH Incorporated has published the *Standard Federal Tax Reporter* every year since 1916, which provides a fairly comprehensive measure of the growth in the federal tax system.[14] This publication contains the full tax code, tax regulations, and summaries of other federal tax pronouncements such as IRS letter rulings and technical advice memoranda.[15] The number of pages in the *Reporter* has grown from 400 in 1913 to 46,900 in 2000, and the number of pages has more than doubled since the 1970s.[16]



Source: CCH Incorporated.

4. THE FEDERAL TAX INDUSTRY

Size of the IRS. The IRS has a budget of $8.2 billion in fiscal 2000, and employs 100,000 workers to administer the federal tax system. A century ago, federal tax and customs collectors had a budget of $12 million and numbered about 10,000.[17]

Other Federal Tax Workers. In addition to IRS workers, thousands of other federal workers are required to manage the federal tax system, including those within the Treasury, the Department of Justice, Congress, the tax courts, and other agencies. One estimate placed the number of non-IRS federal tax workers at 24 percent of the number in the IRS, which would be an additional 24,000 workers in 2000.[18]

Tax Filing. Individuals will send the IRS 127 million tax returns in 2000, including about 20 million returns from farms and small businesses.[19] Partnerships and corporations will file over 7 million income tax returns. Employers will send the IRS 30 million employment tax returns. The IRS will also receive millions of other types of forms, such as over 8 million income tax extension requests. Additionally, businesses and financial institutions will send the IRS 1.1 billion information returns reporting items such as wages, interest, and dividends.[20]

Tax Forms. In 1999, the IRS produced 481 separate forms for individuals and businesses to fill out, ranging from the familiar 1040 to more obscure forms such as Form 8725 "Excise Tax on Greenmail," and Form 8817 "Allocation of Patronage and Nonpatronage Income and Deductions." The total number of IRS forms is up 20 percent from the 402 forms produced in 1990.[21]

IRS Queries. The complexity of the income tax is such that the IRS receives over 110 million phone calls for help by taxpayers each year. Unfortunately, complexity also means that a remarkably high number of taxpayers receive wrong answers to their IRS inquiries. In 1999, the IRS was only able to answer 73 percent of phone inquiries correctly, according to their estimates.[22] IRS figures also indicate that just 55 percent of taxpayers calling last year got through to ask their questions.[23]

IRS Administration. One would think that today's powerful computers could provide large increases in tax administration productivity, allowing the IRS to substantially reduce its workforce. However, the IRS has struggled to pull its technology up to date. Its computers crunch about 60 million lines of code on a hodgepodge of tens of thousands of mainframe, mini, and personal computers. Much of its computer architecture stills dates to the 1960s.[24] The General Accounting Office (GAO) has documented how the IRS has poured billions of dollars into computer upgrading with poor results. There are high hopes that IRS Commissioner Charles Rossotti can generate progress in the agency, but his task is daunting, as he noted in 1998, "[IRS] technology is just remarkable for how backward it is."[25]

5. THE PRIVATE TAX INDUSTRY

Tax Industry. A huge private "tax industry" is required to help the federal government raise $1.95 trillion in revenue in fiscal 2000. Hundreds of thousands of tax lawyers, accountants, enrolled agents, and others assist over 7 million partnerships and corporations, and over half of the nation's 127 million individual and self-employed taxpayers, to comply with federal tax law.

Use of Paid Tax Preparers. Data for 1997 shows that 53 percent of individual tax filers used a paid preparer. This figure has steadily risen from 48 percent in 1990,[26] and from less than 20 percent in 1960.[27]

Tax Preparation Fees. With about 67 million taxpayers using paid tax preparers, and assuming an average fee of $96 (H&R Block's current average fee) tax preparation costs U.S. taxpayers at least $6.4 billion per year.[28] However, many taxpayers with complex tax situations pay for far more expensive tax help. The estimate also doesn't include corporate returns which can cost millions of dollars to prepare, nor does it include post-filing costs such as responding to IRS notices and audits. Two other estimates of the size of the tax preparation business have been $30 billion and $40 billion.[29]

Tax Preparation Firms. H&R Block is the largest tax preparation firm employing 87,000 workers, and filing about 17 million tax returns for individuals each year.[30] H&R Block's tax preparation revenues increased 30 percent between 1997 and 1999, and are up about another 20 percent this year.[31] Beyond H&R Block, which handles 25 percent of the individual tax preparation business, and second place Jackson Hewitt, are many thousands of smaller practitioners. A special tabulation by the IRS found that 1.054 million different paid tax preparers had signed individual tax returns in 1997, but it is not known how many of these individuals are full-time tax professionals.[32]

Tax Accountants. In 1999, there were 1.66 million accountants and auditors in the United States.[33] Of these, perhaps 30 percent, or 498,000, are in tax practice.[34]

Tax Lawyers. In 1999, there were 577,000 lawyers in the United States.[35] Of these, perhaps 10 percent, or 58,000, are in tax practice.[36]

Enrolled Agents. Enrolled agents are tax professionals who receive a qualifying license from the U.S. Treasury. There are about 35,000 enrolled agents in the United States.[37]

Total Tax Industry. One estimate put total employment in the U.S. tax industry at well above one million workers.[38] This appears to be reasonable if one includes federal tax workers, private sector tax professionals and their support staff, and state and local government tax workers, who may be more numerous than federal government tax workers.[39] Alternately, note that IRS figures indicate that the tax compliance time burden will be over 3 million person-years in 2000 (see next page), much of which is accounted for by professional tax practioners, as opposed to individual taxpayers.

6. PROBLEMS AND COSTS CREATED BY TAX COMPLEXITY

Wasted Time. The IRS and the Office of Management and Budget (OMB) estimate that Americans will spend 6.1 billion hours (over 3 million person-years) filling out tax forms, keeping records, learning tax rules, making calculations, and other tax-related work in fiscal 2000.[40] These "compliance costs" include both business and individual taxpayer activities. Even the simplest tax system would have some compliance costs, but the current system greatly increases costs with its excessive complexity.

Time is Money. A monetary cost for these billions of unproductive hours can be estimated. A measure of the "opportunity cost" of compliance time has been roughly estimated by the OMB at $26.50 per hour in 1996, or about $30 today.[41] Thus, federal tax compliance costs based on 6.1 billion hours of compliance time are about $183 billion.

Other Compliance Cost Estimates. A few other estimates have been made of federal tax compliance costs. Tax compliance expert Joel Slemrod figures that income tax compliance costs represent about 10 percent of income tax collected.[42] A Tax Foundation study estimated that compliance with the entire federal tax system cost taxpayers $225 billion in 1996, or about 15 percent of taxes collected that year.[43] The latter study figured that income tax compliance alone cost $157 billion, or about 19 percent of income taxes collected.

Business Tax Compliance. Businesses from the smallest mom-and-pop store to the largest corporation face many complex tax issues. The income tax is the most complex tax to deal with because accounting for items such as depreciation and inventory can be tortuous. Large corporations can spend over $10 million per year on tax compliance, and must deal with different tax systems in the dozens of states and foreign countries in which they operate. Mobil Corporation once brought their tax return and related documents into a congressional hearing to illustrate the tax monster that they must comply with. Their tax documents ran 6,300 pages and weighed 76 pounds.[44]

For small businesses, studies have found that tax compliance costs can be larger than actual taxes paid. For small businesses with assets of less than $1 million, compliance costs are estimated to be at least three times larger than taxes collected.[45] The IRS National Taxpayer Advocate finds that the heavy compliance burden on small businesses is one of the most serious problems with the federal tax system.[46]

Enforcement Costs. Compliance costs cited generally do not include taxpayer costs that occur post-filing. Responding to IRS audits, notices, liens, levies, seizures, and fighting the IRS in court can cost individuals thousands of dollars and businesses millions of dollars. For example, the IRS assesses about 30 million penalties each year, which because they are often erroneous, can impose significant time and monetary costs on taxpayers.[47] In fact, poor IRS penalty administration is the fifth "most serious problem

facing taxpayers" according to the IRS National Taxpayer Advocate, and is the most litigated area of tax law for individuals and the self-employed.[48]

Uncertainty Costs. The pace of federal tax law changes has sped up substantially since the 1970s. Since then, a major tax law change has occurred about every 18 months creating planning difficulties for businesses, investors, and other taxpayers. Tax rates have gone up and down, tax credits and other provisions have come and gone, with the result that nobody knows what to expect next from the government. For example, the research and development tax credit has been repeatedly extended, but not made permanent. As a result, businesses planning long-term research projects don't know whether to factor in the credit when planning their investments. Even just the threat of a tax rule change can cause taxpayers to alter their behavior, thus resulting in less efficient economic choices being made.

Administrative Difficulty. Complexity makes the tax laws unclear regarding how economic transactions are to be treated and how much tax is owed. The more complex the tax system, the greater the errors by taxpayers, tax professionals, and the IRS. As noted, the IRS was only able to answer 73 percent of taxpayer phone inquiries correctly in 1999.[49] For years, *Money* magazine asked a panel of tax experts to each compute tax liability for a hypothetical family. The results have consistently shown wide variations in the expert's answers, as a result of both errors and ambiguity in the tax laws. In 1998, 46 out of 46 experts surveyed came up with different answers, which ranged widely from $34,240 to $68,912.[50]

Inequity and Unfairness. The complexity created by social engineering in the tax code can create unfairness, or perceptions of unfairness, from "horizontal inequities." This occurs when families with similar incomes pay substantially different amounts of tax. Unfairness also results when similar activities are treated differently. For example, tax incentives for education may reward an individual who takes a paid school class, but not an individual who buys an encyclopedia for self-learning. Many such inequities permeate the income tax code, with the result that about 60 percent of Americans surveyed think the current system is "unfair."[51]

Tax Evasion. Tax evasion results both from a high tax burden and high levels of complexity. Complex tax systems spawn greater tax evasion because tax administrators have more difficulty finding the missing tax base. Estimates of income tax evasion in the United States place taxes evaded at over 20 percent of taxes collected, or about $200 billion annually.[52] Federal workers have not set a good example: IRS studies in the mid-1990s found that almost half a million federal employees were tax delinquents owing the government over $2 billion in back taxes. Over 100,000 had not even filed required returns.[53]

Economic Distortion Costs. In addition to taxpayer compliance costs and government tax administration costs, the tax system imposes large distortions, or "excess burdens" on the economy.[54] These arise because taxes create incentives and disincentives for individuals and businesses to take actions that are not economically efficient. These actions are caused by tax-induced changes in prices, wages, interest rates, and profits in different parts of the economy. As a result, various industries may receive too much or

too little investment, individuals may not save and invest enough, and businesses may take actions which minimize tax liability, but don't maximize economic growth.

These costs don't arise just from the complexity of the tax system, but complexity does exacerbate these economic distortion losses. Estimates of distortion costs from collecting additional, or marginal, taxes are in the range of 20 to 50 percent of the added revenue raised.[55] In other words, a new spending program which costs $100 million will impose an excess burden on the economy of perhaps $50 million, in addition to the paperwork or compliance costs that have been the focus of this report.

Adam Smith's Views. In his classic work, *The Wealth of Nations*, Adam Smith recognized that the total cost of taxation is "a great deal more" than just the amount of revenue collected. He identified four additional burdens of a tax system, which are as true today as they were when he was writing in 1776. Smith noted:

> *Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the state. A tax may either take out or keep out of the pockets of the people a great deal more than it brings into the public treasury, in the four following ways.*
>
> > *First, the levying of it may require a great number of officers, whose salaries may eat up the greater part of the produce of the tax, and whose perquisites may impose another additional tax upon the people.*
> >
> > *Secondly, it may obstruct the industry of the people, and discourage them from applying to certain branches of business which might give maintenance and employment to great multitudes. While it obliges the people to pay, it may thus diminish, or perhaps destroy, some of the funds which might enable them more easily to do so.*
> >
> > *Thirdly, by the forfeitures and other penalties which those unfortunate individuals incur who attempt unsuccessfully to evade the tax, it may frequently ruin them, and thereby put an end to the benefit which the community might have received from the employment of their capitals ...*
> >
> > *Fourthly, by subjecting the people to the frequent visits and the odious examination of the tax-gatherers, it may expose them to much unnecessary trouble, vexation, and oppression; and though vexation is not, strictly speaking, expense, it is certainly equivalent to the expense at which every man would be willing to redeem himself from it.*
>
> *It is in some one or other of these four different ways that taxes are frequently so much more burdensome to the people than they are beneficial to the sovereign.* [56]

7. WHAT CREATED OUR COMPLEX TAX SYSTEM?

Simplification is Not a Top Priority. As the federal tax system has become more complex, most politicians say that they are for tax simplification. However, other tax system goals, such as the creation of special incentives, have so far trumped the goal of overall tax simplification in the legislative process.[57]

Social Engineering. Many complicated features of the tax code are designed to promote particular activities that some believe are beneficial to society. These activities have readily identifiable beneficiaries so that the tax benefits are easy to appreciate. For example, there are now eight different higher education incentive provisions under the income tax - each involving a separate set of hoops for taxpayers to jump through in order to qualify.[58] Unlike special tax incentives, tax simplification has no particular constituency, as the benefits are broadly distributed to all members of society.

Income Redistribution. The simplest tax would be a "head tax" requiring equal dollar payments by all citizens. Legislators usually reject this approach because "ability to pay" is thought to be an important feature of a tax system. However, an excessive focus on ability to pay, particularly in the income tax, has led to many complex provisions in the tax code. These features include the five-bracket rate structure, exemptions, credits, the alternative minimum tax, the earned income tax credit, and phase-outs. The tax system now has 22 provisions which phase-out as incomes rise, such as personal exemptions and the child tax credit.[59] Such features create computational complexity, additional record-keeping, and errors. Note that the tax code could be simplified, without altering the level of redistribution in the system, by combining and reworking these provisions.

Budget Scoring Procedures. Beginning in the 1970s, and accelerating in the 1980s and 1990s, budget rules have forced congressional tax-writing committees to place great emphasis on revenue-neutrality and fitting revenue changes into precise budgetary projections.[60] Unfortunately, these pressures have often come at the expense of tax rules that are simple and that promote economic growth.

Continual Change. Since the 1970s, the federal government has passed a major tax bill with hundreds of changes every year or two. New legislation sets off rounds of changes in federal tax regulations and guidance to interpret the new rules, and often requires substantial tax form changes by the IRS. Many hours must be spent relearning the rules each time tax changes occur, and businesses face complications because they must apply different rules to different time periods for such items as depreciation.

In recent Congressional testimony, the IRS National Taxpayer Advocate summarized the extent of recent tax changes: "Since the Tax Reform Act of 1986 and ending in 1998, Congress made approximately 6,500 changes to Title 26 [the tax code] in 61 pieces of legislation. In fact, the Taxpayer Relief Act of 1997 and RRA 1998 alone made 1,260 changes to the tax code. The magnitude of the changes made by those two pieces of legislation resulted in revisions of at least 100 separate IRS forms."[61]

Inconsistency Within the Tax Code. The tax code itself contains many internal inconsistencies as a result of its development piecemeal over time. For example, the 22 different phase-outs in the income tax code have varying rates and applicable income levels. Also, the meaning of key terms are sometimes different in different parts of the code. Another example of inconsistency is that two businesses with similar operations can face different income tax rates and rules if they operate under different legal structures.

Emphasis on Precision. Tax legislators, and officials designing tax regulations, often strive for high levels of precision in measuring the tax base. Under the income tax, great efforts are made to measure "income," even though experts often disagree as to how to do this properly. For example, tax experts have debated for decades the correct treatment of items such as depreciation and capital gains. Real world complications such as inflation mean that efforts to create perfect tax precision for items such as these can be very complex.

Professor Michael Graetz says that "to limit complexity requires a willingness by Congress to enact law that is arbitrary."[62] In other words, simple rules should be encouraged, even if they do not have precise accuracy or fairness. For example, the current reduced capital gains tax rate is a rougher but simpler method of countering the effect of inflation on capital gains than indexing the tax base would be.

The Complexity of the Economy. The U.S. economy is highly complex with about 27 million businesses paying 133 million workers and performing billions of transactions. Many businesses today operate in dozens of states and foreign countries with each jurisdiction having a distinct set of tax rules. U.S. corporations now operate 21,000 affiliates in foreign countries and must account for them under both the U.S. income tax system and foreign tax systems.[63]

The federal government's largest tax source, the income tax, is placed on a tax base, "income," which is particularly difficult to measure in today's economy. Income takes many forms, and is getting more difficult to measure all the time with the growing use of complex financial instruments, intricate business structures, globalization, and new forms of flexible employment and compensation patterns.

8. WHO SAID WHAT ABOUT TAX COMPLEXITY?

Complexity of the tax laws is the number one problem facing taxpayers.
Val Oveson, National Taxpayer Advocate, IRS.[64]

It's time for a complete overhaul of our income tax system ... I feel it's a disgrace to the human race.
Future President Jimmy Carter campaigning in 1976.[65]

The hardest thing in the world to understand is the income tax.
Albert Einstein, as quoted in *Crown's Book of Political Quotations*.

The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person.
Adam Smith, *The Wealth of Nations*, 1776.[66]

As I fill out my tax forms this year, it's clear that taxes are too high and the code is too complicated ... I want to pull the income tax out by its roots and throw it away so it never grows back.
House Ways and Means Committee Chairman Bill Archer.[67]

Every tax bill, whether an increase or cut, is the culmination of strident debate and Gordian compromise. This can lead to mind-numbing complexity as the different politicians, with their different philosophies, fight for a bill that represents their respective agendas. To pass a bill, the competing political factions split the differences and come up with Frankenstein, leaving taxpayers with the impossible task of sorting it all out.
Senator William Roth and William Nixon, *The Power to Destroy*, 1999.

We're beginning to write tax measures late at night, behind closed doors ... [creating] 1,200 page monsters, we vote for it, no one knows what's in it ..It's our doing ... We're the ones doing it, not the IRS.
Senator Daniel Patrick Moynihan, February 2, 2000.[68]

Our income tax system has been destroyed by complexity – a complexity caused largely by well-meaning efforts to achieve theoretical purity, eliminate every real and imagined abuse, and address non-tax policy objectives.
Former IRS Commissioner Fred Goldberg.[69]

[T]he single most complicating factor in tax administration is the frequency and number of changes to the tax law.
Val Oveson, National Taxpayer Advocate, IRS.[70]

The [tax] law is now so complex that it affects taxpayers' ability to comply - and often affects their willingness to comply, as well . . . A good part of what we call non-compliance with the tax laws is caused by taxpayers' lack of understanding of what is required in the first place. Once you acknowledge that reality, it makes good business sense to increase our efforts to help taxpayers comply rather than relying solely on after-the-fact enforcement.

IRS Commissioner Shirley Peterson in Congressional testimony, 1992.[71]

Taxation of business is even more complicated [than individual taxation]. The average Fortune 500 company spends over $2 million per year on tax matters; many of the largest corporations spend over $10 million per year. Even after all this expense, neither the company nor the IRS is completely sure what the correct tax liability really is. Audits, appeals, and litigation can drag on for years, so it is quite common for a large corporation to have its tax liability still unsettled 10 years after the return was filed.

Tax compliance expert, Joel Slemrod, in *Tax Notes*, February 27, 1995.

The costs of tax compliance for American businesses and families are excessive, and these expenditures of time and money do not contribute one whit to the long-term success of the American economy.

Professor Michael Graetz, 1999.[72]

No one should ever see how law or sausage is made.

Attributed to Chancellor Otto von Bismarck.[73]

It will be of little avail to the people that the laws are made by men of their own choice, if the laws be so voluminous that they cannot be read, or so incoherent that they cannot be understood; ... or undergo such incessant changes that no man who knows what the law is today can guess what it will be tomorrow. Law is defined to be a rule of action; but how can that be a rule, which is little known, and less fixed?

James Madison, *The Federalist Papers, No. 62.*

9. TEN WAYS TO SIMPLIFY THE TAX CODE

For a number of years, the organizations representing the nation's tax accountants and tax lawyers have pursued tax law simplification. The federal tax system has become so complicated that even these experts have had enough!

