



December 14, 2016

The Honorable Orrin G. Hatch, Chairman
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Kevin Brady, Chairman
House Committee on Ways & Means
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Ron Wyden, Ranking Member
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Sander M. Levin, Ranking Member
House Committee on Ways & Means
1102 Longworth House Office Building
Washington, DC 20515

Re: [2017 AICPA Compendium of Tax Legislative Proposals – Simplification and Technical Proposals](#)

Dear Chairmen and Ranking Members:

The American Institute of CPAs (AICPA) submits for your consideration the enclosed 2017 AICPA Compendium of Tax Legislative Proposals – Simplification and Technical Proposals.

The AICPA is the world's largest member association representing the accounting profession, with more than 418,000 members in 143 countries and a history of serving the public interest since 1887. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

The AICPA is actively pursuing, and has published, positions on a number of major legislative proposals that are directly related to tax reform. Our focus in this Compendium of Tax Legislative Proposals is on changes to provisions in the Internal Revenue Code that need attention, recommendations that are technical in nature and recommendations that perhaps can be readily addressed.

We intend to continue our efforts in this area and submit further comments and proposals on major tax issues and reform efforts. The AICPA urges you to consider the enclosed proposals for inclusion in future tax legislation. If you would like to discuss any of these proposals in more depth or have any questions, please contact me at (408) 924-3508, or annette.nellen@sjsu.edu; or Melissa Labant, AICPA Director of Tax Policy & Advocacy, at (202) 434-9234, or mlabant@aicpa.org.

Sincerely,

Annette Nellen, CPA, CGMA, Esq.
Chair, AICPA Tax Executive Committee

AMERICAN INSTITUTE OF CPAs

**Compendium of Tax Legislative Proposals
Simplification and Technical Proposals¹**

**Approved by the
Tax Executive Committee**

January 2017

¹ Available online at <http://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/2017-AICPA-Compendium-of-Tax-Legislative-Proposals.pdf>.

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FOREWORD

The American Institute of CPAs (AICPA) actively pursues, and publishes positions on a number of legislative proposals. These positions address legislative proposals as well as statutory provisions we have identified as needing modification. We believe that these legislative proposals correct technical problems in the Internal Revenue Code (IRC or “Code”) or simplify existing provisions. We believe these proposals generally promote simplicity and fairness and are generally noncontroversial.

This Compendium includes items focused on improving tax administration, making the tax code fairer, and effectively promoting important policy objectives. It is not a comprehensive list of all provisions that we believe Congress should add back or remove from the reformed Code. We intend to continue our efforts in this area and make further recommendations in the future.

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Proposal: Standardize definitions to avoid multiple meanings for the same term

Present Law

There are several terms used throughout the Internal Revenue Code² that are defined in multiple ways. For example, the term “small business” is defined using varying parameters that are not consistently used. Some of these provisions, such as section 195, do not use the term “small business,” although the rule includes a preferential treatment to help “small businesses.” The chart below illustrates some of these definitional variations.

Classification/ Provision	Start-up Costs	Current Year Asset Acquisitions	Total Assets	Gross Receipts	Number of Shareholders or Employees	Capital
§1202 gain exclusion for qualified small business stock			Total assets of \$50 million or less			
§1244 ordinary treatment for loss on small business stock						\$1 million or less
§41 research tax credit use against payroll tax				Generally gross receipts under \$5 million and no gross receipts in any tax year preceding the prior 5-year period		
§45R health insurance credit for small employers					25 or fewer full-time equivalent employees (wage	

² All references herein to “section” or “§” are to the IRC of 1986, as amended, or the Treasury Regulations promulgated thereunder.

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					threshold also specified)	
§55(d) AMT exception for C corporations				\$7.5 million		
§263A small retailer exception				\$10 million or less		
§448 small business exception				\$5 million or less		
§179 expensing		Less than \$2.5 million of eligible assets				
§195 start-up expenditures increase	Start-up expenditures under \$55,000					
S corporation provisions					100 or fewer shareholders	

Another term with multiple definitions is “modified adjusted gross income.” A few examples of differing definitions for this term are listed below. Note that some of these provisions, such as sections 36B, 1411 and 5000A, were all enacted by the same legislation (Affordable Care Act). Also, some of the provisions, such as section 135 and 530, involve education provisions.

- Section 135, Income from United States savings bonds used to pay higher education tuition and fees – adjusted gross income determined without regard to sections 135, 137, 199, 221, 222, 911, 931 and 933; and after application of sections 86, 469 and 219.
- Section 530 Coverdell education savings accounts - adjusted gross income increased by any amount excluded from gross income under sections 911, 931 or 933. This definition is also used for section 24, Child tax credit.
- Section 36B Refundable credit for coverage under a qualified health plan - “adjusted gross income increased by any amount excluded from gross income under section 911, any amount of interest received or accrued by the taxpayer during the taxable year which is exempt from tax, and an amount equal to the portion of the taxpayer's social security benefits (as defined in section 86(d)) which is not included in gross income under section 86 for the taxable year.”
- Section 1411 Imposition of tax - adjusted gross income “increased by the excess of the amount excluded from gross income under section 911(a)(1), over

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the amount of any deductions (taken into account in computing adjusted gross income) or exclusions disallowed under section 911(d)(6) with respect to the amounts described in paragraph (1).”

- Section 5000A Requirement to maintain minimum essential coverage - adjusted gross income increased by any amount excluded from gross income under section 911 and any tax-exempt interest income.

The term “net investment income” has multiple definitions. For example, the definition at section 1411 Imposition of tax, is quite broad including rents and passive activity income, which are not included in the definition of the term used at section 163(d) for the investment interest expense limitation.

Description of Proposal

The uniformity of the definition of common terms is necessary. If there is a reason for different definitions, then changing the terminology is essential. For example, if there is a reason to have varying definitions of modified adjusted gross income, using different terms or addressing the adjustment in a different manner is necessary.

Analysis

Multiple definitions for the same term add complexity to the tax law. This complexity can increase the chance of errors in compliance and planning. Also, transparency is harmed because taxpayers cannot easily understand how a rule may or may not apply to them.

Conclusion/Recommendation

Find existing terms in the Code that have multiple definitions. If there is no reason for different definitions, standardize the definition. Consider if transitional relief is needed along with the change. If there is a reason justifying the different definitions, change the name of one of the terms to avoid confusion. In crafting legislation, consider use of existing terms rather than creating new definitions.