Recently, the American Institute of Certified Public Accountants, the American Bar Association, and the Tax Executives Institute recommended the following "10 Ways to Simplify the Tax Code:"

1. **Scrap the Alternative Minimum Tax (AMT).** The individual and corporate AMTs should be repealed. The individual AMT will soon start hitting millions of middle-class taxpayers, a result that was not the original intention of this complex add-on tax. The corporate AMT requires businesses to keep two separate sets of books for tax calculations, and hits struggling companies when they can least afford it.

2. **Simplify Education Tax Incentives.** The tax code contains eight separate subsidies for higher education, each with different qualifying requirements. These could be rolled into a single deduction or credit.

3. **Streamline Capital Gains Taxes.** The tax code contains a variety of capital gains rates and holding periods. These should be rolled into a single rate and holding period for long-term gains.

4. **Simplify Definitions of a Family.** Different tax code provisions such as the EITC and the dependent exemption use different definitions of family status. These should be harmonized.

5. **Phase Out the "Phase-Outs."** At least 22 provisions in the income tax code phase-out benefits as income rises creating calculation complexity and eligibility uncertainty. These should be eliminated or made uniform.

6. **Safe Harbors for the Self-Employed.** The self-employed are penalized if they do not pay the correct tax payments each quarter during the year. These rules should be simplified as it is often difficult for small businesspeople to know how much to pay.

7. **Independent Contractors.** Tax rules require businesses to apply a confounding and subjective 20-question test to determine whether workers are employees or outside workers. These rules should be made more objective.

8. **Make Temporary Provisions Permanent.** Numerous tax code provisions such as the research and development tax credit create great uncertainty as they repeatedly expire and must be re-enacted. These provisions should be made permanent.

9. **Capitalization and Expensing.** Many business expenses must be capitalized and written off over numerous years, rather than simply expensed in the year purchased. But the determination of which business expenses receive which treatment are very complex and create uncertainty for businesses planning purchases. This determination should be made simpler and more objective.

10. **International Tax Rules.** The tax rules relating to the international operations of U.S. businesses are perhaps the most complicated in the federal tax code. Rules such as the foreign tax credit and subpart F are causing greater trouble all the time as more and more U.S. companies expand abroad to take advantage of foreign business opportunities.

10. CONCLUSIONS

The rise in popularity in recent years of tax reform proposals, such as the flat tax and the national retail sales tax, has been largely based on frustration with the complexity of the current income tax. While movements towards an alternative system currently seem to be on hold, there is as much support as ever for tax simplification.

In 1997, the congressionally-appointed National Commission for Restructuring the IRS reported on the large administrative problems facing the IRS, and "found a clear connection between the complexity of the Internal Revenue Code and the difficulty of tax law administration and taxpayer frustration."[74] The report helped lead to the passage of the IRS Restructuring and Reform Act of 1998, which reformed aspects of the IRS's operations, and contained procedures to respond to increasing tax complexity.

The Act required that the Joint Committee on Taxation include in its reports on proposed major tax bills a discussion of complexity issues raised by the changes.[75] In addition, the IRS office of the National Taxpayer Advocate was strengthened, and now provides an annual report which discusses compliance burdens, the most serious problems facing taxpayers, and heavily litigated parts of the tax laws. The most recent annual report listed 53 specific tax changes that Congress could enact to simplify the tax code.[76] These reports are making tax complexity more concrete and visible, and they are useful to Congress in helping to determine where tax reforms are most needed.

At recent Senate Finance Committee hearings, Senator Daniel Patrick Moynihan proposed creating a tax simplification commission.[77] He suggested that the lawmaking process does not adequately reward simplicity in formulating policy. The core problem, he notes, stems from the legislative process, and is not just the fault of the IRS.

Now would seem to be an opportune time for Congress to pursue tax simplification because the federal budget is expected to be in surplus for the foreseeable future. In the past, high deficits often led Congress to enact particularly complicated tax provisions, which were designed to fine-tune and limit federal revenue losses. With a surplus, simplification reforms can be pursued that also cut taxes, thus providing a double benefit to taxpayers.

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[1] This figure is the number of pages in the CCH *Standard Federal Tax Reporter.*
[2] *Annual Report to Congress, FY 1999*, National Taxpayer Advocate, IRS.
[3] Time/CNN poll reported in *Tax Issues: National Public Opinion*, Congressional Research Service, May 28, 1998.
[4] As quoted in the *Atlanta Constitution*, April 15, 1999.
[5] Based on the page count of the CCH *Standard Federal Tax Reporter.*

[6] *The Income Tax: What It Is, How It Got That Way, and Where We Go From Here*, Michael Graetz, 1999, pg. 81.
[7] Tax code page count and word estimate by author based on the January 2000 code as published by the Research Institute of America (RIA). Page counts include table of contents and index pages. There are about 1,000 words per page in the RIA code, thus indicating 2.8 million total words. However, different code versions can give different counts. The West Group's 1999 two-volume Title 26 measures 3,469 pages but has about 800 words per page, thus giving the same total word count of 2.8 million words. CCH's two-volume code for 2000 has a much longer page count at about 4,990 pages, but it includes much more code history and has a smaller typesize.
[8] JEC estimate based on an average 600 words per page.
[9] This percentage is calculated by excluding the table of contents and Administration sections of the code.
[10] Based on the author's page count of RIA's five-volume set of federal tax regulations for 2000, and an estimated average 1,200 words per page.
[11] *Overview of the Federal Tax System*, Committee on Ways and Means, June 14, 1993.
[12] These figures are from CCH Incorporated, *News Release*, January 14, 2000. Note that the first U.S. income tax was enacted during the Civil War but was eliminated in 1872. Another income tax was enacted in 1894 but was struck down by the Supreme Court. In 1913, the Sixteenth Amendment to the Constitution was ratified allowing the modern income tax to be enacted that year.
[13] *The U.S. Income Tax: What It Is, How It Got That Way, and Where We Go From Here*, Michael Graetz, 1999, pg. 87.
[14] CCH Incorporated, *News Release*, January 14, 2000.
[15] Note that the CCH *Standard Federal Tax Reporter* does not contain all resources that a tax practitioner may require to do her job. For example, it generally does not include full text of IRS rulings and Tax Court cases. These items are available in other CCH publications are not included in this page count.
[16] Similar explosive growth of the code and regulations was measured by Art Hall, in *Special Brief*, Tax Foundation, March 1996.
[17] *Statistical Abstract of the United States, 1902*; *Annual Report of the Secretary of Treasury, Fiscal Year 1900*; and JEC estimates.
[18] *Special Report*, Tax Foundation, September, 1994.
[19] See Table 21, *SOI Bulletin*, IRS, Fall 1999, and return projections in *SOI Bulletin*, Winter 1998-1999.
[20] *Tax Administration: Potential Impact of Alternative Taxes on Taxpayers and Administrators*, General Accounting Office, January, 1998.
[21] Phone communication with Rosalie LaPlant, Forms and Publications Division, IRS, March 28, 2000.
[22] *Budget of the United States Government, Fiscal 2001, Appendix*, pg. 854. See also *Tax Administration IRS' 1999 Tax Filing Season*, General Accounting Office, December 1999.
[23] *Tax Administration IRS' 1999 Tax Filing Season*, General Accounting Office, December 1999
[24] "The IRS: Still Trying to Modernize, 30 Years Later," George Gutman, *Tax Notes*, February , 2000. See also Jeffrey Birnbaum in *Fortune* magazine, April 13, 1998
[25] As quoted by Jeffrey Birnbaum in *Fortune* magazine, April 13, 1998.
[26] *SOI Bulletin*, IRS, various isues.
[27] *The Income Tax: What It Is, How It Got That Way, and Where We Go From Here*, Michael Graetz, 1999, pg. 81.
[28] H&R Block fee from H&R Block press release March 24, 2000, based on the first two months of 2000.
[29] See "Why You Can't Trust the IRS," Daniel Pilla, *Cato Policy Analysis*, April 1995 for the $30 billion estimate, and Amity Shlaes's *The Greedy Hand*, 1999 for the $40 billion estimate.
[30] H&R Block Web page, and phone call with H&R Block Government Affairs Office, March 2000. *Also Hoover's Handbook of American Business*, 2000.
[31] H&R Block financial statements on company web page at www.hrblock.com.
[32] Tabulation by Frank Zaffino, Office of Planning and Finance, IRS, per phone call of April 5, 2000.
[33] Current Population Survey data from *Employment and Earnings*, Bureau of Labor Statistics, January, 2000.
[34] Author's estimate. The accounting profession's main professional organization, the AICPA, which has 330,000 members, was unable to provide an accurate estimate of the number of U.S. tax accountants. Note that about 20 percent of the Big 5 accounting firms business is taxation, but these firms employ many non-accountants in areas such as management consulting.

[35] Current Population Survey data from *Employment and Earnings*, Bureau of Labor Statistics, January, 2000.
[36] Author's estimate. The American Bar Association was not able to provide an accurate estimate of the share of U.S. lawyers who practice tax.
[37] Testimony of Gregory Shteinbis on behalf of the National Association of Enrolled Agents before the Senate Finance Committee, April 15, 1999.
[38] *State and Local Taxation and Economic Growth: Lessons for Federal Tax Reform*, Richard Vedder for the Joint Economic Committee, December, 1995.
[39] The Bureau of Census reports that total state/local employees employed in "Financial Administration" was 363,000 in 1998.
[40] The IRS estimates are summarized in *Information Collection Budget of the U.S. Government*, Office of Management and Budget (OMB), Fiscal Year 1999. This estimate is the total information collection burden imposed by the Treasury Department. The IRS is currently preparing a study to update its methodology regarding taxpayer compliance burdens with the help of an outside consultant.
[41] *Report to Congress on the Costs and Benefits of Federal Regulations*, OMB, 1997 and draft report for 1999. In 1999, average compensation costs for U.S. workers was $20/hour, but individuals filling out tax forms are likely to have a higher compensation rate. See *Employer Costs for Employee Compensation*, Bureau of Labor Statistics, March 1999.
[42] "The Simplification Potential of Alternatives to the Income Tax," Joel Slemrod in *Tax Notes*, February 27, 1995.
[43] See "The Simplification Potential of Alternatives to the Income Tax," Joel Slemrod in *Tax Notes*, February 27, 1995. And see *Special Brief*, Tax Foundation, March 1996. For a summary of studies see *Tax Administration: Potential Impact of Alternative Taxes on Taxpayers and Administrators*, General Accounting Office, January, 1998
[44] *The Income Tax: What It Is, How It Got That Way, and Where We Go From Here*, Michael Graetz, 1999, pg. 85.
[45] *Special Brief*, Tax Foundation, March 1996.
[46] *Annual Report to Congress, FY 1999*, National Taxpayer Advocate, IRS.
[47] See testimony of Daniel J. Pilla, Senate Finance Committee, September 23, 1997 as reprinted *in Pilla Talks Taxes*, December 1997, and *Pilla Talks Taxes*, Summer, 1997. See *also IRS Data Book Publication 55B*, IRS, 1997.
[48] *Annual Report to Congress, FY 1999*, National Taxpayer Advocate, IRS.
[49] *Budget of the United States Government, Fiscal 2001, Appendix*, pg. 854. See *also Tax Administration IRS' 1999 Tax Filing Season*, General Accounting Office, December 1999.
[50] "6 Mistakes Even the Tax Pros Make," Joan Caplin, *Money Magazine*, March, 1998.
[51] *The Income Tax: What It Is, How It Got That Way, and Where We Go From Here*, Michael Graetz, 1999, pg. 24.
[52] See "The Fair Tax and Tax Compliance: An Analytical Perspective," Dan Mastromarco, in *Tax Notes*, April 20, 1998.
[53] "Tax Compliance of Federal Employees Still Needs Improving," *Tax Notes*, August 20, 1999.
[54] For a discussion of the excess burdens of taxation, see Harry Watson in *The Encyclopedia of Taxation and Tax Policy*, Urban Institute Press, 1999.
[55] See "General Equilibrium Computations of the Marginal Welfare Costs of Taxes in the United States," Charles Ballard, John Shoven, and John Whalley in the *American Economic Review*, March 1985. Dale Jorgensen estimates the marginal excess burden at 39 cents per dollar of tax revenue. See "The Economic Impact of Fundamental Tax Reform," Dale Jorgenson, 1996. For a summary table of estimates see *Costly Returns: The Burdens of the U.S. Tax System*, James Payne, 1993. See also *Tax Reduction and Economic Welfare*, by Richard Vedder and Lowell Gallaway, Joint Economic Committee, April 1999.
[56] *An Inquiry into the Nature and Causes of The Wealth of Nations*, Adam Smith, University of Chicago Press, 1976, Volume 2, pg. 351.
[57] For a discussion of this issue, see "Who Makes the Case for Tax Simplification," Gene Steuerle *in Tax Notes*, July 14, 1997.
[58] AICPA fact sheet entitled "Highlights of the Complexity of Tax Benefits for Higher Education."
[59] This includes phase-ins, phase-outs, and floors. *Overview of Present Law and Issues Relating to Individual Income Taxes*, Joint Tax Committee, JCX-18-99.
[60] See, for example, Michael Graetz, pages 117 and 187.

[61] Statement of Val Oveson, National Taxpayer Advocate, IRS, before the Subcommittee on Oversight, Committee on Ways and Means, see *IRS National Taxpayer Advocate's Annual Report to Congress*, FY 1999. Note that tax publisher CCH Incorporated calculates that there have been 10,000 changes to federal tax laws since 1986. CCH press release, January 14, 2000

[62] *The U.S. Income Tax: What It Is, How It Got That Way, and Where We Go From Here*, Michael Graetz, 1999, pg. 60, 87.

[63] For background on international business taxation, see *The NFTC Foreign Income Project: International Tax Policy for the 21st Century*, prepared for the National Foreign Trade Council, 1999.

[64] Testimony before the House Committee on Ways and Means, May 25, 1999.

[65] As quoted by *the Atlanta Constitution*, April 15, 1999.

[66] *An Inquiry into the Nature and Causes of The Wealth of Nations*, Adam Smith, University of Chicago Press, 1976, Volume 2, pg. 350.

[67] House Committee on Ways and Means, Press Release, April 16, 1998.

[68] Senate Finance Committee hearings, February 2, 2000.

[69] As quoted in the *Wall Street Journal*, February 28, 2000.

[70] Testimony before the House Committee on Ways and Means, February, 2000.

[71] As quoted in "Why You Can't Trust the IRS," Daniel Pilla, *Cato Policy Analysis*, April 1995.

[72] *The U.S. Income Tax: What it is, How It Got That Way, and Where We Go From Here*, Michael Graetx, 1999.

[73] As quoted in *The U.S. Income Tax: What It Is, How It Got That Way, and Where We Go From Here*, Michael Graetz, 1999, pg. 115.

[74] As described by the Joint Committee on Taxation. See JCS-6-98 description of secs. 4021-4022 of the 1998 Tax Act.

[75] See, for example, the Joint Tax *Committee's Overview of Present Law and Issues Relating to Individual Income Taxes* (JCX-18-99) for an extensive discussion of complexity in the individual income tax.

[76] *Annual Report to Congress, FY 1999*, National Taxpayer Advocate, IRS.

[77] Hearings before the Senate Finance Committee, February 2, 2000. See also *Tax Notes*, February 7, 2000.

EDWARD MEZNER
CERTIFIED PUBLIC ACCOUNTANT
2314 PELHAM ROAD
ROCKFORD, ILLINOIS
61107
(815) 399-5654

Honorable Donald A. Manzullo
415 South Mulford Road
Rockford, IL 61108

You should be aware of what the Internal Revenue Service is doing, probably under the guise of "tax simplification" or efficiency.

Enclosed are copies of blank Forms 5500-EZ for 1998 and for 1999. Note that the 1998 form is one page, and it can be copied. The 1999 form contains the same information, but it is five pages, and the original forms must be sent in, making it more difficult to correct any errors.

It seems to me that the savings, if any, to the U.S. government by processing five pieces of paper instead of one cannot justify the extra burden for the taxpayer.

Edward Mezner

Edward Mezner, C.P.A.

Form **5500-EZ**

Department of the Treasury
Internal Revenue Service

Please type or print

Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan

This form is required to be filed under section 6058(a) of the Internal Revenue Code.

▶ See separate instructions.

OMB No. 1545-0956

1998

This Form is Open to Public Inspection

For the calendar plan year 1998 or fiscal plan year beginning , 1998, and ending , 19

This return is: *(i)* ☐ the first return filed *(ii)* ☐ an amended return *(iii)* ☐ the final return *(iv)* ☐ a short plan year (less than 12 mos.)

Check here if you filed an extension of time to file and attach a copy of the approved extension . . . . . ▶ ☐

Use IRS label. Otherwise, please type or print.		
	1a Name of employer	**1b** **Employer identification number**
	Number, street, and room or suite no. (If a P.O. box, see instructions for line 1a.)	**1c** Telephone number of employer
		1d Business activity code (new codes—see page 6 of instr.)
	City or town, state, and ZIP code	**1e** If plan year has changed since last return, check here . . . . ▶ ☐

2a Is the employer also the plan administrator? ☐ Yes ☐ No (If "No," see instructions.)

2b *(i)* Name of plan ▶

(ii) ☐ Check if name of plan has changed since last return

2c Date plan first became effective Month Day Year

2d Enter three-digit plan number ▶

3 Type of plan: **a** ☐ Defined benefit pension plan (attach Schedule B (Form 5500)) **b** ☐ Money purchase pension plan (see instructions) **c** ☐ Profit-sharing plan **d** ☐ Stock bonus plan **e** ☐ ESOP plan (attach Schedule E (Form 5500))

4a If this is a master/prototype, or regional prototype plan, enter the opinion/notification letter number . .

b Check if this plan covers: *(i)* ☐ Self-employed individuals, *(ii)* ☐ Partner(s) in a partnership, or *(iii)* ☐ 100% owner of corporation

5a Enter the number of qualified pension benefit plans maintained by the employer (including this plan). . . ▶

b Check here if you have more than one plan and the total assets of all plans are more than $100,000 (see instructions) . . . . ▶ ☐

6 Enter the number of participants in each category listed below:		Number
a Under age 59½ at the end of the plan year	**6a**	
b Age 59½ or older at the end of the plan year, but under age 70½ at the beginning of the plan year	**6b**	
c Age 70½ or older at the beginning of the plan year	**6c**	

7a *(i)* Is this a fully insured pension plan which is funded entirely by insurance or annuity contracts? . . ▶ ☐ Yes ☐ No

If "Yes," complete lines 7a(ii) through 7f and skip lines 7g through 9d.

(ii) If 7a(i) is "Yes," are the insurance contracts held: . . . . . ▶ ☐ under a trust ☐ with no trust

b Cash contributions received by the plan for this plan year	**7b**	
c Noncash contributions received by the plan for this plan year	**7c**	
d Total plan distributions to participants or beneficiaries	**7d**	
e Total nontaxable plan distributions to participants or beneficiaries	**7e**	
f Transfers to other plans.	**7f**	
g Amounts received by the plan other than from contributions	**7g**	
h Plan expenses other than distributions	**7h**	
8a Total plan assets at the end of the year	**8a**	
b Total plan liabilities at the end of the year	**8b**	

9 Check "Yes" and enter amount involved if any of the following transactions took place between the plan and a disqualified person during this plan year. Otherwise, check "No."		Yes	No	Amount
a Sale, exchange, or lease of property	**9a**			
b Payment by the plan for services	**9b**			
c Acquisition or holding of employer securities	**9c**			
d Loan or extension of credit	**9d**			

If 10a is "No," do not complete line 10b and line 10c. See the specific instructions for line 10b and line 10c.