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Proposal: Consolidate and simplify the multiple types of tax-favored retirement plans and the rules governing them

Present Law

The IRC provides for more than a dozen tax-favored employer-sponsored retirement planning vehicles, each subject to different rules pertaining to plan documents, eligibility, contribution limits, tax treatment of contributions and distributions, the availability of loans, portability, nondiscrimination, reporting and disclosure. The following plans are currently representative of the variety that are sponsored by an employer: simplified employee pension (SEP), salary reduction SEP, savings incentive match plan for employees of small employers (SIMPLE), SIMPLE-401(k), profit sharing, money purchase pension, 401(k), 403(b), 457, target benefit, defined benefit, cash balance and the defined benefit / 401(k) combination created in the Pension Protection Act of 2006 (Pub. L. 109-280). Although some consolidation of the rules governing these options were introduced in recent years, further simplification of the confusing array of retirement savings options should take place.

Description of Proposal

Possible measures for simplifying the number and complexity of the various types of retirement plan vehicles include the following:

1. Create a uniform employee contributory deferral type plan. Currently there are four employee contributory deferral type plans: 401(k), 457, 403(b), and SIMPLE plans. Having four variations of the same plan type causes confusion for many plan participants and employers.
2. Eliminate the nondiscrimination tests based on employee pre-tax and Roth deferrals for 401(k) plans. They artificially restrict the amount higher-paid employees are entitled to save for retirement by creating limits based on the amount deferred or contributed by lower-paid employees in the same plan. They result in placing greater restrictions on the ability of higher-paid employees to save for retirement than those placed on lower-paid employees. Although the 403(b) plan is of a similar design, there is no comparable test on deferrals for this type plan.

There are currently two tests:

- a) The actual deferral percentage (ADP) test which limits the amount highly compensated employees can defer pre-tax or by Roth after-tax contributions by reference to the amount deferred by non-highly compensated employees. This test applies only to a 401(k) plan.
- b) The actual contribution percentage (ACP) test similarly limits the amount of employer matching contributions and other employee after-tax contributions (which are based on employee contributions) that highly compensated

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employees may receive. This test is applicable for both 401(k) and 403(b) plans.

Example of complexity in the rules: In the case of the traditional 401(k) plan, both the ADP and ACP tests apply, while the same deferral and match formula in a 403(b) plan results in applicability of only the ACP test.

3. Create a uniform rule regarding the determination of basis in distributions. Depending on the plan type, there are currently different methodologies to help determine basis in a distribution. For example, in a Roth individual retirement account (IRA) or 401(k), basis is considered returned first while in a traditional IRA or 401(k), basis is distributed on a pro-rata basis in the case of a total distribution, and distributed based on an algebraic formula if there are a series of payments.
4. Create a uniform rule of attribution. Currently, the rules of attribution are governed by various Code sections with subtle differences. The attribution rules are used for different purposes under the Code:
 - a) Section 267(c) referenced and modified in determining a disqualified person under prohibited transaction rules.
 - b) Section 318 for determination of highly compensated and key employee status.
5. Create a uniform definition for terms to define owners. Currently, there are different definitions for the terms “highly compensated employee” and “key employee.” A defining factor of a “highly compensated employee” is a 5% owner which is further defined as an individual with a direct or indirect ownership interest of more than 5%. The ownership rules governing a “key employee” consider the 5% ownership rule but also consider persons owning 1% with compensation of \$150,000 or more annually.
6. Eliminate the required minimum distribution rules. Participants must begin taking distributions by April 1 of the year following the year they turn age 70 ½ or they are subject to penalties. However, there are no minimum distribution rules governing the timing of distributions related to a Roth IRA. In the case of qualified plans, a less than 5% owner who continues employment may defer taking distributions until his or her subsequent separation from service. Additionally, in the case of a traditional IRA, the participant is entitled to consolidate multiple accounts, subsequently taking a required minimum distribution from a single IRA; however, in a qualified plan the required minimum distribution is taken from each plan individually and consolidation is not permitted.

If full elimination of required minimum distribution rules is not possible, the age requirement of 70 ½ needs addressing. The rules are improved if the

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distributions are required to begin on a specific birthday as opposed to the computation of the “half-year birthday” for purposes of these regulations.

7. Create uniform rules for early withdrawal penalties. There are currently different rules governing penalties depending on whether the account is an IRA or a qualified plan. An example of this complexity is a distribution for higher education expenses; for an IRA, the distribution avoids the 10% excise tax, except if the distribution is from a qualified plan, it is subject to the excise tax. The same is true for qualified first-time homebuyer distributions and medical insurance premiums.

Analysis

Taxpayers appreciate the opportunity to fund retirement plan accounts and save current tax dollars, the benefits of which are used as a main source of income for many individuals during their retirement years. Employer-sponsored qualified retirement plans are important vehicles with which employers can assist their employees to achieve their retirement goals as taxpayers can contribute a larger amount of money to employer sponsored plans than to IRAs or Roth IRAs. While it is not mandatory for employers to offer retirement benefits to their employees, there are incentives such as tax deductions, which are available to employers who contribute to qualified retirement plans on behalf of their employees.

When small businesses grow and explore options for establishing a retirement plan, they encounter numerous alternatives subject to various rules, which can become overwhelming. We think there are too many options available for consideration before a business can decide which plan is appropriate. Some plans are only available to employers with a certain number of employees, whereas other plans require mandatory contributions or create significant administrative burdens. Such administrative burdens include annual return filings, discrimination testing, and an extensive list of notice requirements with associated penalties for failures and delays in distributing such notices to employees.

To determine which plan is right for their business, owners must consider their cash flow, projected profitability, anticipated growth of the work force, and expectations by their employees and co-owners. The choices are overwhelming, and many plans are too complex or expensive for small business owners.

Additionally, the myriad of rules surrounding these plans and the tax treatment of their benefits creates confusion among plan participants. This confusion adds to the factors that keep many plan participants from enrolling in their employer’s plan and saving for retirement. With differing contribution limits and tax treatment of distributions, participants become overwhelmed. With our nation’s mobile workforce, it is not uncommon for an employee to participate in multiple retirement plans during their working career, and even have multiple concurrent balances. Should these employees happen to work for differing types of employers (e.g., private-sector, not-for-profit and government entity), they are exposed to very different rules governing their benefits. By

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simplifying the number of available retirement plan options as well as the rules surrounding those options, the decrease in level of confusion to employers will lead to increased levels of plan participation leading to healthier employee retirement savings.

In addition, Federal tax laws and regulations governing retirement plans are overly complex compounding the difficulty for employers who wish to offer retirement plan options to their employees. In order to increase the incentive to employers to set up and maintain retirement plans for their employees, it is imperative that the laws and rules governing retirement plan offerings are as simple and straightforward as possible.