		Yes	No
10a Does your business have any employees other than you and your spouse (and your partners and their spouses)? . ▶	**10a**		
b Total number of employees (including you and your spouse and your partners and their spouses) ▶			
c Does this plan meet the coverage requirements of Code section 410(b)? . . . . . ▶	**10c**		
11a Did the plan distribute any annuity contracts this plan year? . . . . . ▶	**11a**		
b During this plan year, did the plan make distributions to a married participant in a form other than a qualified joint and survivor annuity or were any distributions on account of the death of a married participant made to beneficiaries other than the spouse of that participant? . . . . . ▶	**11b**		
c During this plan year, did the plan make loans to married participants? . . . . . ▶	**11c**		

Under penalties of perjury and other penalties set forth in the instructions, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature of employer (owner) or plan administrator ▶ Date ▶

For Paperwork Reduction Act Notice, see the instructions to Form 5500-EZ. Cat. No. 63263R Form **5500-EZ** (1998)

Form **5500-EZ**

Department of the Treasury
Internal Revenue Service

Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan

This form is required to be filed under section 6058(a) of the Internal Revenue Code.

▶ **Type or print all entries in accordance with the instructions to the Form 5500-EZ.**

Official Use Only

OMB No. 1545-0956

1999

This Form is Open to Public Inspection.

Part I **Annual Report Identification Information**

For the calendar plan year 1999 or fiscal plan year beginning MM / DD / YYYY **, and ending** MM / DD / YYYY

A This return is:
(1) ☐ the first return filed for the plan;
(2) ☐ an amended return;
(3) ☐ the final return filed for the plan;
(4) ☐ a short plan year return (less than 12 months).

B If you filed for an extension of time to file, check the box and attach a copy of the extension application ▶ ☐

Part II **Basic Plan Information** — enter all requested information.

1a Name of plan

1b Three-digit plan number (PN) ▶

1c Date plan first became effective MM / DD / YYYY

Caution: *A penalty for the late or incomplete filing of this return will be assessed unless reasonable cause is established.*

Under penalties of perjury and other penalties set forth in the instructions, I declare that I have examined this return, including accompanying schedules, statements, and attachments, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature of employer or plan administrator

Date MM / DD / YYYY

Typed or printed name of individual signing as employer or plan administrator

0 3 9 9 0 0 0 1 1 N

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2a Employer's name and address (Address should include room or suite no.)

1)

2)

c / o

3)

4)

5)

6)

7)

8)

2b Employer Identification Number (EIN)
(Do not enter your Social Security Number)

2c Employer's telephone number

2d Business code
(see instructions)

3a Plan administrator's name and address (if same as employer, enter "Same")

1)

c / o

2)

3)

4)

5)

6)

3b Administrator's EIN

3c Administrator's telephone number

4 If the name and/or EIN of the employer has changed since the last return filed for this plan, enter the name, EIN and the plan number from the last return below:

a Employer's name

b EIN

c PN

0 3 9 9 0 0 0 2 1 0

Official Use Only

5 Preparer information (optional)

a Name (including firm name, if applicable) and address

1)

2)

3)

4)

5)

6)

b EIN

c Telephone number

6 Type of plan: (a) ☐ Defined benefit pension plan (attach Schedule B (Form 5500))

(b) ☐ Money purchase pension plan (see instructions)

(c) ☐ Profit-sharing plan

(d) ☐ Stock bonus plan

(e) ☐ ESOP plan (attach Schedule E (Form 5500))

7a If this is a master/prototype, or regional prototype plan, enter the opinion/notification letter number

b Check if this plan covers:

(1) Self-employed individuals, (2) ☐ Partner(s) in a partnership, or (3) 100% owner of corporation

8a Enter the number of qualified pension benefit plans maintained by the employer (including this plan)

b Check here if you have more than one plan and the total assets of all plans are more than $100,000 (see instructions) ▶

Number

9 Enter the number of participants in each category listed below:

a Under age 59 1/2 at the end of the plan year

b Age 59 1/2 or older at the end of the plan year, but under age 70 1/2 at the beginning of the plan year

c Age 70 1/2 or older at the beginning of the plan year

Official Use Only

10a (1) Is this a fully insured pension plan which is funded entirely by insurance or annuity contracts? ▶ ☐ Yes ☐ No
If "Yes," complete lines 10a(2) through 10f and skip lines 10g through 13d.
(2) If 10a(1) is "Yes," are the insurance contracts held: ▶ (1) ☐ under a trust (2) ☐ with no trust

10b Cash contributions received by the plan for this plan year

c Noncash contributions received by the plan for this plan year

d Total plan distributions to participants or beneficiaries (see instructions)

e Total nontaxable plan distributions to participants or beneficiaries

f Transfers to other plans

g Amounts received by the plan other than from contributions

h Plan expenses other than distributions

	(a) Beginning of Year	(b) End of Year
11a Total plan assets	.00	
b Total plan liabilities	.00	

12 **Specific Assets:** If the plan held any assets in one or more of the following specific categories, check "Yes" and enter the current value as of the end of the plan year. Otherwise, check "No."

	Yes	No	Amount
a Partnership/joint venture interests	☐	☐	
b Employer real property	☐	☐	
c Real estate (other than employer real property)	☐	☐	

0 3 9 9 0 0 0 4 1 Q

Official Use Only

	Yes	No	Amount
d Employer securities			
e Participant loans (see instructions)			
f Loans (other than to participants)			
g Tangible personal property			

13 Check "Yes" and enter amount involved if any of the following transactions took place between the plan and a disqualified person during this plan year. Otherwise, check "No."	Yes	No	Amount
a Sale, exchange, or lease of property			
b Payment by the plan for services			
c Acquisition or holding of employer securities			
d Loan or extension of credit			

If 14a is "No," do not complete line 14b and line 14c. See the specific instructions for line 14b and line 14c.

	Yes	No
14a Does your business have any employees other than you and your spouse (and your partners and their spouses)? ▶		
b Total number of employees (including you and your spouse and your partners and their spouses) ▶		
c Does this plan meet the coverage requirements of Code section 410(b)? ▶		
15a Did the plan distribute any annuity contracts this plan year? ▶		
b During this plan year, did the plan make distributions to a married participant in a form other than a qualified joint and survivor annuity or were any distributions on account of the death of a married participant made to beneficiaries other than the spouse of that participant? ▶		
c During this plan year, did the plan make loans to married participants? ▶		

0 3 9 9 0 0 0 5 1 R

Millikin Benning Kleckler —MBK—
Certified Public Accountants

1809 Tenth Street
Monroe, Wisconsin 53566
Telephone (608) 325-5035
Fax (608) 328-2843

October 13, 2000

Small Business Tax Subcommittee
Room B363
Rayburn House Office Building
Washington, DC 20515

Dear Mr. Manzullo:

It is my pleasure to have the opportunity to submit my thoughts on tax simplification and fairness in connection with the small business owner. In my CPA practice, I deal with many small business owners, from farmers and self-employed business owners to small banks and other corporations. On their behalf, I would like to submit the following items for discussion.

Under the current tax code, S corporations are required to include on the W-2 of a greater than 2% shareholder/employee the value of the health insurance premiums paid on their behalf. This employee/shareholder is then subject to the same percentage deduction for this premium on page 1 of the 1040 as is allowed to self-employed individuals. There may have been a good reason for this treatment back when this rule was established, but I feel that this rule has outlived it's validity. I believe that this health insurance should be a corporate deduction for legitimate employees of the corporation, regardless of whether they own stock in the corporation and there should be no addition to the employee's income for this expense. In other words, I believe the tax treatment for this expense should be the same for S corporations as it is for C corporations.

Along the same line, I believe self-employed individuals are at a significant tax disadvantage with regard to health insurance premiums. Unless they have a working spouse with health insurance coverage, the self-employed person not only has to pay these premiums, but they get to deduct only 60% of the premium and this deduction is not allowed on their business schedule C or F. Contrast this with the normal employee/employer situation where the employee gets a tax free benefit, and the employer gets a 100% deduction. Because of this disparity in tax treatment, many self-employed individuals make their spouse an employee of the business just to take advantage of the tax benefits. In many cases, especially for small farmers, the spouse may be the only employee. As a result, this business owner is required to do all of the payroll tax filings simply to get this tax deduction. I believe a more logical

approach would be to treat this self-employed person as an employee of the business for purposes of this deduction. Therefore, the schedule C or F would reflect the health insurance of the owner as an employee benefit deduction and put this owner on a more level playing field when compared to an employee.

The last item I want to discuss is the self-employment tax. Currently, this high level of tax (15.3%) combined with the lowest level of income tax puts the minimum marginal tax rate on the self-employed at around 30%. If the individual is lucky enough to have a working spouse, the individual could easily have a marginal tax rate approaching 50% when state income tax is added in. I recently had to inform someone that his $30,000 of schedule C income was going to cost him $12,000 of income and social security tax. It's very difficult to make $3,000 estimated tax payments every quarter when your income is only $2,500 per month. The root of this problem is the 15.3% social security tax levied on the first dollar of self-employment net income. I believe there should be more parity between the employee and the self-employed. As you know, the employee has one-half of his social security tax paid by his employer, whereas the self-employed pay it all. Not only does this disparity cause feelings of unfairness, but it also causes some self-employment income to be unreported. I believe there should be some form of reduction in the social security tax burden of self-employed individuals. One suggestion would be to cut the SE tax to 7.65% and increase the social security earnings limit to twice the current level for self-employed individuals. This would cause the lower income self-employed to pay one-half of the social security tax they currently pay. I realize this would cause a reduction in their social security earnings credit and eventually in their social security benefits, but a large portion of the self-employed would welcome this tax reduction. For those that are concerned about their benefits, there could be in place an optional social security contribution or create an optional IRA account that self-employed taxpayers could contribute to that would replace this social security benefit reduction.

As you can see, my main focus has been on creating fairness in the tax system, not necessarily tax simplification. I believe that with fairness you get compliance and obviously this is the main goal of any tax system. I have read the suggestions of the AICPA and agree with all of them.

I appreciate the opportunity to submit my suggestions and concerns of the current tax system. Thank you for giving me the opportunity.

Very truly yours,
MILLLIKIN BENNING KLECKLER

Donald A. Benning, Partner

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FAX 815-385-0366

October 18, 2000

Don Manzullo
C/o Small Business Subcommittee on Tax, Finance and Exports
Rayburn House Office Building
Room B363
Washington DC 20515

Dear Congressman Manzullo:

I have received your letter concerning the hearing held before the Small Business Subcommittee concerning the complexity of the tax code, especially on small business. I have read the testimony provided by the American Institute of Certified Public Accountants, David A. Lifson, and concur with his testimony and the supporting detail included as part of that testimony.

Interestingly enough, in reading Mr. Lifson's testimony, I find that while it thoroughly covered the material and the issues that are pertinent to this discussion, they do so in a fashion that will probably not move anyone to action.

Tax simplification has been on the agenda in Congress since the last major reform bill that was completed in 1986. However, as the testimony of the AICPA indicates, there has been a gradual and continuing escalation of the complexity of the tax code over the years that have made it not only cumbersome, but in many instances, impossible to deal with by the average business taxpayer.

When I came back to public accounting 25 years ago, the accountant I worked for, Elmer Adams, on many occasions said that he could fix the tax law. Elmer said that all we would have to do is make him dictator and he'd straighten it all out in a very short period of time. His comment taken in context was probably a truism in that one individual charged with the responsibility of reforming the tax code and with absolute authority probably could shake the barrel and reduce its size, complexity, and bring it down to some type of meaningful group of statutes that we could all not only live with, but under.

In order to reform the tax code, one must begin that reformation somewhere and I would suggest the following points with a little different twist using some of the common sense learned from Mr. Adams during the period of time that I worked with him.

1. All depreciation expense should be changed to straight-line. That straight-line depreciation would apply to any depreciation taken on any assets by any business entity in the United States. A uniform system of lives should be adopted which apply directly to all assets depreciated under the straight-line method so that a deviation could be checked not by auditors in the field, but by the computers. Once the determination was made as to the effect, i.e. increases in income tax caused by this change to straight-line for all depreciation, one can then adjust, for small business, the expensing allowance from its present level of $20,000 to $25,000, $30,000, or even $40,000. This change, while not appearing to be of great magnitude, I assure you would simplify the preparation of small business tax returns immeasurably. If you would like additional information or reference, I will send you a copy of the programs that we buy that compute depreciation under the present system, straight-line for book, tax depreciation, AMT, and ACE.

2. The AMT tax should be repealed in its entirety for small business, individuals, and corporations. If we recall when the last major piece of reform legislation came out of Congress in 1986, the tax rates were reduced to 15 and 28%, the majority of all tax preferences were either eliminated or put into a situation where a tax preference gain is taxable, and losses were only deductible to the extent of gains, thereby removing most of the shelters that were available in the pre-1986 law. The purpose of AMT was to make sure that all Americans paid some tax and didn't use, for instance, the devices that were left, losses carried forward or credits that were still available under the system. At the time of its passage AMT affected very few taxpayers, but today in the case of the sale of a business, the distribution of the proceeds from that sale are generally taxed at long-term capital gains rates and if the proceeds are substantial, AMT adds back the state income taxes that were paid on that sale plus taxes that gained which is normally taxed at 20%, at anywhere between 26 and 28%, thereby causing capital gains rates to be greater than 20%. This should have been clear when the committee revised the capital gains rates just recently, but apparently it was either ignored, overlooked or you couldn't give up the revenue.

3. Prior to 1986, The General Utilities Act allowed C Corporation owners to avoid income tax at the corporate level on the sale of their businesses converting the entire proceeds from the sale to long-term capital gain treatment was repealed. Under present statutes with that repeal, an individual owning a C Corporation who has been prudent, reinvested money in his corporation, and maintained his business in a professional manner is penalized in that he must first recognize the gain on the sale of his assets at the corporate level and then at the personal level. The net effect of this is a tax rate of between 58 and 62% on the sale of those small businesses. The solution is obviously to sell the stock of the corporation, however, most buyers want to do asset purchases and so then we begin to manipulate the numbers of the transaction to distort it to try to arrive at some sort of equalization that will balance the ill effects of the tax law versus the economics of the transaction. Replace the "General Utilities" concept!

4. Pension reform is necessary for most small businesses. The bills passed now by the house and senate, which apparently have not gotten to the President's desk, increasing IRA's for individuals to $5,000 and $7,500 if you are over 50, should be more than sufficient at this point for small businesses. First of all, it gives the small business owner discretion in how much money he wishes to bonus to his employees for inclusion in their IRA's. Secondly, from the employee's perspective, once the money is paid, it is 100% vested in the employees name and generally comes under his dominion and control, thereby negating the necessity for all kinds of 5500 forms to be filed with the government proving that nothing irregular is happening.

The four items listed above are certainly not sufficient to reform the entire tax code from its present state. However, they would be a beginning and there would be positive effects that would occur from these revisions immediately. You have to start someplace, and if you try to reform the whole thing in one whack it is never going to happen and we will continue to piece together this quilt which will go on infinitely, written in a language no one understands, causing problems with compliance so that the average American businessman is going to be put in the position of breaking the laws of the United States of America, in some cases, unwillingly, and in some cases, knowingly, through sheer aggravation and anger.

Cordially yours,

Henry J. Fleming, Jr.
Certified Public Accountant

HJF/jeb

Lindgren Callihan VanOsdol

LCV

October 13, 2000

Congressman Donald A. Manzullo
409 Cannon Building
Washington, D.C. 20515

Dear Congressman Manzullo:

Thank you for asking us to comment as to the complexity of the tax code on small business.

Enclosed is a copy of the preface to Montgomery's Federal Tax Handbook from 1935. For many years, Mr. Montgomery was the preeminent authority on the U.S. tax system. I know you will appreciate his stance on the tax code, which really is little different from what tax attorney's, and CPA's have been saying for decades.

Our firm supports the AICPA's cry for simplification and especially advocate repeal of the alternative minimum tax provisions of the Code.

Sincerely,

LINDGREN, CALLIHAN, VAN OSDOL
& CO., LTD.

Richard Lamm

Richard Lamm

Enclosure

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FEDERAL TAX HANDBOOK

1934-35

By

ROBERT H. MONTGOMERY, C.P.A.

OF LYBRAND, ROSS BROTHERS AND MONTGOMERY; COUNSELLOR-AT-LAW.
FORMER PRESIDENT, NEW YORK STATE SOCIETY OF CERTIFIED
PUBLIC ACCOUNTANTS

THE RONALD PRESS COMPANY
NEW YORK

PREFACE

"The time has come, the Walrus said, to speak of many things." In Great Britain for over half a century there has been continuous progress in fairness, flexibility and satisfactory administration of an income tax law imposing rates relatively far in excess of those imposed in the United States.

With us, in a little more than twenty years, we have a continuous retrograde record, with just a few notable exceptions.

During all of this time lawyers and accountants familiar with the practical application of the several Acts have offered suggestions for simplification and fairness, which suggestions have not been followed. Curiously enough some of the suggestions which were most severely criticized by the lawyers and accountants were those which opened up to certain taxpayers opportunities to avoid just taxes. But as nearly all of the laws contained provisions which imposed unjust and unnecessary taxes upon the same taxpayers, those who legally avoided paying what they were not required to pay were not guilty of moral turpitude.

In the prefaces to my tax books commencing in 1917 I have analyzed the Acts in some detail so that it is not necessary for me to prove my point that taking our laws as a whole from 1913 to 1934 they constitute a mess. The mess has not been a political one. When the 1913 law was being drafted, the chief exponent of sane and fair methods was Congressman, now Secretary of State, Hull. During the period of our highest tax rates in 1918, Senator Simmons, Chairman of the Senate Finance Committee, with reference to the proposal to permit consolidated returns, said that the provisions with respect to consolidated returns were enacted "because the principle of taxing as a business unit what in reality is a business unit is sound and equitable and convenient both to the taxpayer and to the government."

When the 1934 law was enacted, the Democrats again were in power. For a pitifully small additional amount of revenue they prohibited consolidated returns and forced upon a very small body of taxpayers an unjustifiable and indefensible burden. Not content with the attempt to penalize those who were supposed to be making big money, they struck at all small business concerns. For instance, if a shopkeeper wishes to discard some of his equipment before it is

worn out and sells it for a few dollars, he cannot deduct his loss. Some one else similarly situated who has made a study of our tax laws will send the discarded equipment to the junk pile and is permitted to deduct his loss.

The provisions withholding from taxpayers the right to deduct realized losses appear to violate the fundamental principle that an income tax, in order to be levied in proportion to capacity to pay, must be based upon net income and not gross income.

It is now common enough to find taxpayers with no net income at all subject to what is called an income tax.

Some of the lawmakers who cry most loudly "soak the rich" are themselves immune from tax not because they are poor but because they avoid the income tax.

There has been a hue and cry against so-called tax evaders. Many speeches were made in the last Congress which should be characterized as dishonest, but I will merely call them the "unintelligent mutterings of the ignorant and uniformed." Many charges were made that certain rich men—names of ten being used—had been guilty of evading income taxes. I will assume that most of those who made the charges are too ignorant to know the difference between tax avoidance—which is legal—and tax evasion which is illegal.

I have no apology to make for calling attention to any lawful plan which enables taxpayers to save money.

During his later years on the United States Supreme Court Bench, Justice Holmes was noted for his uncompromising attitude toward all those who evaded the laws of the land. But he never allowed himself to be influenced by uninformed public clamor. Few judges have had a greater facility for the use of expressive language. In *George D. Horning v. District of Columbia* (254 U. S. 135), he sums up the difference between "avoidance" and "evasion" when he says:

> "It may be assumed that he intended not to break the law, but only to get as near to the line as he could, which he had a right to do; but if the conduct described crossed the line, the fact that he desired to keep within it will not help him. It means only that he misconceived the law."

Avoidance does not even involve moral turpitude. When tax rates are oppressive and unscientific, the instinct of self-preservation asserts itself strongly. When there is no concealment of material facts, there can be no "wilful" evasion. There is not even negligence. The law purports to define in meticulous detail what sort of

transactions are taxable. If taxpayers can think of a way of doing something, which way is not forbidden in the law, there is no fraud, nor attempted evasion. The courts uniformly protect taxpayers who merely select methods of transacting business which involve the least or no liability for tax. The position of taxpayers under a highly intricate tax law is not that of an independent, impartial judge trying to be fair no matter who is hurt. No possible criticism can be directed at taxpayers who follow the law as it is, rather than as it would be, if Congress had said something else.