One of the reasons the rules are complex is related to flexibility in employer plan design. There are different sets of rules regulating eligibility, contribution limits, tax treatment of contributions and withdrawals, availability of loans and portability of the numerous plan types. Another reason is to ensure that retirement benefits are available to all employees and not just highly compensated employees.

While retirement plan complexity has long been a topic of discussion, not nearly enough has been done to address the issue.

Conclusion/Recommendation

The number of retirement plan choices requires consolidation and the rules governing these plans require simplification, with appropriate transition rules as needed.

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Proposal: Simplify the small business health insurance tax credit under IRC section 45R

Present Law

IRC section 45R, which was enacted under the Affordable Care Act, provides a tax credit for certain qualified small employers who provide health insurance coverage to their employees.

Per section 45R, a qualified small employer is one that meets all of the following conditions:

1. Employ no more than 25 full-time equivalent employees

Because the eligibility rules are based in part on the number of full-time equivalent employees (FTE) and not the actual number of employees, a determination is made as to which employees are counted towards the number of FTEs. Self-employed business owners, more than 2% shareholders of S corporations, more than 5% owners of C Corporations as well as family members of these owners are not included when calculating an employer's number of FTEs. However, part-time and leased employees are counted toward the number of FTEs.

Next, an employer must determine each part-time employee's number of hours of service in order to derive the employer's number of FTEs. This step requires that the employer perform a detailed analysis of each employee's hours or use simplifying assumptions which are not as favorable to the taxpayer as counting hours. Any hours worked in excess of 2,080 are not included in the calculation. For employers that experience high turnover or hire seasonal workers, this requirement is particularly difficult to determine.

In 2014, the IRS issued Treas. Reg. § 1.45R-2(d)(2), which provides guidance on how to determine the number of hours of service. The regulation provides three methods to determine the total number of hours of service as follows:

- a) Use actual hours worked by determining actual hours of service from records of hours worked and hours for which payment is made or due (payment is made or due for vacation, holiday, illness, incapacity, etc.);
- b) Use a days-worked equivalency whereby the employee is credited with 8 hours of service for each day for which the employee is credited with at least one hour of service for services performed and for certain periods when no services are performed (e.g., vacation); or
- c) Use a weeks-worked equivalency whereby the employee is credited with 40 hours of service for each week for which the employee is credited with at least one hour of service for services performed and for certain periods when no services are performed (e.g., vacation).

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2. Average employee salary is no more than \$50,000 (as indexed for inflation) per full-time equivalent employee

The total wages paid to an employee for the year for purposes of the credit means wages subject to Social Security and Medicare tax withholding determined without considering any wage base limitations. This amount is available from the Form W-2, *Wage and Tax Statement*, Box 5.

3. Employer pays at least 50% of full-time equivalent employees' health insurance premiums

This requirement is met as long as the employer paid at least 50% of single (employee-only) coverage for each employee enrolled in any health insurance coverage provided by the employer. This requirement is met even if the employer actually provided more expensive coverage, such as family coverage, and contributed less than 50% of the more expensive coverage.

4. Employees are enrolled in health insurance coverage through the Small Business Health Options Program

Beginning in 2014, an employer must provide insurance through a qualified health insurance plan offered through the Small Business Health Options Program (SHOP Marketplace) in order to qualify for the credit. Many employers have found that the SHOP Marketplace does not provide the most affordable coverage.

Both small tax-exempt employers and all other small employers are eligible for the credit, with slightly different rules. For tax-exempt small employers, the maximum credit is 35% of premiums paid limited to the amount of certain payroll taxes paid. For all other small employers, the maximum credit is 50% of premiums paid. Both tax-exempt and all other small employers are subject to a premium limitation equal to the average cost of health insurance, as determined by HHS, from the small group market in the employer's state or area of the state. Also, employers claiming the credit must reduce their health insurance premium deduction by the credit determined under IRC section 45R(a).³

The credit is claimed on Form 8941, *Credit for Small Employer Health Insurance Premiums*, and is part of the general business credit. Small tax-exempt employers report the general business credit on Form 990-T, *Exempt Organization Business Income Tax Return*. All other small employers report the general business credit on Form 3800, *General Business Credit*.

Description of Proposal

In order to determine the amount of the credit, a small employer is required to perform numerous labor intensive, complex calculations. In the majority of cases, the calculations

³ IRC section 280C(h).

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are so cumbersome and difficult that small employers must hire tax professionals to perform the work. In addition, prior to beginning the calculations, employers must gather an extensive amount of data that they otherwise would not have to compile.

The AICPA believes that a simpler provision is possible and necessary for a fully functional, meaningful credit for small employers to use as an incentive to purchase health insurance or continue providing health insurance to its employees. A simpler provision should include ways to reduce the small businesses compliance burden as well as the cost to calculate the credit.

The AICPA urges Congress to consider the following proposals which, if enacted, would enhance the operation of the credit and make it a more viable option for small businesses.

A. Eliminate the Phase-out Calculations for Employee Count and Annual Salary

The AICPA proposes eliminating the phase-out calculations for both the employee count as well as the average annual salary. The removal of the phase-out calculations will minimize compliance burdens on small employers in terms of both time and money. In addition, more small employers will benefit from credit eligibility.

Currently, the credit begins to phase out once the number of FTEs exceeds ten and the average annual wages exceeds \$25,000. A wage of \$25,000 is an extremely low threshold to begin a phase-out, especially in certain areas of the country with a high cost of living such as Washington, DC or New York City. Placing a phase-out of ten FTEs on the number of employees that constitutes a small business, ensures that only the smallest of employers will receive the full credit. Additionally, with both of the criteria in place, many small employers find their credit quickly diminishes or that they do not qualify for the credit at all.

Our members have also discovered that the phase-out calculations are time-consuming and difficult which increases the cost of preparing a client's tax return. The added cost reduces the benefit of the credit to which their client is entitled.

B. Eliminate the Small Business Health Options Program Requirement

The AICPA suggests eliminating the requirement that only health insurance premiums paid by an employer for their employees who are enrolled in the SHOP Marketplace qualify for the credit. Although it has been available in paper form since late 2013 and launched on-line in 2014, the full array of benefits of the SHOP Marketplace (e.g., employee choice, lower policy costs due to increased competition and transparency among health insurance providers), are not yet fully operational. This void has left small employers and employees to search outside of the SHOP Marketplace for policies that best fit their needs. Additionally, small employers in certain states may have until 2017 to switch their existing plans that are not Affordable Care Act compliant, to a plan that complies with the rules of the Affordable Care Act. Therefore, many employers have chosen to stay with their current plan.