The newspapers have been full of criticisms of taxpayers who have deducted losses during recent years. Usually the taxpayers have been accused of "evading" taxation. We are told that Congress has now stopped most of these nefarious practices, and that the next Congress will go still further. The only inference is that hereafter losses will not be allowable deductions. No one seems to sympathize with the taxpayer's actual position. Perhaps he paid $100,000 for securities in 1929. He sold them in 1931 for $20,000. He had income from other sources on which, if he had no allowable deductions, he would pay a tax of $10,000. He deducts his security loss of $80,000 and pays no tax. Lately he has been called a malefactor.

Is it not obvious that he is actually out of pocket the difference between $80,000 and $10,000? The $100,000 investment may have represented the savings of a lifetime. During the years he was saving the $100,000 he paid taxes on it, probably much in excess of $10,000. He deserves sympathy, not criticism, even though the sale was made to his wife. If the sale was made at market prices and all of the other elements of a valid sale were present, the loss was allowable under the law.

The important point is that something which cost $100,000 dropped to $20,000. No attempt should be made to deprive taxpayers of the opportunity to offset losses against gains. There should be no unjust and unscientific provisions in tax laws. It will be deplorable if taxpayers take the same attitude toward tax laws as they did toward the Eighteenth Amendment.

I do not believe in threats; I do believe in cooperation. As I have pointed out in my tax books, there are many allowable deductions of which taxpayers do not take advantage. There are many lawful ways of reducing taxes. No one can criticize taxpayers who follow the tax laws and at the same time minimize their burden. Certainly tax-

payers have had little to do with framing tax measures. If there has been no cooperation it is not the fault of taxpayers.

As they have little chance of controlling the spending power of government through their elected representatives, the only individual actions that taxpayers can take which directly have any results seem to be to refuse to pay any unlawful tax, to seek to reduce their taxes to a minimum, and to refuse to pay larger taxes than can lawfully be required.

I am indebted to my legal and accounting associates for most of the material in this book. I have had the invaluable assistance of my partners, Walter A. Staub, C.P.A., Conrad B. Taylor, C.P.A. and Robert E. Warren, C.P.A.; and my associates, J. Marvin Haynes, C. J. McGuire, W. C. Magathan, and H. A. Tufel, all of the Bar of the District of Columbia; James O. Wynn of the District of Columbia and New York Bars; G. G. Blattmachr, Irving H. Bull, J. A. Marik and Thomas Tarleau, all of the New York Bar; J. J. Pugh, C.P.A. of the Pennsylvania Bar; E. E. Wakefield, C.P.A. of the Massachusetts Bar; Arthur J. Hair of the Illinois and California Bars; S. Lester McCormick of the Ohio Bar; John J. Cordner, C.A., C.P.A., N. B. Bergman, C.P.A., H. E. Bischoff, C.P.A., H. R. Hersperger, C.P.A., A. L. Jonah, C.P.A., W. H. Davidson and Robert W. Myers.

ROBERT H. MONTGOMERY

1 East 44th Street, New York City,
December 10, 1934.

Glenn Miller & Associates, CPAs, P.C.
• *Advisor to Business Owners* • *Tax Problem Solving* • *Business Valuations* •

October 10, 2000

Congressman Donald A. Manzullo
Small Business Tax Subcommittee
Rayburn House Office Building, Room B363
Washington DC 20515

OCT 2 0 2000

IRMO: Response to your letter of October 3, 2000

Dear Congressman Manzullo:

I sincerely thank you for the personal letter and opportunity to give an opinion. Tax simplification is a worthy task, and it is wise to use the AICPA for guidance.

I read the AICPA's data and I find no points of disagreement. That is not uncommon because the AICPA is quite thorough and has the top national experts on virtually every committee it has, and taxation has a formidable group of experts.

Rather than my priorities, I suggest that the AICPA could best help your committee prioritize their suggestions. I assume they would need some input from you and/or your committee as to what are the higher priorities of your committee or Congress in general. Or do you simply want the AICPA to tell you what their clients want most? They can prioritize them for you in any way you request. That might be a good idea to just ask them to prioritize the list each from the viewpoint of Congress, the IRS, tax preparers, corporations, and individuals. Their hard work was to reach editorial agreement on the content of their suggestion list and to make their suggestions understandable. To prioritize them is a much simpler task.

To continue to make progress on tax simplification, I suggest that the concepts developed by Congressional committees be provided to the AICPA to draft the initial suggested structure, language and alternatives for the tax committees to further develop, modify and pass. AICPA pays lobbyists to influence tax legislation, and may as well have AICPA staffers help draft the proposals.

Best of luck with the tax quagmire. We do not need to overhaul the tax code, but we do need a consistent trend of improving the rules rather than worsening them.

I deeply admire your work ethic and for representing us so well in Northern Illinois.

Very truly yours,

Glenn D. Miller

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October 24, 2000

Honorable Donald A. Manzullo
Room B363
Rayburn House Office Building
Washington, D.C. 20515

Dear Congressman Manzullo:

I appreciated your letter of October 3, 2000 requesting input regarding the impact of the complexity of the tax code on small business. The transcript of David Lifson and his remarks to the Small Business Subcommittee on Tax, Finance, and Exports held much interest to me. I agree with many of his remarks.

My practice serves many small business persons in the Rockford regional area. I also have several clients in other regions of Illinois and other states. Tax preparation and planning is a major portion of my practice. Industry groups served by my firm include professional service firms, real estate and construction firms, various types of non professional service companies, and estates and trusts. I have also worked with farmers and small manufacturing companies.

Many of the small business clients I serve, directly or indirectly state their feelings of confusion and perplexity with various areas of the tax code and regulations. They are not neccessarily in favor of elimination of the Internal Revenue Code (IRC), just some reasonable fairness and simplicity to it.

As requested, I offer to you some of my thoughts on areas of tax law ripe for streamlining, adjustment, or outright elimination, especially in relation to their impact on small business and agriculture.

* Elimination of the alternative minimum tax (AMT).
  Both the corporate and individual AMT should be eliminated. Complexity is caused by the need to compute tax liability twice. The various adjustments to perform the computation are beyond most taxpayers level of reasoning.

* Simplify the UNICAP provisions of IRC Section 263A.
  This law especially adds complexity for the manufacturing clients. Establish some safe harbor rules and decrease the complexity of the provisions and rules.

* Estimated tax payment rules. The so called safe harbor rules to avoid penalties have been changed frequently in the last several years. Establish a 100 percent safe harbor percentage and stick to it. Also, establish the quarterly periods as calendar quarters, rather than the current three, five, eight, and twelve month periods respectively.

* Small business retirement plans. While further options have been opened up to small businesses in recent years, there is still much to do. In general, provide for cost effective, simple plans that maximize participation and minimize paperwork.

* Cash basis of accounting. The ceiling for use of the cash method should be further increased to a higher, yet fair amount.

* Phase out ranges for various provisions. These ranges add significant complexity. They should be eliminated entirely or have standard, indexed ranges for ALL provisions to which they apply.

It is important to keep in mind that the complexity to small business hits not only my clients, but myself as well. My ability to serve and advise the people I serve is constricted and hampered.

I would be happy to discuss my comments further. Please contact me if I can be of further assistance.

Sincerely,

Leland L. Freberg, CPA
Leland L. Freberg
Certified Public Accountant
Limited Liability Company

FY 1999 National Taxpayer Advocate's Annual Report to Congress

Legislative Proposals

[Click for Text Only Version]

Introduction

As noted in the section addressing the most significant problems faced by taxpayers, the complexity of the tax law heads the list of taxpayer concerns. Chief among the complaints received is the burden constant changes in the tax laws have on taxpayers' efforts to comply. The effect of any new law change needs to be considered in this context. Therefore, we urge Congress to limit any new tax law changes. However, we believe that the proposals listed in this section can have a beneficial impact on overall tax simplification and improve the fairness and equity of the tax system.

The National Taxpayer Advocate recommends changes in the Internal Revenue Code directly to Congress where current Internal Revenue Code requirements create inequitable treatment or where such change will alleviate barriers to tax compliance such as through tax simplification. Taxpayer Advocate Service employees routinely identify situations where current law may prevent the resolution of taxpayer problems, or where it is determined that service might be improved or burden to the taxpayer reduced by a legislative change. Internal and external stakeholders also refer issues to the Taxpayer Advocate Service that require legislative change.

In the Fiscal Year 1997 Annual Report, we recommended 18 proposals, five of which were in some measure incorporated into the Restructuring and Reform Act of 1998 legislation. The remaining 13 proposals were resubmitted for inclusion in the Fiscal Year 1998 Annual Report. We are again submitting 12 of those proposals in addition to 22 legislative proposals that were first recommended in the Fiscal Year 1998 report. We believe these proposals are still relevant; several have been included in bills that did not pass and other proposals are consistent with recommendations made by the Joint Committee on Taxation, Treasury's Office of Tax Policy and external stakeholder groups.

During fiscal year 1999, the National Taxpayer Advocate continued to encourage suggestions for improvement from a variety of internal and external sources and received a number of legislative proposals for consideration. We developed recommendations as the result of Problem Solving Day contacts, Senate Finance Committee correspondence and Taxpayer Advocate Service cases. The National Taxpayer Advocate staff also

developed proposals resulting from interaction with the functional business areas within the IRS. The Taxpayer Equity Committee and regional advocacy councils submitted several proposals, which are included in the 19 new proposals contained in this report. Tax practitioners, state tax associations and professional associations submitted proposals. The Citizen Advocacy Panels also included legislative recommendations in their suggestions for improvement to IRS processes.

Fifty-three legislative proposals, (12 first made in fiscal year 1997, 22 from fiscal year 1998 and 19 new in fiscal year 1999) are grouped by issue. The fiscal year 1999 proposals are labeled "new" before the number and the fiscal year 1997 and fiscal year 1998 proposals are labeled "prior." A comprehensive table of legislative proposals can be found at the end of this section.

Following are the broad topical areas and links to the 53 proposals:

Credits/Offsets
1. Date of Application
2. Extend Statute for Claims

Deductions
3. Education Loans
4. Home Ownership
5. Residential Property
6. Computer Software

Disclosure
7. Suicide Threats

Early Withdrawal Tax/Retirement Plans
8. Waiver to Pay Tax
9. Waiver in Cases of Hardship

Earned Income Tax Credit
10. Simplify Eligibility Requirements
11. Qualifying Child (Definition)
12. Qualifying Child (Household)
13. Age Requirements
14. Exempt From Offsetting

Expenses (Business)
15. Employee Business Expenses
16. Internal Revenue Code Section 179 Property

Interest
17. Abatement for Nondeficiency Taxes
18. Fixed Rate of Interest for Installment Agreements
19. Compound Interest
20. Limit Interest on Tax Liability
21. Abatement for Error and Delay
22. Abate Interest in Hardship

Miscellaneous
23. Provision for Error Correction
24. Examination of Returns/Assessments - Small Dollar
25. Filing Date

26. Information Reporting

Payment of Tax
27. Installment Payments
28. Abatement of Tax

Penalty
29. Mitigation of Failure to Pay Penalty
30. Estimated Tax Penalty
31. Eliminate Failure to Pay Penalty
32. Waiver of Failure to Pay Penalty in Installment Agreements
33. Reasonable Cause - Frivolous Return

Refunds
34. Extend Statute - Deficiency Reversed
35. Undeliverable Notification
36. Prepaid Credits
37. Credit Elects
38. Invalid Assessments
39. Extend Statute - Reliance on Government Agency
40. Reverse Offsets in Hardship
41. Offset Bypass Other Debts in Hardship
42. Override Refund Statute

Tax Collection
43. Limitation on Collection Waiver

Tax Preparation/Reporting Treatment
44. Married Couples Operating a Business
45. Charitable Contributions
46. Taxability of Social Security Benefits
47. Income Averaging for Commercial Fishing
48. Automatic Extension to File
49. Rounding
50. Alternative Minimum Tax
51. End of Year Repayment
52. Repayment Previously Reported
53. Phase-out Deductions/Exemptions

Comprehensive Explanation of Legislative Proposals to the Internal Revenue Code

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Credits/Offsets

This section includes proposals that allow taxpayers the benefit of prepaid credits when applied to other liabilities and extend the claim period to receive a refund of levy proceeds.

1. Date of Application

(Prior #27) -- *Allow an Overpayment Credit to Be Applied to Other Liabilities as of the Same Date That the Credit Would*

Have Been Applied to Tax on the Overpaid Return. [Sections 6601 and 6611]

Current Law: Section 6601(f) states that if any portion of a tax is satisfied by an overpayment, then no interest shall be imposed on the portion of the tax satisfied during the period that interest would have been allowed on the overpayment of tax had it not been applied.

Section 6611(b)(3) provides that, for a tax return filed after the last date prescribed for filing such return (including extensions), no interest shall be allowed or paid for any day before the date on which the return is filed. Therefore, when a taxpayer files a delinquent return with an overpayment of credits, the credits will be credited to another tax period as of the date the delinquent return is received.

Reason for Change: Most overpaid delinquent returns are prepaid by withholding, estimated tax, deposits or other credits paid or deemed paid prior to the filing of the related return. The Treasury generally has possession of the funds prior to the return filing date. These amounts are applied to the liability for which they were originally designated as timely payments, unless actually received later. Penalties and interest imposed for balances owed for the later periods are perceived as inconsistent and unfair since there is a widespread perception that there is no penalty for the late filing of a refund return.

Proposed Change: Amend section 6601 to allow an overpayment credit (or portion thereof) to be applied to other liabilities as of the same date that the credit would have been applied to tax on the overpaid return.

2. Extend Statute for Claims

(Prior #32) -- *Allow Taxpayers to Get A Return of Levied Property During the Two-Year Period From the Date of the Levy [Section 6343(d)]*

Current Law: Section 6343(b) was added to the law by the Federal Tax Lien Act of 1966. It amended section 6343 (relating to the authority to release levy) to allow for the return of property where the Secretary determines the property has been wrongfully levied upon. Property may be returned anytime; however the return of money levied upon or received from the sale of property may only be returned within nine months from the date of the levy. Legislative history suggests that the purpose for the nine month period is to encourage third parties who claim an interest in the property seized to take prompt action to recover their property. If the IRS seizes property under the belief that it belongs to the taxpayer, collection action may be ended because the liability is satisfied. However, later the IRS may find that under the law the money must be returned.

The same nine month limitation mandated by section 6343(b) applies to section 6343(d). Section 6343(d), which allows for the return of property in certain cases, was added to the Internal Revenue Code as part of TBOR2. These "certain cases" include four situations where any property levied upon may be returned to the taxpayer if the Secretary determines that the return is proper under the law. This section further refers to prior law section 6343(b) for the provisions stating "the provisions of section (b) shall apply in the same manner as if such property had been wrongfully levied upon."

Reason for Change: While there are situations where the IRS wrongfully levies a third party and the levy is not discovered within the nine month period for refund under section 6343(b), anecdotal information suggests that these do not occur frequently. We are seeing more taxpayers affected by this nine month limitation under the provision of section 6343(d) that states "the levy on such property was premature or otherwise not in accordance with administrative procedures of the Secretary."

A recent Chief Counsel opinion, and a Significant Service Advisory on the termination of installment agreements and subsequent levy/seizure actions because the taxpayer would not sign an extension of statute, heightened the awareness of the nine month limitation. The IRS was not able to address defaulted agreements where the action was more than nine months old when it was determined that we were handling these agreements improperly. Other taxpayers impacted by the Counsel opinion were able to receive refunds of payments made for the prior two years, under section 6511(a), because their payments were considered overpayments because of the improper statute extension and did not involve levy or seizure action.

Recent reviews of open and closed seizure cases also identified situations where administrative procedures were not followed prior to the seizure and sale; however, any possibility of returning money was barred by the nine month limitation. The nine month period appears to be an arbitrary number of months, which can result in inequitable treatment of taxpayers.

Proposed Change: Change the wording in section 6343(d) to "the provision of subsection (b) shall apply in the same manner as if such property had been wrongly levied with the following exceptions:

- an amount equal to the amount of money levied upon or received from such sale may be returned at any time before the expiration of 2 years from the date of such levy,
- no interest shall be allowed under subsection (c)."

Deductions

This section includes proposals to simplify individual, residential, rental, and business deductions.

3. Education Loans

(Prior #3) -- *Simplify Education Loan Interest Deductions [Section 221(d)]*

Current Law: The Tax Reform Act of 1997 allows interest deductions for qualified education loans for 60 months. However, the 60-month term is confusing as to when it begins and ends and any periods of suspension. Taxpayers must keep records to verify the qualified expenditures. Records from several years ago may not be available for inspection.

Reason for Change: Replacing the 60-month limit on the deduction with a lifetime dollar limit will result in better compliance and decreased complexity. Additionally, taxpayer burden will be reduced by simplified rules

and record keeping standards that are easily attainable for documenting deductions of interest for qualified education loans.

Proposed Change: Replace the 60-month limit on the deduction with a lifetime dollar limit and simplify the rules for documenting deductions of interest for qualified education loans.

4. Home Ownership

(Prior #4) -- *Simplify Home Ownership Deductions [Sections 163(h)(B) and 163(h)(C)]*

Current Law: Acquisition points and refinancing points receive disparate treatment because of complexities in the law. All home mortgage points are eventually deductible. Some are amortized over the life of the loan, while some are deducted in the year of the loan. Current law also allows deductible mortgage interest only to the extent that it does not exceed the fair market value of the principal residence. A fully-secured loan may become only partially deductible in a declining housing market. Recently, home equity lenders have begun offering equity loans up to 135 percent of fair market value. There is no ready mechanism to alert taxpayers who will inadvertently claim deductions greater than those allowed because under current reporting rules, lenders send a Form 1098 showing the full amount of interest paid.

Reason for Change: For deductibility of points, simplification will eliminate the complex calculations required of taxpayers and help them comply with the requirements. For interest deductibility, budget savings will result due to increased taxpayer compliance with smaller enforcement costs. Taxpayers and even some tax professionals are not aware of these limitations, causing excess deductions to be taken. In declining housing markets, such as in Texas and California in the 1980's, many taxpayers probably did not adjust deductible interest. A built-in safe harbor could protect taxpayers from declines. In light of greater than 100% equity lending trends, safe harbors or tables would be simpler than current, often incorrect, estimates and calculations and be less expensive than enforcement costs and lost revenue caused by excessive deductions.

Proposed Change: Change section 163(h) to allow a deduction for all refinancing mortgage points for personal residences in the year paid. Simplify the rules, which link the deductibility of interest on loans for original purchase, refinance, or home equity to the current fair market value of the home. Provide purchase safe-harbors and simple conversion tables.

5. Residential Property

(Prior #6) -- *Simplify Deductions Used on Residential Rental Property [Section 179]*

Current Law: Currently, personal property purchased and used in connection with residential rental property must be depreciated over seven years. Many taxpayers are not aware of the limitation imposed by section 179, and the cost of certain personal property is often listed on the tax return as another expense and deducted in full in the year of purchase. Section 179 (d)(1) defines 179 Property and states that it does not include property described in section 50(b). Section 50(b)(2) is "PROPERTY USED FOR

LODGING" and excludes non-lodging commercial facilities, hotels and motels and certain certified historic structures. Therefore, residential rental property is section 50(b) property.

Reason for Change: A change to section 179 will result in simplification and increased compliance. This common error and misclassification are normally uncovered during an audit. This burdens the taxpayer with interest and possible penalties when the correct procedure is not followed.

Proposed Change: Change section 179 to permit full deductions in the year the expense occurs for personal property (carpeting, refrigerators, washers, etc.) purchased and used in connection with residential rental property.

6. Computer Software

(Prior #8) -- *Simplify Deductions for Business Software [Section 167(f)]*

Current Law: Current law provides that most software must be amortized over 36 months. Common software for word processing, communications, and tax preparation is usually updated within the current 36-month recovery period. This causes additional complexity in tax preparation when the deduction is claimed over several years.

Reason for Change: Compliance would increase with a decrease in complexity. The 36-month period is regularly overlooked by many taxpayers.

Proposed Change: Amend section 167(f) and include computer software in section 179(d)(1) as section 179 Property to allow the direct deduction in the year of purchase of non-customized computer software up to a specified dollar limit.

Disclosure

This section proposes to extend disclosure authority for suicide threats.

7. Suicide Threats

(Prior #16) -- *Extend Disclosure Authority for Suicide Threats to Local Enforcement Agencies [Section 6103]*

Current Law: Section 6103(i)(3)(B), "Emergency Circumstances," allows the Service to disclose necessary return information to any Federal or State law enforcement agencies in situations involving danger of death or physical injury, but it may not provide information to local law enforcement authorities, such as county, city, or town police.

Reason for Change: When a taxpayer threatens suicide as part of a tax-related issue, the IRS employee who hears the threat is prevented from contacting local law enforcement authorities. These authorities are usually the closest to the situation and are in closer contact with suicide hot lines and other social agencies that may be available to help the individual. Often, the individual's address that is available to IRS employees through various

records, is the information that would most aid a local law enforcement agency. This action could save the life of an individual who may be suffering serious stress from a tax-related situation. This is an extremely sensitive area and a great deal of discretion would need to be exercised. However, the potential to save a human life clearly prevails over other concerns.

Proposed Change: Amend section 6103(i)(3)(B) to allow the IRS to contact and provide information to specified local law enforcement agencies when a creditable suicide threat is received.

Early Withdrawal Tax/Retirement Plans

This section includes proposals to waive the 10% addition to tax for early withdrawal in hardship cases and where the amount withdrawn is used to pay taxes.

8. Waiver to Pay Tax

(New) -- *Waive the 10% Addition to Tax for Early Withdrawal from Retirement Plans for Payment of Federal Taxes*

Current Law: Section 72(t) imposes a 10 percent addition to tax for early withdrawals from an IRA or other qualified plan. Section 3436 of the Restructuring and Reform Act of 1998 created an additional statutory exception to section 72(t) for early distributions made after December 31, 1999, resulting from a levy under section 6331 of the Internal Revenue Code. Chief Counsel Notice N (36)000-2 announcing a change in litigation position effectively accelerated this date to cover all open years.

Reason for Change: We are concerned that taxpayers who withdraw funds voluntarily from a qualified IRA to pay assessed Federal taxes will receive disparate treatment because such withdrawals are subject to the 10% tax. There are currently fifteen statutory exceptions to section 72(t) for early distributions.

Proposed Change: Allow the waiver of the 10% addition to tax for early withdrawal from an IRA or other qualified retirement plan when such withdrawal is for the payment of assessed tax.

9. Waiver in Cases of Hardship

(Prior #39) -- *Waive the 10% Addition to Tax for Early Withdrawal from an IRA or Other Qualified Plan in Cases of Hardship [Section 72t]*

Current Law: Section 72(t) imposes a 10 percent addition to tax for early withdrawals from an IRA or other qualified plan. This is an addition to tax (not a penalty) and, as such, there is no provision for a waiver. Section 402(f)(1) requires that the plan administrator, when making an eligible rollover distribution, provide a written explanation to the recipient. Section 6652(h) imposes a penalty of $10 for each failure to furnish the required statement, up to a maximum of $5,000.

Reason for Change: The plan administrator's failure to furnish the required statement to the recipient of an eligible rollover distribution can result in the taxpayer being liable for thousands of dollars in additional tax, yet the penalty to the administrator is only $10 per failure (maximum of $5,000). In a particular case that came to the attention of the National Taxpayer Advocate's office, when a company went out of business, about 500 employees received distributions that were eligible for rollover and none of them received the required statement from the administrator. Many of these taxpayers were unemployed and could not afford the 10% addition to tax imposed on the distribution, yet the Service does not have the authority to waive the tax.

Proposed Change: Amend section 72(t) to allow the Secretary authority to waive the 10% additional tax when it can be documented that the plan administrator failed to furnish the required statement to the taxpayer.

Earned Income Tax Credit

This section includes a group of proposals that impact the eligibility for, the computation of and the inequity of the offset provisions for the Earned Income Tax Credit.

10. Simplify Eligibility Requirements

(New) -- *Simplify the Earned Income Tax Credit (EITC) [Section 32]*

Current Law: Section 32 allows a refundable credit for low-income wage earners.

Reason for Change: One of the greatest areas of burden for lower income taxpayers is the computation of the Earned Income Tax Credit. This credit has grown in complexity over the years. This issue has been listed in this report for several years as one of the most serious problems facing taxpayers. IRS continually lists Earned Income Tax Credit computation as one of the most common errors made on tax returns.

Unfortunately, the complexity of section 32 has made the Earned Income Tax Credit extremely difficult to compute, especially for the targeted population. The instructions for this credit take-up over three pages in the Form 1040 instructions - not including the two-page Earned Income Tax Credit table or the separate Schedule EIC, which itself has a page of instructions. In what may be a first, the worksheet that is provided in the instructions to "aid" in figuring this credit has its own worksheet (for self-employed taxpayers). However, under current law, there appears to be no way in which the instructions or worksheets could be substantially simplified. The problem is in the complexity of the law.

Many low-income individuals often pay a professional tax return preparer simply so that they can obtain this credit, sometimes finding that the return preparation fee is at least as much as the credit. While the current concern about taxpayers erroneously claiming (and being allowed) the Earned Income Tax Credit is understandable, a simpler system could approximate a form of "rough justice" that would provide this credit to the greatest number of individuals at the least burden to the public. A simpler system would also

have the benefit of being easier to administer while ensuring compliance.

The primary contributor to the complexity of the Earned Income Tax Credit computation is the long list of eligibility tests, modifications to income, and unique definitions of items.

Proposed Change: Amend section 32 to simplify the Earned Income Tax Credit definitions and calculations, in the following ways:

- Redefine "earned income" to be simply wages, salaries, and tips (from line 7, Form 1040) and - if applicable- business income (from line 12, Forms 1040).
- Redefine "qualifying child" to bring it in line with the existing definition of "dependent child."
- Simplify the overall eligibility for the Earned Income Tax Credit to taxpayers who have a "qualifying child" and who have income (Adjusted Gross Income plus tax exempt income) under a certain amount.

This proposal does not change the nature or targeted audience of the Earned Income Tax Credit. It would, however, make the credit comprehensible to many taxpayers who may now forgo the credit or pay more to a tax preparer than they earn from the Earned Income Tax Credit. A simpler Earned Income Tax Credit computation would have the added benefit of allowing the Service to automatically compute the taxpayer's credit without any additional forms or information from the taxpayer.

11. Qualifying Child (Definition)

(Prior #1) -- *Simplify the Definition of Qualifying Child for the Earned Income Tax Credit [Section 32(c)(3)]*

Current Law: Although similar, sections 32 and 151 have somewhat different tests for eligible children for purposes of obtaining the Earned Income Tax Credit and for purposes of obtaining personal exemptions for dependents, respectively. In general, section 32 has a general test, a relationship test, an abode test, and an age requirement. Section 151 (and its companion section 152) have a general test, a relationship test, an age requirement, a support test, and a test for children of divorced parents. The eligibility tests to claim children as dependents under section 151 have been in place for many years and most taxpayers are familiar with them. While the section 32 tests are similar to the section 151 tests, under current law, differences can confuse taxpayers and unnecessarily complicate determining who is a qualifying child for the Earned Income Tax Credit.

Reason for Change: Having two different definitions for eligible children under sections 32 and 151 makes the Internal Revenue Code unnecessarily complex. Taxpayers can easily be confused by the different tests used in section 32 for a "qualifying child" and the tests used in section 151 for a "dependent child." The Internal Revenue Code should adopt a uniform definition of eligible children. Recently adopted provisions of the tax code have attempted to tie their definitions of terms to already existing definitions. For example, section 101 of the Tax Reform Act of 1997, the Child Tax Credit ties its definition of "qualifying child" in part to section 151. To simplify claiming the Earned Income Tax Credit and to reduce the burden on millions of taxpayers, the proposal recommends that the law be changed so

that a more uniform definition is used.

Proposed Change: The proposal would reduce the distinctions between "qualifying child" in section 32, relating to the Earned Income Tax Credit, and "dependent child" as used in section 151(c)(3), relating to personal exemptions for dependents. The proposal amends section 32 to provide that a child is qualified if the child meets the definition of a child claimed as a dependent under section 151(c)(3) and the child has his or her principal place of residence with the taxpayer for over one half the year. (Note: This proposal does not amend section 32's identification and United States residency requirements.)

12. Qualifying Child (Household)

(Prior #21) -- *Amend Section 32(c)(1)(C) to Permit the Earned Income Tax Credit to Taxpayers Who Reside with Other Eligible Adults*

Current Law: Section 32(c)(1)(C) states that, if two or more individuals would be treated as eligible individuals with respect to the same qualifying child for taxable years beginning in the same calendar year, only the individual with the highest Modified Adjusted Gross Income for such taxable years will be treated as an eligible individual with respect to such qualifying child. The term "eligible individual" (defined in section 32(c)(1)(A)(i)) means any individual who has a qualifying child for the taxable year.

A qualifying child is defined in section 32(c)(3) as an individual (1) under age of 19 unless the individual is a student (as defined in section 151(c)(4)) who has not attained the age of 24 or is permanently and totally disabled (as defined in section 22(e)(3)), (2) who is a son or daughter of the taxpayer, or a descendant of the taxpayer, a stepson or stepdaughter of the taxpayer, or an eligible foster child of the taxpayer, (3) the qualifying child (other than eligible foster child) must share the same principal place of abode as the taxpayer for more than one-half of the taxable year. The term "eligible foster child" means an individual who is not a son or daughter, descendant, stepson or stepdaughter of the taxpayer. Additionally, the taxpayer cares for the child as the taxpayer's own child and has the same principal place of abode as the taxpayer for the taxpayer's entire taxable year.

Section 6021 of the Restructuring and Reform Act of 1998 contains an "Amendment Related to the Revenue Reconciliation Act of 1990" that amends section 32. This change removed the identification requirement of qualified children from the definition of eligible individuals and qualifying children [Formerly section 32(c)(3)(A)(i-v)]. Instead, the identification requirements are a prerequisite for claiming the Earned Income Tax Credit.

Reason for Change: The application of the provision would permit the IRS to deny the credit to an otherwise eligible parent of a child who shares expenses with a person with a higher Modified Adjusted Gross Income even if the person with the higher Modified Adjusted Gross Income did not identify the child on his return. We believe that these provisions should only be applicable when the child is a blood relative or legal charge of both otherwise eligible individuals and the child is identified on both tax returns. In LeStrange v. Commissioner, T.C. Memo. 1997-428, the Tax Court held that the provisions of section 32(c)(1)(C) are only operative in those circumstances where both otherwise eligible individuals identify the

qualifying child on their individual returns. The application of section 6021 of the Restructuring and Reform Act of 1998 would negatively impact the otherwise eligible parent of a child who shares expenses with a person with a higher modified Adjusted Gross Income.

Proposed Change: Amend section 32(c)(1)(C) so that the Earned Income Tax Credit is not denied to taxpayers /parents (with qualified children) who would otherwise be entitled to the credit, merely because they share household expenses with another adult who could claim the credit, if the person with the higher Modified Adjusted Gross Income did not identify the child on his return. Additionally, this should only apply if the child is a blood relative or legal charge of the other adult. This would eliminate an "eligible foster child" from the definition of a qualified child when applying this section.

(***Note:*** Recently passed legislation narrows the definition of eligible foster child so that the tie breaker rule will no longer be reached in the case of unrelated adults living together. The rule may still be a problem for relatives sharing the same household.)

13. Age Requirements

(Prior #22) -- *Eliminate the Age Requirement for Taxpayers to Qualify for the Earned Income Tax Credit [Section 32(c)(1)(A)(II)]*

Current Law: Section 32(c)(1) defines "Eligible Individual" for claiming the Earned Income Tax Credit. The term "eligible individual" means (1) any individual who has a qualifying child for the taxable year, or (2) any other individual who does not have a qualifying child for the taxable year, if the individual lives in the United States for more than one-half of the taxable year and the individual has attained age 25 but not attained age 65 before the close of the taxable year (section 32(c)(1)(A)(II)). Additionally the individual may not be a dependent for whom a deduction is allowable under section 151 to another taxpayer for the taxable year.

Reason for Change: This is inequitable to taxpayers who are under 25 and over 64 with no dependents whose income is within the range for Earned Income Tax Credit (under $9,770 for 1997 with a maximum credit of $332 available). Not allowing the Earned Income Tax Credit to taxpayers under age 25 who are independent is especially unfair. These persons (between 19 -24 years old) are not eligible to be claimed as dependents because they are not full-time students.

Proposed Change: Amend section 32(c)(1)(A)(II) to allow taxpayers under the age of 25 to qualify for Earned Income Tax Credit if they meet the other qualifications found in section 32 and amend section 32(c)(1)(A)(II) to allow taxpayers over 64 to claim the credit if they do not receive Social Security Benefits.

14. Exempt From Offsetting

(Prior #38) -- *Exempt the Earned Income Credit (EITC) from Offsetting to Federal Tax and Debtor Master File (DMF) Liabilities [Section 6402(a)]*

Current Law: Section 32(a) sets forth the allowance of a credit for eligible individuals. To be eligible, taxpayers must be working/wage earning, low income, and have a qualifying child living with them. Congress originally enacted this to encourage low-income families to stay employed rather than going on the welfare rolls. The law has been on the books since 1974. It has been amended and extended many times but the intent has remained the same.

Section 3507(a) sets forth the requirement that employers with employees eligible for the Earned Income Tax Credit shall, upon request by the employee, include the Earned Income Tax Credit amount at the time of paying the employee's wages. In other words, employees may, upon request, receive the Earned Income Tax Credit throughout the year rather than at the time of filing their tax return. Experience has shown that very few of those employees eligible receive the Advanced Earned Income Tax Credit even though it is available to them.

Sections 6402(a), (b), and (d) set forth the provision of law commonly known as the refund offset program. These sections give the authority/requirement that overpayment on a taxpayer's account will FIRST be credited to any past due taxes of that taxpayer, next to estimated income taxes, and then to any past due child support which has been certified to the Secretary by that federal agency. If any overpayment exists after the application of these sections, a refund will be issued to the taxpayer. This section of the Internal Revenue Code has been in effect for several years. It too has been amended and extended several times. Initially, the Congressional intent of this provision was the collection of past due child support.

Reason for Change: Congress has set forth a provision allowing the Earned Income Tax Credit as an economic incentive. They have also directed the interception of any overpayments (refunds) including the Earned Income Tax Credit, when the taxpayer has an open Federal tax debt or a liability such as delinquent child support on the Debtor Master File. There is a conflict between these provisions. The refund offset program is a backup collection tool, which, by its very nature results in unequal treatment of taxpayers i.e., a taxpayer may avoid the refund offset provision by simply adjusting his or her withholding so that no overpayments exist when the tax return is filed. In addition, Congress directed the interception of ANY overpayment available including the Earned Income Tax Credit. In addition, a qualified taxpayer who elects to receive the Advanced Earned Income Tax Credit will receive that credit throughout the year, thus avoiding the refund offset provision of the Internal Revenue Code. This creates inequitable treatment of taxpayers in similar positions since the taxpayer that does not take the Advanced Earned Income Tax Credit is penalized by having their refund offset to other debts. It also undermines the intent of the Earned Income Tax Credit as an incentive for the working poor to remain employed since they receive no benefit from the credit.

Proposed Change: Amend section 6402(a) to exempt the Earned Income Tax Credit from offset.

Expenses (Business)

This section includes proposals that will allow more equitable treatment of

business deductions for both employees and self-employed individuals.

15. Employee Business Expenses

(Prior #2) -- *Amend Deduction for Reimbursed Employee Business Expenses [Section 62(a)(2)]*

Current Law: Certain reimbursed trade and business expenses of employees are deductible under section 62(a)(2). The deductions are allowed by part VI (section 161) and consist of expenses paid or incurred by a taxpayer, in connection with the performance of services as an employee, under a reimbursement or other expense allowance arrangement with his or her employer. The expenses that are unreimbursed are deductible from Adjusted Gross Income as itemized deductions (section 63(d)) and are subject to the 2 percent floor of section 67.

Reason for Change: Current treatment of employee business expenses is inequitable to taxpayers who are not reimbursed by their employers and do not itemize deductions. These taxpayers, who are paying for expenses for their employer's benefit without being reimbursed, may not have sufficient other deductions such as home mortgage interest or charitable contributions to claim itemized deductions. Other taxpayers may not have sufficient deductions to exceed the 2 percent floor of section 67. These taxpayers are therefore not allowed the benefit of deducting legitimate expenses that others can deduct simply because their employer does not reimburse expenses.

Proposed Change: Change section 62(a)(2) to allow employee business expenses greater than employer reimbursement and unreimbursed expenses to be reported as a deduction from gross income instead of a Miscellaneous Itemized Deduction (subject to the 2% of Adjusted Gross Income threshold) on Schedule A.

16. Internal Revenue Code Section 179 Property

(Prior #7) -- *Allow Section 179 Expenses to be Claimed in Whatever Year the Taxpayer Makes the Election*

Current Law: A taxpayer may elect to treat the cost of any section 179 property as an expense that is not chargeable to capital account. Any section179 property cost is allowed as a deduction for the taxable year in which the section 179 property is placed in service.

Reason for Change: Taxpayers may not be able to receive the benefit of the §179 expense for the year of purchase. They should not be denied this deduction.

Proposed Change: Allow taxpayers to elect to claim section 179 expense in whatever year they choose.

Interest

This section includes several proposals that would broaden the interest abatement requirements and limit the assessment of interest on balances

owed.

17. Abatement for Nondeficiency Taxes

(New)-- *Extend the Abatements of Interest Provisions Attributable to Errors and Delays to Nondeficiency Federal Taxes [Section 6404(e)(1)]*

Current Law: Section 6404(e) sets forth the rules for abatements of interest that are attributable to unreasonable errors and delays by IRS. Section 6404(e)(1) (B) limits the types of tax on with interest may be abated to "any tax described in section 6212(a)." This effectively limits the authority to abate interest under section 6404(e) to income, estate, gift, generation skipping, and certain excise taxes. This generally precludes abatements of interest on employment taxes, the remainder of excise taxes, and certain other taxes.

Reason for Change: Many situations arise in which the abatement of interest under section 6404(e) is appropriate. As with other types of taxes, errors and delays sometimes occur in the administration of employment, excise, and other tax issues. Employment taxes, especially, create a large number of processing problems and (as a result) a significant number of Taxpayer Advocate Service cases. Allowing the provisions of section 6404(e) to apply to these other taxes would serve the dual purpose of increasing the efficiency of the tax system and being more equitable to taxpayers.

Proposed Change: Remove the limitations on the types of taxes on which interest may be abated by deleting the words "described in section 6212(a)" from section 6404(e)(1) (B).

18. Fixed Rate of Interest for Installment Agreements

(New) -- *Amend Section 6621 to Allow a Fixed Rate of Interest When The Taxpayer Has a Valid Installment Agreement*

Current Law: Section 6621(a)(2) states that the interest underpayment rate will be the sum of the Federal short-term rate determined for the first month in each calendar quarter beginning after such month [section 6621(b)] plus 3 percentage points. Therefore, when a taxpayer is given an installment agreement the interest rate has the potential of changing every quarter through the life of the agreement.

Reason for Change: The adjustment of the interest rate for underpayments greatly complicates the computation of interest. When establishing an installment agreement, the Service is unable to give a taxpayer an exact pay-off date or a total of the amount to be paid due to the inevitable fluctuation of the rate of interest. Allowing taxpayers to have a fixed-rate installment agreement would have the dual benefit of simplifying the installment agreement process for both taxpayers and Service employees. To protect taxpayers when interest rates are declining, provision for adjusting the interest rate downwards would need to be included in this provision. This is similar to the situation with a fixed-rate home mortgage loan, where the mortgage holder is protected from rate increases, but may re-finance if rates fall. Without this downward adjustment, taxpayers with valid agreements might be tempted to default when interest rates decline.