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Elimination of the requirement that an employer must purchase insurance through the SHOP Marketplace is necessary. The Affordable Care Act was designed to maximize the number of Americans who have health insurance, therefore, it should not matter for purposes of the credit if an employer provides insurance to their employees through the SHOP Marketplace or another insurance provider that may better suit their needs. The insurance should, however, satisfy the minimum essential coverage requirements of the Affordable Care Act.⁴

C. Expand the Credit Period

The AICPA recommends replacing the two-consecutive-taxable year credit period with a five-consecutive-taxable year credit period. The five-consecutive-taxable year credit period will begin with the first taxable year in which the employer offers a qualified health plan and claims the credit.⁵ Limiting the credit to a two-year time period does not provide enough incentive to small employers to provide insurance to their employees. The 2012⁶ and 2015⁷ United States Government Accountability Office (GAO) studies on the state of the credit as well as the 2015⁸ GAO study on the state of the SHOP Marketplace, all named the two-year credit limit as a hurdle that most small businesses face when claiming the credit.

The purpose of the credit was to incentivize small businesses to offer insurance to their employees and their families for the first time or to continue to offer insurance to them. For employers who have not offered insurance in the past, the credit would provide them temporary monetary aid until the SHOP Marketplace was fully operational. A fully operational SHOP Marketplace would then provide small employers a variety of lower-cost insurance options than historically available to them. However, both the 2014⁹ and 2015¹⁰ GAO studies have shown that the SHOP Marketplace continues to perform well below expectations and employers do not have the lower-cost plan options from which to choose. For small employers who have historically provided their employees with insurance, the credit is designed to help them sustain that benefit to their employees by offsetting some of the cost.

⁴ As defined in section 5000A(f).

⁵ Additionally, provide transition relief to employers who claimed the credit for 2014 and 2015 and may have stopped offering coverage in 2016, to enable these employers to utilize the credit for a total of five years after 2013.

⁶ U.S. Government Accountability Office Report to Congressional Requesters titled *Small Employer Health Tax Credit: Factors Contributing to Low Use and Complexity*, Report No. GAO-12-549.

⁷ U.S. Government Accountability Office Report to Congressional Committees titled *Private Health Insurance: Early Evidence Finds Premium Tax Credit Likely Contributed to Expanded Coverage, but Some Lack Access to Affordable Plans*, Report No. GAO-15-312.

⁸ *Ibid.*

⁹ U.S. Government Accountability Office Report to the Chairman, Committee on Small Business, House of Representatives titled *Small Business Health Insurance Exchanges: Low Initial Enrollment Likely due to Multiple, Evolving Factors*, Report No. GAO-15-58.

¹⁰ U.S. Government Accountability Office Report to Congressional Committees titled *Private Health Insurance: Early Evidence Finds Premium Tax Credit Likely Contributed to Expanded Coverage, but Some Lack Access to Affordable Plans*, Report No. GAO-15-312.

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D. Remove the Premium Contribution Limitation

The AICPA recommends eliminating the condition limiting the credit if the average insurance premiums determined by HHS, for the small group market, in the state in which the employer offers insurance, are lower than the actual premiums paid by the employer for insurance. This requirement adds unnecessary complexity to the determination of the amount of the credit.

E. Eliminate the Uniform Contribution Requirement

The AICPA recommends eliminating the requirement that an employer must make non-elective contributions on behalf of each employee of a uniform percentage, not lower than 50%, of the premium cost of the qualified health plan. This requirement adds unnecessary complexity to the calculation of the credit and may deter small businesses from taking advantage of the credit.

Analysis

Small businesses are not required, under the Affordable Care Act, to offer or provide health insurance coverage to their employees. However, the credit offers temporary assistance to small employers for providing health insurance to employees, thus possibly making them more competitive in hiring and retaining employees and more likely to offer coverage.

The credit is often not cost-effective to calculate. The calculations required by the Code are extremely complex and often times, employers find that they are only entitled to a small credit or none at all.

The GAO reported to Congress on the state of the credit in 2012¹¹ and 2015.¹² In both studies, it was found that the number of small employers taking advantage of the tax credit was much lower than originally anticipated. Since the main purpose of the credit is to help small employers afford to offer health insurance to their employees, – which is consistent with the goal of the Affordable Care Act to expand the number of covered individuals – the studies reinforced the fact that the credit is not working as intended. The GAO found, for example, in the 2015¹³ study, that approximately 168,000 small employers claimed the credit in 2012¹⁴ as compared to the number of employers eligible for the credit, which was estimated at 1.4 million to 4 million. This data was consistent in the findings of the 2012¹⁵ study.

¹¹ U.S. Government Accountability Office Report to Congressional Requesters titled *Small Employer Health Tax Credit: Factors Contributing to Low Use and Complexity*, Report No. GAO-12-549.

¹² U.S. Government Accountability Office Report to Congressional Committees titled *Private Health Insurance: Early Evidence Finds Premium Tax Credit Likely Contributed to Expanded Coverage, but Some Lack Access to Affordable Plans*, Report No. GAO-15-312.

¹³ *Ibid.*

¹⁴ U.S. Government Accountability Office Report to Congressional Requesters titled *Small Employer Health Tax Credit: Factors Contributing to Low Use and Complexity*, Report No. GAO-12-549.

¹⁵ *Ibid.*

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Based on the GAO studies as well as our members' experience with the credit, the reasons for low usage of the credit center around the following criteria:

1. Phase-out of the credit based on number of employees and average annual wages

The full credit is allowed if the eligible small employer has ten or fewer FTEs and the average annual wages do not exceed \$25,000. These two criteria are too restrictive and do not allow for a wide enough range of small employers to take advantage of the credit. The credit begins to phase out once the FTE count exceeds ten and the average annual wages exceeds \$25,000. The credit is completely eliminated when the employer has either 25 FTEs or if the average annual wages exceeds \$52,000.

Due to the extremely low wage limitation and low employee threshold, the phase-outs make credit eligibility difficult. Also, numerous calculations are required before determining the amount of the credit that is available to the employer. As a result of the phase-outs, many businesses that expected to benefit from the credit discovered that the actual amount of the credit for which they qualified was negligible or non-existent.

2. Two-year credit limitation

Beginning in 2014, the credit is only available for two consecutive years beginning with the first taxable year in which the employer files Form 8941 to claim the credit, having acquired qualified health insurance through the SHOP Marketplace. Having the provision apply to a taxpayer for only a two-year period starting with the first year the taxpayer, adds confusion and obscures the law's effect. For employers who have not offered health insurance to their employees in the past, the short-term credit is not enough of an incentive to purchase insurance for their employees. After the two-year credit period, the employer may not be in the position of being able to afford to offer their employees this benefit.

3. Calculating the number of full-time equivalent employees

Calculating the number of FTEs is difficult and time consuming because as stated in the "Credit Eligibility and Recordkeeping" section of this letter, an employer needs to determine which employees to include in the number of FTEs and then calculate the number of hours of service per employee. These tasks are laborious, time-consuming and costly.

4. Small Business Health Options Program Requirement

Beginning in 2014, only premiums related to coverage provided to employees who are enrolled in a qualified health insurance plan offered through the SHOP Marketplace qualify for the credit. This requirement places an unnecessary

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restriction on small employers who want to go outside of the SHOP Marketplace to provide insurance to their employees.

The GAO reported to Congress in 2014 on the state of the SHOP Marketplace¹⁶ and discovered a much lower than expected enrollment. The GAO identified the following factors which may have caused the dismal enrollment numbers:

- a) The primary incentive for many small employers to use the SHOP Marketplace was to have the ability to claim the credit for small employer health insurance premiums. However, due to the complexity of the credit and difficult eligibility hurdles, many employers are eligible for only an insignificant amount of credit or none at all.
 - b) Due to the two-year credit limitation, there is insufficient incentive for small employers to move to the SHOP Marketplace for health insurance for their employees.
 - c) Inability of small employers to renew their existing plans on the SHOP Marketplace (small employers have the option to remain with their existing policies until 2017 even if the policies do not meet the requirements of the Affordable Care Act).
 - d) The employee choice feature on the SHOP Marketplace is not yet fully operational.
 - e) There are not enough health insurance policy options for employers to choose from on the SHOP Marketplace since many insurance providers do not offer coverage through the SHOP Marketplace.
 - f) The SHOP Marketplace insurance premiums are not necessarily lower than non-SHOP Marketplace insurance premiums since many insurance providers have not yet signed up to issue insurance through the SHOP Marketplace.
5. Insurance premiums are within specified limitations

There is a condition which limits the credit if the average insurance premiums determined by the HHS, for the small group market, in the state in which the employer offers insurance, are lower than the actual premiums paid by the employer for insurance.

Conclusion/Recommendation

Simplify the small business health insurance tax credit under IRC section 45R.

¹⁶ U.S. Government Accountability Office Report to the Chairman, Committee on Small Business, House of Representatives titled *Small Business Health Insurance Exchanges: Low Initial Enrollment Likely due to Multiple, Evolving Factors*, Report No. GAO-15-58.

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Proposal: Harmonize and simplify education-related tax provisions

Present Law

The IRC includes several education incentives that are divided into two general categories:

1. Those incentives that are intended to help taxpayers meet current higher education expenses; and
2. Those incentives that encourage taxpayers to save for future higher education expenses.

The first category includes provisions that are divided into three main subcategories: (1) exclusions from taxable income such as scholarships (section 117), employer-provided education assistance (section 127) and working fringe benefit (section 132); (2) deductions including the student loan interest deduction (section 221) and the tuition and fees deduction (section 222); and (3) credits including the American Opportunity Tax Credit and Lifetime Learning Credit (section 25A).

The second category, intended to fund future education, includes educational savings bonds (section 135), qualified tuition programs (section 529), and Coverdell Education Savings Accounts (section 530).

Analysis

Legislation (S. 1090 and H.R. 2253)¹⁷ was introduced in the 113th Congress to replace the existing education credits at section 25A with a single credit covering the first four years of post-secondary education.

The proposed legislation modifies the phase-out mechanism, but otherwise mostly retains the special rules of section 25A. S. 1090 proposed the repeal of section 222, a temporary provision that allows a limited deduction for certain tuition and fees.

The table that follows provides a summary of the current education incentives.

Description of Proposal

The AICPA recommends simplification and harmonization of tax benefits for higher education.¹⁸ Specifically, we recommend the following changes for the existing

¹⁷ H.R. 3393, [Student and Family Tax Simplification Act](#), dated October 30, 2013, Bill proposes to consolidate various credits including the hope credit, the American opportunity tax credit, the lifetime learning credit and the deduction for qualified tuition and related expenses into a new combined American opportunity tax credit.

¹⁸ The AICPA submitted [testimony](#) to the Senate Finance Committee hearing on Education Tax Incentives and Tax Reform on July 25, 2012.

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education provisions that provide a benefit to higher education tuition and related expenses:

1. Replace tax incentives (i.e., Hope Credit, American Opportunity Tax Credit, and Lifetime Learning Credit) intended to help taxpayers meet current higher education expenses with one new or revised credit. Combining features of these incentives into one credit would simplify the tax benefits and remove duplicative provisions relating to higher education expenses.
 - a) Apply the credit on a “per student” rather than a “per taxpayer” basis, offering a potentially larger tax benefit per family.
 - b) Make the credit available for any six years of post-secondary education, including graduate-level and professional degree courses. A credit for four years (that includes graduate-level and professional degree programs) is beneficial to many taxpayers, but we suggest increasing the limit to six years.¹⁹
 - c) Make the credit available only to students meeting the definition of “student” under section 25A(b)(3).
 - d) The tax return reporting requirement should continue including the social security number (SSN) or other taxpayer identification numbers (TIN) of the student associated with the expenses claimed with respect to the credit taken for the tax year. Accordingly, allow tracking of amounts claimed over time by the student’s identification number. These changes may result in improved compliance and enforcement.
 - e) The credit should be 100% refundable and phased-out for high-income taxpayers if Congress deems a phase-out necessary. Make the phase-out limitations consistent with any other education-related incentive.
 - f) Allow a parent to claim the credit on their return as long as the child is a qualifying dependent of the parent.
2. Repeal the student loan interest deduction (section 221) and the tuition and fees deduction (section 222) to relieve taxpayer confusion by reducing the number of provisions. The purpose of this recommendation is to simplify the Code without discussion of the total amount of education incentives for taxpayers.

¹⁹ U.S. Department of Education, National Center for Education Statistics. (2013). The Condition of Education 2013 (NCES 2013-037), [Institutional Retention and Graduation Rates for Undergraduate Students](#). A recent report from the U.S. Department of Education stated that “about 59% of full-time, first-time students who began seeking a bachelor’s degree at a 4-year institution in fall 2005 completed that degree within 6 years.” The [statistics used in this report](#) were released in November of 2012 and furthermore, it is a growing standard that more recent metrics for graduation rates and various performance metrics analyze higher education in six year completion intervals rather than four.