Proposed Change: Amend section 6621 to allow a fixed rate of interest,

which could be adjusted downward for taxpayers with valid installment agreements. Make the appropriate changes to section 6622, requirement for compounding interest daily, and cross reference section 6159, Agreements for Payment of Tax Liability in Installments. Provisions should address the scope and nature of the usage of the fixed interest rate and state criteria for determining the applicable rate of interest (i.e. whether the is rate determined when agreement is submitted or when accepted).

19. Compound Interest

(Prior #9) -- *Apply Compound Interest Based Only on the Underlying Tax [Section 6622(b)]*

Current Law: Section 6622 was added to the Internal Revenue Code in 1982 and made effective for interest accruing after December 31, 1982. This section provides for interest to be compounded daily. Section 6622(b) specifically identifies that, with respect to additions to tax under sections 6654 (Individual Estimated Tax Penalty) and 6655 (Corporation Estimated Tax Penalty), interest does not apply. [In all other cases of penalties and/or additions, compounded interest is then considered to apply.]

Reason for Change: The application of compounded interest to penalties and additions to tax artificially raises the effective interest rates to a level significantly higher than even prevailing unsecured liability rates. Private business practice does not add interest to additions. For example, an addition for late payment of one month's payment on a mortgage or credit card payment is added to only the payment that is late. It does not affect other payments nor is interest computed on the addition. Also, the inordinately high number of penalties in the Internal Revenue Code often results in several penalties being applied simulta-neously to the same tax, all with compounding interest. Recent events have graphically demonstrated that Congress did not intend for these exorbitantly high tax liabilities to be artificially computed.

Proposed Change: Amend section 6622(b) to read, "Exception for Penalties or Other Additions to Tax. - Subsection (a) shall not apply for purposes of computing the amount of any penalty or addition to tax authorized under this title."

20. Limit Interest on Tax Liability

(Prior #10) -- *Limit the Total Amount of Interest That Can Accumulate on a Liability to 200% of the Underlying Tax Liability [Section 6601(a)]*

Current Law: Section 6601(a) provides that interest will be computed "for the period from such last date [generally the return due date] to the date paid." There is no limit on the amount of interest that may accrue.

Reason for Change: Over the past few years, the IRS and Congress have heard stories in which accruals have raised a tax liability to many times its original amount. In some situations, the assessment and collection processes have been extended for many years and the taxpayer's current age, health, and financial situations have changed to the point that these interest accruals can never be paid. Precedence is found in the Internal Revenue Code for limiting

additions to a percentage of the tax in many penalties present. For example, the Failure to File Penalty is limited to a maximum of 25 percent of the underlying tax.

Proposed Change: Amend section 6601(a) by adding "or until the accrued interest reaches 200% of the underlying tax." to the end of the sentence.

21. Abatement for Error and Delay

(Prior #29) -- *Abate Interest Attributable to Unreasonable Errors and Delays by Internal Revenue Service [Section 6404(e)]*

Current Law: Section 6404(e)(1), under Abatement of Interest Attributable to Unreasonable Errors and Delays by Internal Revenue Service, states that the Secretary may abate the assessment of all or part of interest attributable in whole or part to unreasonable error or delay by an officer or employee of the IRS in performing a ministerial or managerial act. The application of these provisions and the definitions of ministerial and managerial act in the regulations prevents the IRS from addressing situations where considerations of equity and fair tax administration require the abatement of all or part of the assessed interest.

Reason for Change: Interest abatement issues have continually plagued taxpayers and the Service. A significant portion of the cases worked in the Problem Resolution Program over the last twenty years have involved interest abatement issues and the problem has surfaced as one of the major Problem Solving Day issues as well. Prior to 1986, the Service was allowed to make few adjustments to interest assessments absent an assessment in error. The Tax Reform Act of 1986 provided for the abatement of interest attributable to unreasonable delays and errors by the Service for certain "ministerial acts" in instances "where the failure to abate would be widely perceived as grossly unfair." Determining what constituted a "ministerial act" for purposes of the statute and its implementing regulations was confusing for Service personnel and for the taxpayer. Accordingly, interest was rarely abated under the "ministerial act" provision of the statute, unless the taxpayer's specific situation mirrored one of the examples provided in the applicable regulations.

With the passage of Taxpayer Bill Of Rights 2, an additional basis for abatement of interest was added to section 6404. Assessed interest which is attributable to unreasonable error or delay by the Service for certain "managerial acts" can also be abated. The proposed regulations defining "managerial acts", however, are very limited in scope and relief continues to be unavailable for certain taxpayers where it is undisputed that the interests of fairness and efficient tax administration would be better served by the abatement of specific interest accruals. Included among these would be abatement of interest in situations where erroneous advice has been provided to a taxpayer by the IRS.

Proposed Change: Amend section 6404(e) by renumbering subsection (e)(2) as (e)(3) and adding the following new subsection:

Section 6404(e)(2) Exception, --Notwithstanding any provision of paragraph (e)(1), the Secretary may abate any assessment of interest or portion thereof, attributable to unreasonable error or delay, where the Secretary determines that the failure to abate such assessment is not in the best interest of the taxpayer or the United States.

(*Note*: Treasury is still considering revision to the regulations related to abatement of interest and to expanding the applicability of these provisions.)

22. Abate Interest in Hardship

(New) -- *Amend Section 6404(e) to Allow the Internal Revenue Service to Abate Interest in Hardship Situations*

Current Law: Section 6404(e)(1), Abatement of Interest Attributable to Unreasonable Errors and Delays by the Internal Revenue Service, states that the Secretary may abate the assessment of all or part of interest attributable in whole or part to unreasonable error or delay by an officer or an employee of the Internal Revenue Service in performing a ministerial or managerial act.

Reason for Change: The provisions are limited and do not provide relief for situations where considerations of equity and fair tax administration require the abatement of all or part of the assessed interest. In addition, the narrow definition of ministerial and managerial act prevents the abatement of interest in some situations where there are errors or delays. Senate Finance Committee and Problem Solving Day cases have reflected situations where the taxpayer was experiencing significant hardship and relief could be provided by a partial abatement of interest but the law prevented the IRS from providing that relief.

Proposed Change: Add subsection (j) to section 6404, Abatements, to allow IRS to abate interest in situations where the taxpayer is experiencing a significant hardship, where failure to take the action would result in a gross disservice to the taxpayer, or where it would be considered equitable treatment of the taxpayer as defined by regulation.

Miscellaneous

This section includes a group of miscellaneous proposals that would benefit both the taxpayer and the IRS by reducing burden, resolving inequities and clarifying situations that cause taxpayer error.

23. Provision for Error Correction

(New) -- *Permit the IRS to Correct Its Errors in Taxpayer Cases*

Current Law: The IRS has only limited authority to correct errors it makes in handling taxpayer cases. For example, where the IRS determines it has improperly levied on property, section 6343(b) allows, within nine months of the date of the levy, the IRS to return money in an amount equal to that received from the sale of such property. As another example, section 6404(e) permits the Service to abate interest when a taxpayer has been assessed additional interest resulting from any unreasonable error or delay by an IRS employee in the performance of a managerial or ministerial act, as long as the taxpayer did not contribute significantly to the delay.

Reason for Change: A taxpayer may experience inappropriate and adverse consequences as a result of an IRS error. While the Code allows the IRS to

provide relief for certain errors, it does not contain express statutory authorization to permit the IRS to correct errors generally. A provision granting the IRS general authority to correct mistakes would make the tax system fairer for all taxpayers.

For example, assume the IRS incorrectly seized and liquidated a taxpayer's Individual Retirement Account in 1990 and applied that money to fully satisfy an outstanding tax liability for a prior year. The taxpayer claimed, at the time of the seizure, that she did not owe this liability. Nevertheless, she paid the ten percent penalty and the appropriate income tax for 1990 on the early distribution of the IRA. In 1991, she wrote to the IRS explaining that she did not owe the liability for the prior year and asked that the IRS refund her the IRA proceeds. The IRS did not respond to her letter.

In 1998, the IRS realizes that the taxpayer did not, in fact, owe the liability that was satisfied with the IRA proceeds. The IRS admits its error and, based on the taxpayer's earlier informal claim, refunds to her the amount of the mistaken liability. Under current law, the IRS cannot re-establish the taxpayer's IRA and cannot refund the ten percent penalty or the additional 1990 income tax generated by the early distribution of the IRA.

Proposed Change: Where it is in the best interests of both the taxpayer and the United States, permit the IRS to provide appropriate relief from the effect of any provision of the Code to taxpayers where (1) the IRS makes a clear and demonstrable error in handling a taxpayer case, (2) the taxpayer has operated in good faith and has not contributed to the error, and (3) the taxpayer's tax position has been impaired by the error. Appropriate relief would generally involve both the taxpayer and the IRS being restored to the tax positions they were in before the error occurred.

24. Examination of Returns/Assessments - Small Dollar

(Prior #19) -- *Accept Telephonic Agreements to Close Cases with Assessments Under $1,500 [Sections 6213(a) and (b)(4)]*

Current Law: Section 6213(a), Restrictions Applicable to Deficiencies; Petition to Tax Court, states that within 90 days, or 150 days if the notice is addressed to a person outside the United States, after the notice of deficiency is mailed (not counting Saturday, Sunday, or a legal holiday in the District of Columbia as the last day), the taxpayer may file a petition with the Tax Court for a re-determination of the deficiency.

Section 6213(b)(4) states in part that, in any case where such amount is paid after the mailing of a notice of deficiency, such payment does not deprive the Tax Court of jurisdiction over such deficiency determined without regard to such assessment.

Reason for Change: The IRS does not have the authority under section 6213(a) to accept an implied consent/or agreement to close cases and assess tax.

In 1990, the Service Center Underreporter functions began an initiative to increase acceptance of oral testimony. The concept was expanded in 1991 to include case closures with assessments based on implied consent (written contacts indicating agreement, but without jurat signatures) or oral (telephonic) agreements. These closures were limited to those cases with

assessments of less than $1,500.

The IRS Chief Counsel determined that under section 6213(b)(4), a signed waiver must be secured from the taxpayer. In 1996, the National Director, Service Center Compliance instructed the IRS Centers not to accept implied consent/oral agreements to close cases. Since the inception of this deviation, Austin Service Center has monitored Audit Reconsideration, PRP, and Late Reply inventories to determine if any taxpayers have raised an objection to an oral agreement. During this six-year period, Austin Service Center did not receive any request for abatement or refund of assessed taxes.

Proposed Change: Amend section 6213 to allow the taxpayer the option of a telephonic waiver of restriction (agreement to an additional assessment) in those cases where the deficiency (not including penalty and interest) does not exceed $1,500. Implementation of this change would reduce taxpayer burden by eliminating an additional taxpayer contact by the IRS to secure formal signatures and reducing the time to close a case, thereby minimizing interest that would accrue. In addition, this change would increase administrative efficiency and result in a cost savings to the IRS Centers.

25. Filing Date

(Prior #11) -- *Amend Section 7502 to Consider the Postmark Date the Filing Date for All Returns or Claims*

Current Law: Section 7502(a) allows for a postmark to be considered the date of delivery for an original return or a claim if that postmark falls within the due date (including extensions) for filing of the return or claim. However, if a taxpayer files a delinquent refund return for 1994 and it is received on April 20, 1998 with a postmark date of April 15, 1998, it will not be considered a timely filed return for the purposes of issuing a refund of prepaid credits because it was received after the return due date.

Reason for Change: Taxpayers misunderstand the postmark rules of section 7502 as they apply to amended or delinquent returns. As a result, refunds and credits have been disallowed for taxpayers filing original returns near the end of the statute of limitations period established by section 6511. The postmark date is material only when a return is filed on or before its due date. If it is mailed after its due date (including extensions), it is considered filed on the date it is received by the IRS.

Proposed Change: Amend section 7502 to allow the postmark date to be considered the filing date for all documents, except for payments filed with the Internal Revenue Service. Section 7502(a)(3) should be added to read:

(1) CLAIMS -- *If any claim for refund or credit (including claims made on properly executed original or amended returns) is postmarked on or before the last date prescribed for allowance of a refund or credit under section 6511, the postmark date shall be deemed the date of delivery.*

26. Information Reporting

(Prior #5) -- *Repeal the Information Reporting Requirements Imposed on Colleges by the New Education Credits Enacted by*

Tax Reform Act of 1997

Current Law: Section 201 of the Tax Reform Act of 1997 provides for a new credit for tuition payments for students or their parents effective in 1998. The statute mandates that colleges provide information documents for tuition paid. A new information-reporting document, Form 1098T, was developed for this purpose.

Reason for Change: The new law requires colleges to collect information that will be of little or no use to the IRS, the college, or taxpayers (student or parents). Colleges must also file information documents with taxpayers and the IRS reporting the tuition paid. This places a large burden on colleges and provides taxpayers with a new document that will be of little use to taxpayers claiming the credit and no use to the large number of taxpayers not taking the credit.

There is a major difference between information reporting on tuition payments and information reporting on interest and dividends. Information reporting on interest and dividends are financial transactions that usually create a taxable event. The payment of tuition like medical expenses, childcare, and dozens of other payments made by individuals may yield a tax deduction or credit - but very often will not. The IRS can check taxpayer compliance of this credit much in the way it does with other credits and deductions. Many types of interest and dividends are difficult for taxpayers to compute (Original Issue Discount, a multi-year Certificate of Deposit, and dividend reinvestment programs etc.). In these cases, information documents are helpful to taxpayers. However, tuition payments are easy to ascertain. Colleges already detail them at great length.

Since various adjustments must be made to the tuition amount when computing the credit (adding certain fees and subtracting others), the amount reported on a Form 1098T is unlikely to be the same as the amount shown as a credit on the return. The college may not have the parents' Social Security Numbers and there is some question about whether the IRS can require the parents to provide them. The parents may not be involved; the student may be paying his or her own tuition and claiming the credit on their own return. The school would not know who would be eligible to claim the credit, in fact it may not be clear to the parents or students exactly who will claim the credit until after the school year is over. Often, Form 1098T will be mailed to the wrong party, at the wrong address, with incorrect amounts. This would make any document-matching program extremely difficult.

Proposed Change: Repeal the information reporting requirements of section 201 of the Tax Reform Act of 1997.

Payment of Tax

This section includes proposals to allow taxpayers another option for payment of tax and to eliminate a section of the code that causes confusion for taxpayers.

27. Installment Payments

(New) -- *Payment of Tax Liability in Installments [Section*

6159(a)]

Current Law: Section 6159(a) states that "the Secretary is authorized to enter into written agreements with any taxpayer under which such taxpayer is allowed to satisfy liability for payment of any tax in installment payments if the Secretary determines that such agreement will facilitate collection of such liability." Under this provision and implementing Treasury regulations, the IRS Chief Counsel has determined that the Service cannot enter into an installment agreement with the taxpayer if payments under the agreement will not fully pay the liability prior to the expiration of the period of limitations for collection as extended by any waiver agreed to by the taxpayer at the time the installment agreement is entered into.

Reason for Change: Often the taxpayer is not able to pay an amount through installments that will full pay his or her tax debt including all penalties and interest. Without the ability to fully pay, the IRS is barred from accepting the taxpayer's proposal for payments. In some of these cases, the taxpayer may qualify for an offer in compromise and be able to compromise his or her tax debt for less than the full amount owed. In other cases, the taxpayer may not qualify for either an installment agreement or an offer in compromise. In these situations, the Service is often faced with either enforcing payment through one or more of the various means available or electing to discontinue efforts altogether. In either case, the taxpayer is harmed through the potential loss of critical assets or through refusal by the government to allow the taxpayer to make payments, that would reduce their debt to the government.

Proposed Change: Amend section 6159(a) to permit the Service to enter into installment agreements with a taxpayer when payments under the agreement may not on the surface fully satisfy the tax liability within the statutory period for collection. If there is any amount remaining after the termination of the statute, it would be treated in a manner consistent with other tax obligations that exist after the culmination of the statutory period for collection. Add the following to paragraph (a):

Section 6159(a)(1) Non-Full Payment Agreements - If the payments under an installment agreement will not fully satisfy the tax liability within the period of limitation for collection including any extension, the Secretary may enter into such an agreement if the amounts to be paid under the agreement exceed the administrative cost of maintaining the agreement and the Secretary determines that such agreement will facilitate collection of such liability.

28. Abatement of Tax

(Prior #31) -- *Repeal Section 6404(b)*

Current Law: Section 6404(a) and (b) have conflicting procedures. Subsection (a) authorizes abatements of the unpaid portion of the assessment of any tax or any liability in respect to that tax which is excessive, is erroneous or illegal or is assessed after expiration of the applicable period of limitation, but subsection (b) states that no claim for abatement shall be filed by a taxpayer in respect of an assessment of Income, Estate, and Gift Taxes. The implication is that the IRS may abate tax on its own initiative, but that taxpayers cannot request the IRS to adjust their tax. IRS offices routinely process claims for abatement of tax and IRS manuals have procedures for processing claims filed within the statute of limitation for reducing tax without requiring that the tax be paid. Section 6404 (a) and (b) were both

parts of the 1954 Code.

Reason for Change: At one time, the IRS insisted that taxpayers pay the amount owed prior to filing a claim for reduction of tax. The 1993 procedures for the Reconsideration of Deficiency Assessments reinforced the change in the audit reconsideration process by providing the taxpayer with the opportunity to present information that was not previously taken into consideration. However, section 6404(b) is often used to deny timely filed amended returns.

Proposed Change: Repeal section 6404(b).

Penalty

This section includes several proposals to eliminate the inequities in the assertions, abatement and computation of penalties.

29. Mitigation of Failure to Pay Penalty

(New) -- *Expand Mitigation of Penalty on Individual's Failure to Pay (FTP) for Months During Period of Installment Agreement*

Current Law: The Restructuring and Reform Act of 1998 section 3303 adds section 6651(h) and provides for the reduction in the Failure to Pay Penalty in cases of timely filed individual returns from .5% to .25% in any month in which an installment agreement is in effect. Section 6651(h) does not, however, provide for halving the penalty, which rises to 1% per month, in any case in which a final notice has been issued.

Reason for Change: The IRS may inadvertently or erroneously issue a final notice in instances where a timely return has been filed and where the taxpayer had either previously contacted the IRS seeking resolution of their account or where administrative practices result in issuance of a notice pursuant to section 6331 through no fault of the taxpayer. Correspondingly, there are other instances where the taxpayer belatedly attempts to resolve an account and is denied any benefit from the mitigation of failure to pay penalty provisions.

Proposed Change: a) Extend the mitigation of Failure to Pay provisions in section 6651(h) when a final notice is issued in error or as the result of administrative practice, and b) Provide a mitigation of the Failure to Pay Penalty provision which reduces the penalty from 1% to .5% in cases of timely filed individual returns in any month in which an installment agreement is in effect where a final notice has been issued.

30. Estimated Tax Penalty

(Prior #12) -- *Simplify the Computation and Assessment of the Estimated Tax Penalty or Eliminate the Penalty and Have Interest Automatically Asserted [Sections 6654(a) and (d)]*

Current Law: Section 6654(a) provides an addition to tax when an individual fails to pay (or underpays) estimated income tax. The addition to

tax or penalty is determined by applying the underpayment rate to the amount of the underpayment for the period of the underpayment. The amount of the underpayment is defined in section 6654(b) as the excess of the "required installment" over the amount paid.

Section 6654(d) defines the "Amount of Required Installments." Generally, the amount of required installments is 25% of the required annual payment. The required annual payment is defined in section 6654(d)(1)(B) as the lesser of (1) 90% of the tax shown on the return for the taxable year or (2) 100% of the tax shown on the return for the preceding taxable year. Section 6654(d)(2)(B) provides for a lower required installment when the annualized income installment is less than the installment computed under the above section [section 6654(d)(1)(B)].

Section 6654(d)(2)(B) provides that for any required installment, an annualized income installment is the excess (if any) of an amount equal to the applicable percentage of the tax for the taxable year computed by placing on an annualized basis (defined in section 6654(d)(2)(C)) the taxable income, alternative minimum taxable income, and adjusted self-employment income for months in the taxable year ending before the due date for the installment over the aggregate amount of any prior required installments for the taxable year. Exceptions to the penalty are found in section 6654(e).