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3. Repeal educational savings bonds (section 135) and merge Coverdell Education Savings Accounts (section 530) into qualified tuition programs (section 529) by allowing the transfer of savings from Coverdell accounts into section 529 accounts. Further harmonization of education benefits will result with the reduction and combination of these savings tools. Provisions should also allow owners of existing section 135 savings bonds to roll their accounts into a new combined section 529/530 savings plan. These provisions will help taxpayers to properly transition into the merge of the education savings accounts.
4. Create a uniform definition of “qualified higher education expenses” (QHEE) for all education-related tax provisions. Specifically, QHEE should include tuition, books, fees, supplies and equipment.
5. If it is determined that phase-outs are necessary, all education-related tax provisions should have the same adjusted gross income (AGI) limitations. By substituting one credit for the several benefits that exist today, the concern for excessively high marginal rates resulting from coordinating phase-out provisions is alleviated. In addition, addressing any remaining concerns is achieved by widening the phase-out range, which would still permit coordination that could simplify matters for taxpayers and improve their understanding of eligibility.

Analysis

For many taxpayers, analysis and application of the education tax incentives are too cumbersome compared with the benefits received. The GAO analyzed 2009 data for tax returns with information on education expenses and found that about 14% of filers (1.5 million of nearly 11 million eligible taxpayers) failed to claim a credit or deduction for which they were eligible. On average, these filers lost a tax benefit of \$466 (GAO 12-560 Report to the Senate Finance Committee). Further, according to GAO research, although the number of taxpayers using the educational tax credits is growing quickly, the complexity of the tax provisions prevents hundreds of thousands of taxpayers from claiming tax benefits to which they are entitled or which are most advantageous to them. Finally, there is evidence that the structure of the provisions prevents low-income taxpayers from getting the tax benefit that Congress envisioned.

Another study performed by the GAO reported²⁰ that although the economic downturn of previous years may have reduced income available for education savings, “even among those families who considered saving for education a priority, fewer than 1 in 10 had a 529 plan (or “Coverdell”).” Therefore, merging the section 530 Coverdell accounts into the section 529 plan is an effective way to promote wider use of the tax benefit and an efficient method to simplify the education benefits available to taxpayers.

²⁰ The GAO Report to the Chairman, Committee on Finance, U.S. Senate on [“Higher Education: A Small Percentage of Families Save in 529 Plans.”](#)

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The complexity and interaction among the various provisions is a recurring theme. At the Spring 2008 House Ways and Means hearing on higher education tax incentives, Karen Gilbreath Sowell, then Treasury's deputy assistant secretary for tax policy, commented that "with more than ten million families claiming tax benefits to help finance higher education each year, Congress must ensure that these benefits work as intended" and that "the complexity of the education tax incentives increases record-keeping and reporting burden on taxpayers and makes it difficult for the IRS to monitor compliance."

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 AGI level of the parents (or possibly the student). Further, in a given year, a parent can have eligibility for different credits for different children, while in subsequent years, credits are 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 American Opportunity Tax Credit if the child also receives tax benefits from education savings accounts. 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 six of the nine provisions. This complication requires taxpayers to make numerous calculations to determine eligibility for the various incentives. Since satisfaction of the many individual tests for each benefit is necessary, 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.

In addition to the complexity described above, there is evidence that erroneous application of education credits contributes to the "Tax Gap." According to a report issued by the Treasury Inspector General for Tax Administration (TIGTA) in 2011, it appears that education credits of approximately \$3.2 billion (\$1.6 billion in refundable credits and \$1.6 billion in nonrefundable credits) were erroneously allowed.²¹ Over four years, erroneous education credits could potentially reach \$12.8 billion.²²

In terms of tax policy, the numerous tax incentives to assist with college expenses are not the only way the federal government provides assistance to college students and their families. Through the Department of Education, the federal government assists low-income individuals through various scholarship and grant programs. We encourage Congress to consider all of these programs together to determine if the desired goals are being met in an effective and efficient manner. Also, give consideration as to where and how the best assistance is provided through the tax law (such as incentives to save for future college expenses) versus grant and scholarship programs while the student is in college (where assistance is needed at the start of the school year rather than when the tax

²¹ Treasury Inspector General for Tax Administration Report 2011-41-083, [Billions of Dollars in Education Credits Appear to Be Erroneous](#), dated September 16, 2011.

²² *Id.*

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return is filed). Give consideration to identifying the targeted income group to whom the federal government would provide financial assistance for higher education expenses. When assessing whether this goal is met, aid distributed through scholarships, grants or tax provisions needs consideration. Although the low- to middle-income families are the desired beneficiaries of most education tax provisions, they are also the ones with lower marginal tax rates, which cause them to ultimately benefit the least from the provisions. For example, families with lower tax liability may not receive the benefits of the non-refundable portion of tax credits and to the extent that any proposed tax deductions are itemized deductions, lower income taxpayers are less likely to receive the benefits because they frequently do not itemize. Finally, a determination is necessary as to which levels of education should yield a tax benefit to taxpayers. All of the education provisions generally cover post-secondary education only. However, the Coverdell Education Savings Account (section 530) also covers elementary and secondary education.

Conclusion/Recommendation

Simplification of education-related tax provisions as suggested above allows taxpayers to better understand the rules and can comply with them in a cost-efficient manner. Such simplification would also improve the transparency and visibility of such tax provisions and allow the monitoring of compliance with the provisions. Simplification of the education-related tax provisions would increase the benefits going to the targeted taxpayers, lower the cost of administering the tax system, and reduce the “Tax Gap.”

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Education Incentives – Exclusions and Deductions				
Code §	Provision	Summary	Qualified Education Expenses Definition	AGI Phase-Out
Exclusions				
117	Exclusion for scholarships	Excludes scholarships from income to the extent it covers qualified education expenses for degree-seeking undergraduate students	Tuition, books, supplies, and equipment; but not room and board	None
127	Exclusion for employer-provided education	The employee excludes from income up to \$5,250 of employer-provided qualified education expenses under educational assistance program	Tuition and fees for undergraduate and graduate courses; books, supplies, and equipment; but not room and board; not necessarily for work-related courses	None
Deductions				
Reg. 1.162-5	Expenses for education	The education must not prepare student for a new job or meet the minimum requirements for a job. Thus, undergraduate education does not qualify. Continuing education courses of a CPA or other licensed professional are examples of qualifying education.	Tuition, fees, materials and possibly some travel and transportation expenses. Self-employed individuals may deduct on Schedule C if related to the business.	None
221	Student loan interest deduction	For AGI deduction of up to \$2,500 for interest paid on qualifying student loan	Tuition, fees, books, supplies, equipment, room and board, transportation, other necessary expenses	S: \$65,000 - \$80,000 MAGI MFJ: \$130,000 - \$160,000 MAGI MFS: No deduction

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Code §	Provision	Summary	Qualified Education Expenses Definition	AGI Phase-Out
222	Qualified tuition and fees deduction (expires 12/31/16)	For AGI deduction of up to \$4,000	Tuition, fees; but not room and board Student-activity fees and expenses for course-related books, supplies, and equipment are included in QHEE only if the fees and expenses require a payment to the institution as a condition of enrollment	<p>S, HOH: If AGI is not more than \$65,000, may deduct \$4,000; if between \$65,000 and \$80,000, may deduct \$2,000</p> <p>MFJ: If AGI is not more than \$130,000, may deduct \$4,000; if between \$130,000 and \$160,000, may deduct \$2,000</p> <p>MFS: No deduction</p>

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Education Incentives – Credits				
Code §	Provision	Summary	Qualified Education Expenses Definition	AGI Phase-Out
25A	American Opportunity Tax Credit	<p>Credit of up to \$2,500 per student: 100% of first \$2,000; 25% of next \$2,000</p> <p>Enrollment of at least half-time is necessary</p> <p>40% of modified credit is refundable (but not for child subject to section 1(g) (Kiddie Tax))</p> <p>If parent pays the expenses, must have authority to claim exemption for the student on tax return</p> <p>No felony drug conviction Regulations explain who gets credit in special circumstances</p>	<p>Tuition, fees, and course materials including books, during first four years of post-secondary education; but not room and board</p> <p>Courses must have association with degree program or recognized education credential</p> <p>Athletic fees, insurance, activity fees are not eligible unless required as a condition of enrollment and paid directly to the institution</p>	<p>S: \$80,000 - \$90,000</p> <p>MFJ: \$160,000 - \$180,000</p> <p>MFS: No credit</p>
25A	Lifetime Learning Credit	<p>Credit of up to \$2,000 per return: 20% on up to \$10,000</p> <p>A non-refundable elective credit</p> <p>If parent pays the expenses, must have authority to claim exemption for the student on tax return</p> <p>Regulations explain who gets credit in special circumstances</p>	<p>Tuition and fees including for graduate courses/continuing education; but not room and board</p> <p>Available for all post-secondary education—not necessarily associated with a degree</p>	<p>S: \$54,000 - \$64,000</p> <p>MFJ: \$110,000 - \$130,000</p> <p>MFS: No credit</p>

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Education Incentives – Planning for College

Education Incentives – Planning for College				
Code §	Provision	Summary	Qualified Education Expenses Definition	AGI Phase-Out
135	Educational Savings Bonds	Allows for partial or total exclusion of interest income on redemption of qualified U.S. savings bonds used for qualifying purposes	Tuition and fees but not for courses involving sports, games, or hobbies that are not part of degree or certificate granting program; not room and board	S: \$77,200 - \$92,200 MFJ: \$115,750 - \$145,750 MFS: No exclusion
529	Qualified Tuition Plans	For College Savings Plan, account owner contributes cash to a plan account for a beneficiary and the contribution is invested according to the terms of the plan For Prepaid Tuition Plan, account owner contributes cash to a plan account and the contribution purchases tuition credits or credit hours based on then-current tuition rates Contributions qualify for the annual gift tax exclusion Earnings are not taxed and can withdrawal funds tax-free if used for qualifying purposes	Tuition and fees, books, computers, technology and other expenses for vocational schools, 2-year and 4-year colleges as well as graduate and professional education; room and board if the beneficiary attends school at least half-time; expenses of special needs beneficiary necessary for his/her enrollment at eligible educational institutions	None
530	Coverdell Education Savings Account	Non-deductible contribution of up to \$2,000 per year for a beneficiary under age 18. Except for special needs beneficiaries, contributions must end at age 18 and must withdraw assets by age 30 Distributions non-taxable to extent funds used for QHEE or qualified elementary and secondary education expenses	Tuition, books, fees, supplies, equipment, tutoring, computer equipment and software, uniforms for both higher education and elementary and secondary education at public, private, and religious schools; room and board for student enrolled at least half-time	S: \$95,000 and \$110,000 MFJ: \$190,000 and \$220,000 MFS: \$95,000 and \$110,000

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Proposal: Standardize the allowable mileage rates for business expense, medical expense, moving expense and charitable contribution purposes

Present Law

A standard mileage allowance, generally determined annually, is allowed to taxpayers in determining their expenses related to employment (54 cents per mile beginning January 1, 2016). Further, a standard mileage allowance, also generally determined annually, is allowed to taxpayers for purposes of medical and moving expense deductions (19 cents per mile beginning January 1, 2016). When necessary, the IRS has the authority to adjust these rates at any time (as it did in mid-year 2011 to reflect the extraordinary rise in gasoline prices). In contrast, the mileage rate allowed for charitable contribution deduction purposes is set by statute at 14 cents a mile (section 170(i)). Prior to 1984, the IRS had the authority to set this rate as well.

Note: Legislation (H.R. 6854 and S. 3246) was introduced in the 110th Congress to allow the IRS to once again set the charitable contribution deduction mileage rate and standardize it at the same amount as that allowed for medical and moving expenses. Separate legislation (S. 3429) also was introduced in the 110th Congress to set the charitable deduction mileage rate at 70% of the business mileage rate. In the 113th Congress, H.R. 1212 was introduced to set the charitable contribution mileage deduction rate at the same amount as that allowed for business expenses.

Description of Proposal

Require the IRS to set and regularly adjust two mileage rates: one for business expenses and another for all non-business purposes (charitable, medical and moving expenses). The IRS should set the non-business rate at a percentage of the business rate, rounded to the nearest half cent. Annual and possibly semi-annual adjustment in certain circumstances of the business rate is necessary. Using the business rate in effect at the time of enactment as the starting point is advised.

Modify section 170(i) to state that a standard mileage rate, as established and regularly adjusted by the IRS, is allowed for usage. Removal of the current language regarding 14 cents per mile is recommended.

Analysis

Currently, taxpayers often need to apply at least two and sometimes three different mileage rates on a single return. The proposal would reduce these numbers to one and occasionally two rates per return. Allowing the IRS to set a fair rate for charitable contribution mileage would recognize the vital role volunteers play in our society. Linking all mileage rate allowances to a single standard and adjusting those rates at least annually would bring transparency, fairness and equity to the process. In addition, the IRS's annual calculation of these rates is simplified.

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Conclusion/Recommendation

Congress should allow the IRS once again to set the charitable contribution deduction mileage rate, standardized to the same amount as that allowed for other non-business purposes (medical and moving expenses). Setting this single rate at a percentage of the business mileage allowance is advised. Adjustment of all mileage allowance rates on an annual basis, possibly with a mid-year adjustment, is needed

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Proposal: Standardize the medical lodging deduction limitation with the allowable business per diem rates

Present Law

Under section 213(d)(2), the amounts paid for certain lodging away from home that is treated as medical care is not indexed for inflation and does not differentiate among high and low cost lodging localities. A taxpayer is limited to a deduction of \$50 per night for lodging if he/she is traveling alone even though few lodging or hotel establishments across the country are available at this rate per night. Additionally, since the rate is \$50 per person, the amount rises to \$100 per night if the taxpayer travels with a companion. Even with a companion rate, this \$100 remains less than the expected cost for medical patients to find reasonable and conveniently located lodging near an urban medical facility.