Reason for Change: The current law is extremely complex for taxpayers and difficult for the IRS to administer. The computations required to determine the penalty amount are complex. The "annualized income installment method" which could result in a lesser penalty is inordinately complex. The exceptions to the penalty, for which many taxpayers qualify, are difficult to compute and serve as an additional source of frustration. Taxpayers are required to complete Form 2210 to show that they qualify for an exception that can lower or eliminate the penalty. Form 2210 is one of the most complex and difficult of the current tax forms.

Proposed Change: (1) Simplify section 6654 so that the computation of the underpayment penalty for estimated tax is easier for taxpayers to compute, or (2) Eliminate the penalty and allow the interest to be automatically asserted.

31. Eliminate Failure to Pay Penalty

(Prior #13) -- *Eliminate the Failure to Pay Penalty [Section 6651]*

Current Law: Section 6651(a)(2) and (3) provide for a penalty of 0.5 percent per month for failure to pay the amount shown as tax on a return, not exceeding 25 percent of the aggregate [tax], unless it is shown that such failure is due to reasonable cause. The Omnibus Budget Reconciliation Act of 1985 added section 6651(d) to provide for the computed rate of the penalty to be increased to 1 percent per month after issuance of the notice under section 6331(d), generally called the final notice, or after notice and demand for immediate payment is given under section 6331(a), generally relating to jeopardy situations.

The penalty was implemented in 1970 to effectively raise the interest rate that, at the time, was 6 percent accruing as simple interest on tax only. A penalty was instituted rather than a change in the interest rate because, interest was deductible from taxable income and penalties were not

deductible. The reason for the rate increase effective January 1, 1986, was little more than a process to raise revenue as part of the Omnibus Budget Reconciliation Act. Originally, this increase was referred to as a "Collection Charge."

Reason for Change: The 1983 and 1986 changes to sections 6621 and 6622 provided for interest to be compounded, applied to most additions to tax, and to be adjusted quarterly as the short-term Federal rate changes. These changes have significantly increased the amounts charged as interest and obsolete the need for a penalty to elevate interest to market rates.

Proposed Change: Repeal sections 6651(a)(2), 6651(a)(3), and 6651(d).

32. Waiver of Failure to Pay Penalty in Installment Agreements

(Prior #33) -- *Amend Section 6651 to Waive the Failure to Pay (FTP) Penalty When an Approved Installment Agreement is in Effect*

Current Law: The Restructuring and Reform Act of 1998, modified section 6651 by adding sub-section 6651(h), which provides for a lowering of the Failure to Pay penalty for certain taxpayers who have entered into and are meeting the terms of an installment agreement. For individuals, the penalty amount for failure to pay is reduced to .25 percent for any month in which an installment agreement is in effect. The provision was effective January 1, 1999.

Reason for Change: The provisions in Restructuring and Reform Act of 1998 do not go far enough in providing an incentive for taxpayers to pay tax by an installment agreement when unable to fully pay the tax when due. The number of defaulted installment agreements remains extremely high. A June 1998 GAO report noted that in fiscal year 1997, $6.5 billion defaulted in installment agreement accounts, roughly the same amount that was collected through that method.

Furthermore, the current law, as amended, does not apply to installment agreements once the 1% rate is triggered as provided for under section 6651(d). Instances may occur to trigger the higher penalty charge in section 6651(d) in which the taxpayer has no control. For example, taxpayers may not receive earlier notices timely, if at all. Others may contact the IRS in response to a notice and are placed in final notice status in order to be transferred to collection personnel because of the size or type of account involved. They, too, are precluded from benefiting from this limitation.

Proposed Change: Waive Failure to Pay penalty for any month in which an installment agreement is in effect. The failure to pay penalty would be reinstated for the entire period, however, if the taxpayer were to default the installment agreement prior to completing the terms of the agreement.

33. Reasonable Cause - Frivolous Return

(Prior #34) -- *Amend Section 6702 (Frivolous Income Tax Return) to Permit Reasonable Cause Penalty Relief to Appropriate Cases*

Current Law: Section 6702 provides for an immediate assessment of a $500 civil penalty against individuals who file frivolous income tax returns or frivolous amended income tax returns or claims. The penalty is not based on the tax liability. A frivolous return may be a valid or invalid return. The intent of the law is to reduce or eliminate returns with altered line items or that clearly claims unallowable deductions or credits based on a frivolous position; reasonable cause does not apply. For penalty relief, taxpayers must seek judicial review after first paying the entire penalty.

Reason for Change: Persons filing a blank return or who make a return with a frivolous position were often labeled as "Illegal Tax Protestors" by the IRS in addition to the imposition of the penalty. The Restructuring and Reform Act of 1998 (section 3707) identified a concern that these designations may affect innocent or subsequently reformed taxpayers. As such, the IRS is no longer permitted to designate taxpayers as illegal tax protestors.

During Problem Solving Days and other contacts, we have become aware of a number of instances in which taxpayers had been "duped" to file a frivolous return by another individual or promoter. Later, after realizing their mistake they filed and paid the tax, moreover, establishing a good track record with respect to taxes. Because of the current law, these individuals are unable to assert reasonable cause as an administrative remedy in seeking penalty relief.

In addition, the current $500 penalty provides an insufficient deterrent to those who purposefully file frivolous tax returns or documents. The penalty amount has not changed since 1982. Therefore, we recommend that the penalty amount be raised to $1,500 and that, in light of the higher amount, the taxpayer receive a pre-penalty notification prior to the assertion of the penalty to afford the taxpayer an opportunity to reconsider such action.

Proposed Change: Add " ... unless such failure is due to reasonable cause." Change: "$500" to "$1,500".

Refunds

This section includes proposals that deal with refund statute issues, notification about refunds and other laws that prevent taxpayers from receiving refunds.

34. Extend Statute - Deficiency Reversed

(New) -- *Allow for an Exception to the Refund Statute [Section 6511(a)] When a Deficiency Determination is Reversed.*

Current Law: Section 6511(a) requires that a claim for credit or refund of an overpayment must be filed by the taxpayer within 3 years after the return was filed or 2 years from the time the tax was paid, whichever period expires later, or if no return was filed by the taxpayer, within 2 years from the time the tax was paid. In relation to the amount of the refund, section 6511(b)(2)(B) states that, when a claim is not filed within the 3 year period, the amount of credit or refund should not exceed the tax paid during the 2 years immediately preceding the filing of the claim.

Reason for Change: Current law does not allow refunds to taxpayers after the statute has expired even if a tax deficiency resulted from an error on the part of the IRS or a reversal of a prior deficiency determination. This is inequitable to compliant taxpayers that pay their deficiency when informed of the additional assessment. Many times the error is not revealed until much later, for example: a case of a partnership with many partners where the issue was discharge of income at the partnership level. The Tax Matters Partner and the Notice Partners all agreed to the deficiency and it was allocated among the partners in accordance with their share of ownership in the partnership. Ninety-seven percent of the partners paid the amount owed and did not question the deficiency. Three of the partners filed for audit reconsideration and it was determined that the partners were not subject to the discharge of income rules because they were insolvent. This determination should have been made for each partner at the partner level. If they were also insolvent, they would have been eligible for refunds. However, by the time the audit reconsiderations were completed, the statute for refund for the other partners had expired and the refunds were barred.

In another circumstance, a monetary award in a class action suit was treated as taxable by IRS. Later it was determined to be nontaxable by a court having jurisdiction over the matter. As in the above-cited example, the statute for refund was barred for those individuals who dutifully paid the additional assessment. The courts have consistently upheld the barred statute in these situations whether or not there was an error on the part of IRS or due to a reversal of a previous determination by the courts. While taxpayers may file protective claims, they may not be aware of all aspects of the case and many are not knowledgeable about how to protect their rights under such circumstances.

Proposed Change: Amend section 6511(a) and section 6514 to allow refunds in the following circumstances:

1. when the taxpayer is due a credit or refund because of an IRS error in application of the law, a computation error or a reversal of a prior determination, and
2. the refund is barred because the claim is filed three years after the return was filed or two years after the tax was paid.

35. Undeliverable Notification

(Prior #20) -- *Allow IRS To Use Electronic Means To Notify Taxpayers That Their Refunds Have Been Returned As Undeliverable*

Current Law: The IRS, after a reasonable effort and lapse of time, may disclose taxpayer identification information to the press and other media for the purpose of notifying taxpayers who are entitled to tax refunds that the IRS has been unable to locate them to give them their refund. Current law restricts the IRS to disclosure of undeliverable refund information to "press or other media," thus not allowing for the use of advanced electronic technology.

Reason for Change: Every year many taxpayers move, do not give the IRS their new address, and thousands of refund checks are returned by the post office because they are undeliverable. In November of 1997, the IRS was still trying to contact 99,919 taxpayers who did not receive their 1996 refund checks. These undeliverable refunds totaled more than $62 million, an

average of $625 per check.

Under present procedures, undeliverable refund lists are generated three times a year with the main refund list run at the end of September. These lists are broken down by IRS Districts and forwarded to Media Relations representatives in the Districts. Media Relations representatives then forward the lists to local newspapers for publication.

This process is "hit or miss" because most of the larger circulation newspapers do not print the lists, and if a taxpayer has moved regionally or nationally, they will not see the lists printed in their former communities. In addition, the IRS is unable to contact taxpayers internationally.

Reason for Change: When the current law was passed, the press and other traditional media were the only means available for the IRS to distribute undeliverable refund information economically to the public. Since that time, technology has advanced and the IRS can distribute information economically to a worldwide audience over the Internet. In addition to the existing process, IRS is proposing to use their Internet site to distribute undeliverable refund information directly to the public. Use of the IRS web site would have the following advantages:

- IRS would be able to reach millions of additional taxpayers worldwide. The IRS internet website recorded more than 300 million hits during the 1997 filing season (January through April 1998).
- IRS would be able to reach taxpayers that have moved out of the circulation area of local newspapers and give taxpayers one central location to check for undeliverable refund information.
- IRS would be able to develop an interactive application that would allow taxpayers to search a database using name, city, state, or zip code. The IRS web site would have the same information currently printed in newspapers.
- IRS would be able to have a change of address form available for taxpayers to download in the same location as the undeliverable refund information.

Proposed Change: Amend section 6103(m)(1) to extend disclosure of undeliverable refund information by the IRS directly to the public via the Internet without being limited to newspapers and other public announcements. The development of an undeliverable refund application on the Internet site would bring a higher level of service to taxpayers, reduce taxpayer burden, and ensure that more taxpayers receive their money back thus increasing confidence in tax administration.

Section 6103(m)(1) as revised: The Secretary may make public taxpayer identifying information for purposes of notifying persons entitled to tax refunds when the Secretary, after reasonable effort and lapse of time, has been unable to locate such persons.

36. Prepaid Credits

(Prior #25) -- *Allow Taxpayers to Receive Refunds of Prepaid Credits on Late Filed Returns [Section 6511]*

Current Law: Section 6511, Period of Limitation on Filing a Claim, requires that a claim for credit or refund of an overpayment must be filed by the

taxpayer within 3 years from the time the return was filed or 2 years from the time the tax was paid whichever of such periods expires later. If no return was filed by the taxpayer, the claim for refund must be made within 2 years from the time the tax was paid. The application of this section prevents taxpayers from receiving refunds or offsets of overpayments of prepaid credits from late filed returns unless these returns are filed within the two-year statute period. When a late filed return is received past the statute date, the taxpayer is allowed to take the prepaid credits against the tax liability and the remaining credits are removed from the account.

Reason for Change: Changing this section would benefit taxpayers by allowing prior refunds or overpayments to offset to current balance due accounts. The argument could be made that the reason for having the statute is to encourage voluntary compliance and timely filing of returns. Taxpayers would not have adequate incentive to file timely if there were no refund restrictions. However, many taxpayers are not aware of the statute provisions. Their reasons for not filing timely vary from negligence or errors on their part or on the part of a third party, to possible emotional stress from some traumatic event in their life.

During the IRS' well-publicized non-filer program, which encouraged taxpayers to file past due returns, many taxpayers filed multiple past due returns, some with refunds that were not credited due to the expiration of the statute of limitations for filing a claim for refund. These taxpayers were not aware of this statute of limitations provision and expected that their refunds would be applied to other liabilities. This resulted in significant taxpayer frustration and negative perceptions regarding a well-intended process. This provision would serve as an incentive rather than a disincentive for taxpayers with past due returns, some of which may contain overpayments of tax credits.

Proposed Change: Two alternative proposals are:

A. Amend section 6511 to read "Claims for credit or refund of an overpayment of any tax will be allowed whenever a return is filed by the taxpayer." No interest should be allowed on the refunds and any overpayment should be credited as of the date the delinquent return is filed.

B. Allow offsets from an otherwise closed year only to certain balance due accounts for the same taxpayer. Offsets would be permitted only to returns due during the period when a credit or refund from the closed year would have been allowable under existing law.

37. Credit Elects

(Prior #26) -- *Allow Reversals of Estimated Payments That Were Elected to Apply for a Succeeding Tax Year [Section 6513(d)]*

Current Law: Section 6513(d) and Revenue Ruling 77-339 provide that, once an overpayment is applied as a credit-elect to the estimated tax for the succeeding year, it cannot be offset against any additional tax subsequently determined for the year of the overpayment. The law allows for reversal of the credit elect only under specific criteria (e.g., IRS error or hardship) and it must be made prior to March 1 of the succeeding year even if a return for that year has not posted.

Reason for Change: Taxpayers filing amended returns for the credit elect year, prior to filing the succeeding year's return, which results in a balance due are not permitted to apply their credit elect for that year to the amount owed. The taxpayer must pay a penalty and interest on the balance due even though the money held by the IRS is available and could be applied if the law allowed.

Proposed Change: Amend section 6513(d) to allow the reversal of a credit elect for estimated tax payments prior to the due date with extensions for the succeeding year provided no return has posted. This credit should be available to pay any additional assessment on the overpayment year as of the due date of the return, the same date used to credit it to the next year as a credit elect. The request for this reversal should be made in writing with the understanding that the credit would not be available to be used as the first estimated tax payment for the succeeding year.

38. Invalid Assessments

(Prior #28) -- *Change the Refund Statute Laws to Allow Refunds of All Money Paid to IRS if the Trust Fund Recovery Penalty Assessment is Later Determined to Be Invalid [Section 6511(a)]*

Current Law: Section 6511(a) provides that the statutory period to file a claim for refund, claim for credit, or refund of an overpayment of any tax imposed is allowed for the refund of payments within two years from the date of payment. Section 6511(a) states a "Claim for credit or refund of an overpayment of any tax imposed by this title in respect of which tax the taxpayer is required to file a return shall be filed by the taxpayer within three years from the time the return was filed or two years from the time the tax was paid, whichever of such periods expires the later, or if no return was filed by the taxpayer, with two years from the time the tax was paid."

Reasons for Change: If a taxpayer was assessed a Trust Fund Recovery Penalty and made payments over multiple years and the IRS later reviewed their determination and reversed the assessment in full, the taxpayer would only be allowed a refund of the funds paid during the preceding two years. There are three specific situations that can result in a refund of payments made on a Trust Fund Recovery Penalty. They are:

1. Corporation in Bankruptcy. If a corporation is in bankruptcy, that case could remain open for many years, with the corporation making payments on the delinquent tax. These payments may eventually affect the balance of Trust Fund taxes due. Meanwhile, the responsible officer(s) is assessed the Trust Fund Recovery Penalty and may make payments including refund offsets from their individual income tax returns. Situations could arise where the corporate trust fund payments would result in a full or partial abatement of the Trust Fund Recovery Penalty. The refund statute prevents the officer(s) from receiving a refund of any payments made prior to the two years from the date of the refund claim. The excess payments are transferred to excess collection.
2. Corporation and officer(s) in Bankruptcy simultaneously. The situation stated above would also be applicable here. The officer(s) bankruptcy is normally closed prior to that of the corporation.
3. Officer(s) in Bankruptcy. The situation stated above would also apply

when only the officer(s) applied for protection under the bankruptcy laws. Credits on the officer's account would be restricted while the bankruptcy case is active.

The South Florida District Taxpayer Advocate's Office was contacted by a taxpayer regarding the liability of the Trust Fund Recovery Penalty. The taxpayer requested assistance in determining if she were truly liable for the penalty and requested a refund of the money paid. The Taxpayer Advocate caseworker, with the cooperation of a Special Procedures Advisor, secured the assessment document and, after consideration of the facts and circumstances, determined that the taxpayer was not liable for the assessment. Unfortunately, payments had been made over several years and the IRS was only able to refund the funds paid within the last two years due to the provisions of section 6511(a). The result is that the Service received funds for an assessment determined to be incorrect.

Proposed Change: Change section 6511(a) to allow refunds of all money paid to IRS if the Trust Fund Recovery Penalty assessment is later determined to be invalid.

39. Extend Statute - Reliance on Government Agency

(Prior #35) -- *Expand the Statute Expiration Date When a Delay Was Caused by Another Government Agency [Sections 6511 and 6514(a)]*

Current Law: Section 6511(a) states that a claim for credit or refund of an overpayment shall be filed by a taxpayer within three years from the time the return was filed or within two years from the time the tax was paid, whichever is later. Section 6514 (a) further states that a refund of any portion of a tax is erroneous and a credit for such portion is void unless the claim for that refund is timely.

Reason for Change: A taxpayer may mistakenly file a timely claim for refund with a government agency that administers the fund financed by the taxes in question. The proceeding at the other agency may not be resolved until after the Internal Revenue Code statute expires. When the taxpayer is successful and asks for a refund, the agency advises that a claim must be filed with the IRS. Although one can argue that the taxpayer should have filed a protective claim with the IRS, few of the IRS's own employees are aware of these procedures. The taxpayer is acting in good faith that the government will handle all parts of the issue.

A specific case brought to the attention of the National Taxpayer Advocate involved a taxpayer who was self-employed outside the United States for tax years 1976 through 1982. During this period, he was assessed self-employment tax on his earnings. In 1983, the taxpayer initiated an appeal with the Social Security Administration to recover the self-employment tax since his earnings were all outside the United States and were not subject to self-employment tax because of a treaty with Sweden. The issue was finally resolved in the taxpayer's favor on November 9, 1988. Then, he was referred to the IRS to apply for the refund. However, the statute of limitations had expired for claiming a refund. The taxpayer could not be expected to know that Social Security's administration of its program does not include refunding monies erroneously paid into that program. He is now faced with having no social security credits for 1976 through 1982 and no way to recover

the money he erroneously paid.

Proposed Change: Expand sections 6511(a) and 6514(a) to include an extension of the statute for refund claims in cases where the taxpayer dealt with another government agency to secure the refund. This statute would expire one year after the determination is made by the other agency on the taxpayer's claim. The legislation should also give the Secretary the authority to prescribe regulations because contingency issues could arise in areas where there is no current problem.

40. Reverse Offsets in Hardship

(New) -- *Amend Internal Revenue Code to Allow the Internal Revenue Service to Reverse Offsets to Other IRS Liabilities [Section 6402(a)] in Hardship Situations*

Current Law: Section 6402(a) states that the Secretary may credit overpayments against any internal revenue tax liability. Previous opinions by Chief Counsel have clarified that the "may" in this section means that the Commissioner has the authority to bypass the application of an overpayment to another internal revenue tax liability under section 6402(a) only if the action is initiated prior to the assessment date (23C) of the return creating the overpayment.

Reason for Change: In hardship situations, the mechanical application of an overpayment to other outstanding IRS tax liabilities prevents the IRS from providing the necessary relief to taxpayers. These overpayments are applied regardless of the circumstances even though the other tax liabilities may not be in active collection status. Often the accounts are suspended because of tolerance, are in currently not collectible status or in the queue. Usually the only monies being applied to these liabilities are the overpayments from current year returns.

Proposed Change: Amend section 6402(a) to allow the IRS to refund an overpayment to a taxpayer in situations where the taxpayer is experiencing a significant hardship, where failure to take this action would result in a gross disservice to the taxpayer or where it would be considered equitable treatment of the taxpayer as defined by regulation.

41. Offset Bypass Other Debts in Hardship

Allow for Refunds to Bypass Offsets to Debts to Other Government Agencies in Hardship Situations [Sections 6402(c) and (d)]

Current Law: Section 6402(a) states that the Secretary may credit overpayments against any Federal tax liability. However, section 6402(c), Offset of Past Due Support Against Overpayments, and section 6402(d), Collection of Debts Owed to Federal Agencies, state that the Secretary shall pay the amount owed, in the order of (c) then (d), after offsetting against any Federal tax liability. It is Chief Counsel's opinion that the Service may bypass a refund offset to Federal tax liabilities under section 6402(a) under limited circumstances but that it cannot bypass the refund under sections 6402(c) and (d).

Reason for Change: Section 6402 provides a method of offsetting tax overpayments to outstanding and overdue debts to other government agencies. The principle of offsetting debts is logical; however, when applied mechanically, regardless of circumstances, the IRS can become indifferent to the needs of its customers. The provisions of sections 6402(c) and (d) need a modification which would enable the IRS to bypass offsets to government agencies in certain rare instances when hardship for the taxpayer warrants such action.

Proposed Change: Amend section 6402 to allow for the bypass of a refund offset under sections 6402(c) and (d) when it is determined that the taxpayer is experiencing a significant hardship.

42. Override Refund Statute

(New) -- *Amend Section 6511(a) to Allow the Internal Revenue Service to Override the Refund Statute in Hardship Situations*

Current Law: Section 6511(a) Period of Limitation on Filing a Claim, requires that a claim for credit or refund of an overpayment must be filed within 3 years from the time the return was filed or 2 years from the time the tax was paid whichever period expires later. If no return is filed by the taxpayer, the claim for refund must be made within 2 years from the time the tax was paid. The Internal Revenue Service Restructuring and Reform Act of 1998 added an exception to this section which allows for the suspension of statute of limitations during a period that an individual is financially disabled.

Reason for Change: Although the recent change in the law will address some instances where the IRS will now be able to provide relief under this statute, it does not address situations where we incorrectly administered the law. This was evident in the recent discovery that the IRS may have improperly informed taxpayer that their installment agreements would be terminated and enforced collection action taken if they did not agree to extend the statute. This change would also impact the refunds on delinquent returns where there are prepaid credits and the three-year statute has expired and the taxpayer is experiencing a significant hardship.

Proposed Change: Amend the section 6511 to allow the IRS to override the refund statute for claims and for prepaid credits on delinquent returns in situations where the taxpayer is experiencing a significant hardship, where failure to take this action would result in a gross disservice to the taxpayer, or where it would be considered equitable treatment of the taxpayer as defined by regulation.

Tax Collection

This section includes proposals to eliminate the inequity in provisions to limit the statute of limitation for collection and to provide closing information to taxpayers when their balance due is satisfied.

43. Limitation on Collection Waiver

(New) -- *Amend Section 6502(a) to Require a Limitation of Tax*

Collection Waivers for Installment Agreements

Current Law: Section 6502(a)(2) as revised by section 3461(a) of the Restructuring and Reform Act of 1998 now reads that for any request made on or before December 31, 1999, where the taxpayer agreed to extend the 10 year period of limitation on collection, the extension will expire the latest of (1) the last day of the original 10 year limitation period, (2) December 31, 2002, or (3) in the case of an extension with an installment agreement, the ninetieth day after the extension.

Reason for Change: Feedback from Problem Solving Day cases and research completed in several district offices verified there is a significant taxpayer population who have signed waivers in connection with installment agreements prior to the date of enactment of the Restructuring and Reform Act of 1998 which have extended the collection statute of limitation far into the future. These extension range from the years 2010 until 2050. These individuals fall into the third category above and will be provided no relief under the new legislation. Therefore, taxpayers that have signed extensions but have been placed in currently not collectible status will have their statutes expire at the ten year period or December 31, 2002 and have their remaining liability excused. Those taxpayers that are faithfully paying even a minimal amount have been placed into what amounts to lifelong installment agreements. In many instances, these taxpayers are not even reducing their balances since accrued penalty and interest are more than their monthly payment amount.

Proposed Change: Amend section 6502(a) by adding the following subsection:

For any request made on or before July 22, 1998, if the taxpayer agreed to extend the 10 year period of limitation for collection, even in connection with an installment agreement, the extension will expire the later of the original ten year limitation period or December 31, 2002. In instances where the waiver will expire between July 22, 1998 and December 31, 2002, the extended collection statute expiration date will apply.

Tax Preparation/Reporting Treatment

This section includes proposals that will simplify and eliminate the inequity in some reporting requirements and provide relief to taxpayers who have unique earning situations.

44. Married Couples Operating a Business

(New) -- *Simplify Reporting Requirements for a Married Couple Who Operate a Business Together*

Current Law: Under current law, a sole proprietorship is generally considered to consist of one individual operating a business alone or with employees. Section 761(a) states that the secretary may, at the election of all the members of an unincorporated organization, exclude such organization from the application of all or part of the partnership subchapter if the organization avails itself of certain activities not directly business related. For Federal Tax purposes, if spouses carry on a business together and share in the

profits and losses, they can be considered to be partners whether or not they have a formal partnership agreement. Regulations require such spouses to file Form 1065, U.S. Partnership Return of Income. Each spouse should carry his or her share of the partnership income or loss to his or her joint or separate returns. Also, each spouse should include his or her respective share of self-employment income on a separate Form 1040, Schedule SE, Self-Employment Tax. If the business arrangement is actually one in which one spouse is the employee of the other spouse, then the owner-operator would need to file quarterly employment tax returns and issue a Form W-2, Wage and Tax Statement, for the wages paid.

Reason for Change: A large number of husband and wife businesses fail to report the business activity in one of the two methods described above. Their reasons vary from the complexity involved in filing Forms 1065, US Partnership Return of Income, and 941, Employers' Quarterly Federal Tax Return and the expense of return preparation costs, to the lack of consideration of the retirement coverage and tax benefits that they are missing. Furthermore, in actual practice, the Service, in certain situations, does acquiesce to Schedule C, Profit or Loss from Business, filing of a husband and wife partnership.

Proposed Change: Modify sections 761(a) and 1402(a) to allow for a couple operating a business together to elect out of the otherwise mandatory partnership reporting requirements and file a Schedule C. This would be accomplished by changing the definitions of partnership and net earnings from self-employment.

45. Charitable Contributions

(New) -- *Amend Section 170(f)(8) Substantiation Requirement for Charitable Contributions*

Current Law: Section 170(f)(8) requires that, for any charitable contribution over of $250.00, the taxpayer must receive a "contemporaneous" written acknowledgement of the contribution by the donee organization that meets the following requirements: 1) the amount of cash and a description of any property other than a cash contribution, and 2) whether the donee organization provided any goods or services in consideration for the contribution. By "contemporaneous" the code states that the acknowledgement must be received on or before, the earlier of, the date on which the taxpayer files a return for the taxable year in which the contribution was made, or the due date for filing such a return.

Reason for Change: The "contemporaneous" requirement, which was added in 1994, causes problems for individual taxpayers as well as charitable organizations. Charitable organizations were unsure exactly what was needed to be documented in the written acknowledgements. Taxpayers were not aware of the time limitation in securing the written acknowledgement. Therefore, when questioned by the IRS during the Examination process, it was too late to secure this information from the organization.

Proposed Change: Amend section 170(f)(8) to allow for non-contemporaneous written documentation from the charitable organization when it is apparent that they have complied with the "intent" of the law, and will now provide written substantiation that complies with the letter of the law.

46. Taxability of Social Security Benefits

(New) -- *Simplify the Rules on Taxability of Social Security Benefits [Section 86]*

Current Law: A portion of Social Security benefits are taxable, under section 86, for individuals who receive over a certain level of income.

Reason for Change: One of the most complex computations that is required on the Form 1040 is the computation of the taxable portion of Social Security benefits. The worksheet that appears in the Form 1040 instructions is extremely difficult, containing 18 lines (1998 Form 1040 instructions). The problem is not the design of the worksheet. Computing the taxable portion of Social Security benefits is complex largely because of the number of items that enter into the computation - including taxable and certain non-taxable income. While the taxability of a portion of Social Security benefits does not impact the lowest income individuals, by definition, it burdens the elderly, many of whom have great difficulty with this computation.

While the taxation of a portion of Social Security benefits is an area of public policy that is beyond the scope of this report, the Taxpayer Advocate Service strongly supports a simplification of these rules.

Proposed Change: Revise the formula for the taxable portion of Social Security so that after taxable income and non-taxable interest are totaled, a stated percentage of the Social Security is taxable. For example, a taxpayer with a certain level of income (including non-taxable interest), could consult a simple table to determine that a given percentage of his or her Social Security income was to be included on the tax return.

47. Income Averaging for Commercial Fishing

(New) -- *Allow Income From Commercial Fishing to be Eligible for Income Averaging Under Section 1301*

Current Law: Section 1301 allows an individual engaged in a farming business to elect to compute his or her current year tax liability by averaging, over the prior three-year period, all or part of his or her income from the trade or business of farming.

Reason for Change: While section 1301 allows individuals engaged in fish farming (aquaculture) to take advantage of the benefits of income averaging, individuals engaged in commercial fishing are denied this benefit. Commercial fishing is an industry that is subject to various uncontrollable elements that result in good years and bad years. Individuals engaged in commercial fishing are subject to fluctuations in their income due to many of the same factors that impact farming (weather, market prices, etc.). Additionally, in many cases, individuals engaged in the commercial fishing industry are exposed to a variety of hardships and dangers.

Proposed Change: Amend section 1301 to state to allow individuals to average income received from commercial fishing in a manner similar to the current averaging of farm income. This could be limited to individuals who derive their primary source of income from commercial fishing for the entire

period.

48. Automatic Extension to File

(New) -- *Amend Section 6081 to Allow Partnerships, Trusts and Individuals an Automatic 6-Month Extension to File*

Current Law: Section 6081(a) states that the Secretary may grant a reasonable extension to file a return, no such extension shall be for more than 6 months. Individuals may obtain an automatic 4-month extension and partnerships and trusts an automatic 3-month extension to file their tax returns. Taxpayers can request these extensions by filing the appropriate form and paying the full amount of tax due by the original due date of the tax return. The taxpayer may obtain a second extension (3 months for partnerships and trusts and 2 months for individuals) by filing the appropriate form with a statement of reason for requesting an additional extension on or before the extended due date of the return. In contrast, section 6081(b) allows for an additional 3 month automatic extension for Corporation Income Tax Returns (both "S" and "C" corporations) when the appropriate form is filed and the tax due is paid by the original due date of the tax return.

Reason for Change: The requirement to file a second extension for Partnerships, Trusts and Individuals results in a significant burden to both taxpayers and their representatives. Practitioners must bill taxpayers for the time taken to prepare the extensions as well as the postage charge. Many taxpayers are not familiar with the requirement to file a second extension and the approval process for these forms. The additional work experienced by IRS in opening the envelopes, posting the extension information, reading and signing the approval section plus the mailing costs, uses valuable resources that could be allocated to enhance other customer services. With the requirement that the tax be paid by the due date of the return, generally no money is collected with this second extension.

Proposed Change: Add section 6081(c) to allow Partnership, Trusts and Individuals automatic extensions for a total of 6 months similar to the provisions for Corporations [section 6081(b)]. For individuals, 2 months would be added to the current automatic extension. Partnerships and trusts would add 3 months to the automatic extension for filing a return.

49. Rounding

(Prior #14)-- *Require Rounding of Cents to Dollars on Tax Returns and Other Documents [Section 6102]*

Current Law: Section 6102(a) authorizes the Secretary to provide, with respect to any amount required to be shown on a tax return, that, either the fractional part of a dollar shall be disregarded, or the fractional part of a dollar shall be disregarded unless it amounts to one half dollar or more, in which case the amount shall be increased by one dollar. Section 6102(b) provides that any person making a return, statement, or other document shall be allowed, under regulations prescribed by the Secretary, to make such return, statement or other document without regard to subsection (a).

Reason for Change: The use of cents confuses both taxpayers and IRS employees processing the returns and frequently results in errors. These errors

should be reduced with a resulting reduction in the cost of correspondence and taxpayer burden associated with correcting the errors. Many tax professionals have been rounding for years and major payroll service firms see this as a step forward in simplifying income tax withholding. This proposal was submitted previously to the Treasury by Commissioner Richardson in December 1993 in an effort to "help IRS shift from a paper based processing environment to one based primarily on electronically filed returns and electronic funds transfers." Currently, amounts on electronic returns are reported in whole dollars only. Many states have already adopted this practice.

Proposed Change: Repeal section 6102(b) which allows taxpayers to report line entries on tax returns and attached schedules in both dollars and cents.

50. Alternative Minimum Tax

(New) -- *Repeal or Reform the Alternative Minimum Tax [Sections 55 - 59]*

Current Law: The tax laws give special tax treatment to certain types of income and expenses. The Alternative Minimum Tax was established to ensure that taxpayers who benefit from this tax treatment pay at least a minimum amount of tax.

Reason for Change: The Alternative Minimum Tax is widely regarded as being unnecessarily complex and burdensome. The Alternative Minimum Tax operates, in effect, as a separate or "parallel" tax system, with many rules that differ from the "regular" tax system. Numerous individuals and organizations have testified before Congress concerning the complexity and burden caused by the Alternative Minimum Tax. In the past, the Alternative Minimum Tax was restricted primarily to higher-income individuals. However, due in part to the gradual effects of inflation and the fact that the Alternative Minimum Tax rate bracket and exemption amount are not indexed to inflation, a far larger number of taxpayers are now potentially impacted.

One of the most significant problems is the large number of taxpayers who are required to make several computations simply to see if they are required to figure their tax under the Alternative Minimum Tax. Taxpayers must often complete the worksheet in the tax form instructions and the separate Form 6251, only to discover that they are not required to pay any Alternative Minimum Tax. Many taxpayers are, in fact, subject to the Alternative Minimum Tax without being aware of its existence. Often, the way that many individuals first hear of the Alternative Minimum Tax is when they receive a notice from IRS.

Ironically, one of the primary purposes for the Alternative Minimum Tax no longer exists - at least to the degree in prior years. The Alternative Minimum Tax was originally designed, at least in part, to ensure that individuals who had invested in tax shelters paid some tax. However, Congress has significantly restricted shelter investments. While the Alternative Minimum Tax still addresses taxpayers with "tax preference" items, many of these taxpayers are at an income level below that originally envisioned. If tax preference items are viewed as a problem, it would be far better to address each of these items, rather than maintain this parallel tax system.

It is important to note that, along with the significant problems for taxpayers, the Alternative Minimum Tax also presents significant compliance and administrative problems for IRS.

Proposed Change: Several alternatives exist to address the problems imposed on taxpayers by the Alternative Minimum Tax:

A. Eliminate the Alternative Minimum Tax for individual taxpayers - This is our first choice among these alternative recommendations. Outright elimination of the Alternative Minimum Tax would do a great deal for simplification and burden reduction of the tax system.
B. Create an Adjusted Gross Income or taxable income level below which taxpayers would not need to consider the Alternative Minimum Tax - For example, married couples, filing a joint return, could be exempt from the Alternative Minimum Tax if their Adjusted Gross Income was less than $150,000. (Separate Adjusted Gross Income amounts would be needed for other filing status.) This would save a large number of taxpayers from the need of worrying about the Alternative Minimum Tax. This alternative addresses one of the most serious problems of the Alternative Minimum Tax - that of the "creep" downward toward middle-income taxpayers. However, this proposal would not resolve the significant burden on taxpayers that remain subject to the Alternative Minimum Tax (those above the Adjusted Gross Income limit). If this option were to be adopted, whatever Adjusted Gross Income or taxable income level is used, the income amount should be indexed. If not, inflation would, eventually, allow the Alternative Minimum Tax to "creep" down toward the "middle-income" taxpayers.
C. Index the Alternative Minimum Tax rate bracket and exemption amount - While only a partial fix, indexing the rate brackets and the exemption amount would limit the problem of the rapidly expanding number of "middle-income" individual taxpayers that will be subject to the Alternative Minimum Tax.

51. End of Year Repayment

(Prior #18) -- *All Funds Received at the End of the Year Should be Excluded From Income When Those Funds Must be Repaid Early in the Succeeding Year [Section 61]*

Current Law: Income is taxable in the year in which it is received for cash basis taxpayers.

Reason for Change: Taxing income in a year when the transaction is incomplete at year's end is unfair. Requiring the taxpayer to adjust income in the year following the receipt of the income is burdensome.

One example is when a taxpayer received a lump sum settlement from the Social Security Administration because of a suit for denial of social security disability in the last week of the year. The taxpayer's insurance company paid him a percent of his salary until the suit was settled and withheld taxes. The settlement letter was not received until the first week of the next calendar year. Under current law, payments from the insurance company have to be reported as income in the year received, although the taxpayer had to return a portion to the insurance company one week later, which was in the subsequent calendar year. The Social Security Administration did not withhold tax on the lump sum payment. The taxpayer received no benefit of

the money the week it was in his possession.

Proposed Change: Add an exclusion from income for incomplete transactions if they occur within a continuous 30-day time period spanning two calendar years.

52. Repayment Previously Reported

(Prior #23) -- *Deduction for Repayment of Income Previously Reported [Section 1341]*

Current Law: Section 1341 provides that individual income tax filers who repay amounts previously reported as taxable income must deduct this repayment as an itemized deduction on Form 1040, Schedule A in most cases.

Reason for Change: If the taxpayer does not qualify to itemize deductions on Schedule A, the deduction is lost. The problems created by this law are inequity and increased taxpayer burden. Most taxpayers use the cash basis of accounting. This method requires that an amount be reported as income when it is received and the amount paid back is deducted in the year it was repaid. Taxpayers have already paid tax on income that was later determined not to be income. Current law does not provide an avenue to claim credit for these taxes paid in error. Taxpayers are penalized for reporting too much income on their original returns.

Proposed Change: (1) Change the law to allow taxpayers to amend their tax return that originally included the income or (2) Change the Internal Revenue Code to allow taxpayers to take the repayment as an adjustment to income on the face of Form 1040, rather than as an itemized deduction, in the year of repayment.

53. Phase-out Deductions/Exemptions

(New) -- *Repeal the Phase-out of Itemized Deductions and the Personal Exemption [Sections 68 and 151]*

Current Law: A number of provisions of the tax law phase-out certain deductions, credits, or benefits based on the taxpayer's income. Both itemized deductions and the personal exemptions (for self, spouse, dependents, etc.) are subject to this type of phase-out. These phase-outs are statutorily mandated and indexed to inflation. For 1999, Form 1040 directs all taxpayers with adjusted gross incomes of over $94,975 to a worksheet in the tax form instructions to compute their allowable exemption deduction. Taxpayers who itemize their deductions and have adjusted gross incomes of over $126,000 ($63,300 for married filing separately) are told to complete a separate worksheet (also in the instructions) to figure the amount of allowable itemized deductions.

Reason for Change: Since both personal exemptions and itemized deductions are on virtually all tax returns of individuals at the affected income levels, the phase-out of these items add significantly to complexity and burden for a large number of taxpayers.

Some taxpayers, whose incomes fall between the levels where the phase-outs first take effect and the level where the exemptions and deductions are finally

exhausted, are subject to a higher marginal tax rate than other taxpayers with larger incomes. This puts the government in the awkward position of mandating tax rates that are effectively regressive at certain levels of income. Additionally, taxpayers often see their exemptions and itemized deductions as "entitlements." No other tax issues are taken so personally. As a result, the phase-outs of itemized deductions and the personal exemptions are often seen by taxpayers as being especially unfair, creating a certain amount of resentment and cynicism.

The repeal of the phase-out of itemized deductions and personal exemptions would not resolve all of the problems and concerns caused by phase-outs. However, allowing all taxpayers to retain these deductions and exemptions would go a long way toward reducing burden, increasing fairness, and restoring faith in the tax system.

Proposed Change: Repeal the phase-out provisions of sections 68 (itemized deductions) and 151(d)(3) (personal exemptions).

Comprehensive Table Of Legislative Proposals

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