Description of Proposal

Remove the strikethrough language from section 213(d)(2) as follows:

- (2) Amounts paid for certain lodging away from home treated as paid for medical care.—

Amounts paid for lodging (not lavish or extravagant under the circumstances) while away from home primarily for and essential to medical care referred to in paragraph (1)(A) shall be treated as amounts paid for medical care if—

- (A) The medical care referred to in paragraph (1)(A) is provided by a physician in a licensed hospital (or in a medical care facility which is related to, or the equivalent of, a licensed hospital), and
- (B) There is no significant element of personal pleasure, recreation, or vacation in the travel away from home.

~~The amount taken into account under the preceding sentence shall not exceed \$50 for each night for each individual.~~

Additionally, simplify the lodging deduction calculation by linking the allowance for medical care lodging deduction with the annually adjusted business per diem rates.²³

²³ This proposal is consistent with the AICPA's proposal to: "Standardize the allowable mileage rates for business expense, medical expense, moving expense and charitable contribution purposes." We recommend the use of business per diem rates for the medical lodging deduction limitation in order to further harmonize and synchronize the non-business rates and limitations used throughout the Code with standard business expense rates.

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Analysis

Eliminating the \$50 limitation and allowing the use of business expense per diem lodging rates would help taxpayers secure affordable lodging near a place suited to facilitate the necessary care, treatment, and healing of the patient. Removing the sentence shown above will also promote administrative efficiency because it is arguably unlikely that travel associated with medical treatments are often an occasion for frivolous expenditures on lodging. There is no need to repeatedly adjust deduction amounts in the future as inflation occurs and prices rise nor keep multiple sets of figures that adapt to price levels across various cities. Linking the lodging rate allowance to regularly published business per diem amounts that are generally adjusted annually is a simple approach that promotes both fairness and equity.

Additionally, we recommend keeping the language: “not lavish or extravagant” in order to protect valuable government resources. Such language discourages any possible, yet unlikely, abuse of the Code while providing taxpayers some relief from the costly expenses of medical care.

Conclusion/Recommendation

Congress should eliminate the \$50 limitation in section 213(d)(2), as shown above, and standardize the lodging allowance for medical care with the allowable per diem rates for business expense.

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Proposal: Allow certain attorney fees and court costs as deductions for adjusted gross income

Present Law

In computing AGI, individuals are allowed to treat costs related to certain types of litigation or award recoveries as deductible for AGI. Attorney fees for other types of non-business litigation, if deductible, are generally treated as expenses for the production of income under section 212 of the IRC. As such, these expenses are treated as miscellaneous itemized deductions subject to the 2% of AGI limitation of section 67 and the overall limitation of section 68 on itemized deductions. In addition, miscellaneous itemized deductions are not deductible in computing AMT.²⁴ Thus, despite the fact that legal fees are incurred and gross income is derived from the litigation or action, taxpayers are not treated similarly with respect to the tax treatment of their legal fees.

Section 62(a)(20) enacted as part of the American Jobs Creation Act of 2004 (P.L. 108-357) provides that attorney fees and court costs connected with the following types of actions are deductible for AGI:

- Unlawful discrimination claim (as defined at section 62(e) which lists 18 types of “unlawful discrimination” actions, such as certain violations under the Civil Rights Act of 1991, the National Labor Relations Act, the Fair Labor Standards Act of 1938, the Family and Medical Leave Act of 1993 and several others);
- Claim of violation of subchapter III of chapter 37 of U.S. Code Title 31; and
- Claim under section 1862(b)(3)(A) of the Social Security Act.

The attorney fee and court cost deduction may not exceed the amount included in gross income from the judgment or settlement of the associated claim.

Section 62(a)(21) was enacted as part of the Tax Relief and Health Care Act of 2006 (P.L. 109-432). This provision allows a deduction for AGI for attorney fees and court costs for any award received under section 7623(b) related to whistleblower awards. The deduction is limited to the amount of the award included in gross income for the year.

²⁴ The AICPA supports repeal of the alternative minimum tax (AMT). AICPA written testimony before the House Committee on Ways And Means, Subcommittee on Select Revenue Measures, dated March 03, 2011, “[Hearing on Small Businesses and Tax Reform](#),” and AICPA submitted comments to the House Committee on Ways and Means on the Tax Reform Act of 2014, dated January 12, 2015; <http://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/AICPA-Comments-on-2014-Camp-Draft-General-Comments-Final.pdf>.

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Description of Proposal

Modify section 62 to allow a deduction for AGI for any attorney fees and court costs paid or incurred by a taxpayer related to any litigation award or settlement that is included in gross income.

Analysis

The Tax Reform Act of 1986 modified the rules on miscellaneous itemized deductions by making them deductible only to the extent they exceed 2% of the taxpayer's AGI. The primary rationale for the change was simplification. The committee report provided the following reasons for change:²⁵

The committee believes that the present-law treatment of employee business expenses, investment expenses and other miscellaneous itemized deductions fosters significant complexity. For taxpayers who anticipate claiming itemized deductions, present law effectively requires extensive recordkeeping with regard to what commonly are small expenditures. Moreover, the fact that small amounts typically are involved presents significant administrative and enforcement problems for the IRS. These problems are exacerbated by the fact that taxpayers may frequently make errors of law regarding what types of expenditures are properly allowable as miscellaneous itemized deductions.

Since many taxpayers incur some expenses that are allowable as miscellaneous itemized deductions, but these expenses commonly are small in amount, the committee believes that the complexity created by present law is undesirable. At the same time, the committee believes that taxpayers with unusually large employee business or investment expenses should have permission to receive an itemized deduction reflecting that fact. Similarly, in the case of medical expenses and casualty losses, a floor is provided under present law to limit those deductions to unusual expenditures that may significantly affect the individual's disposable income.

Accordingly, the committee believes that the imposition of a 1% floor on miscellaneous itemized deductions constitutes a desirable simplification of the tax law. This floor will relieve taxpayers of the burden of recordkeeping, unless they expect to incur expenditures in excess of the percentage floor. Also, the floor will relieve the IRS of the burden of auditing deductions for such expenditures when not significant in aggregate amount.

The committee also believes that the distinction under present law between employee business expenses (other than reimbursements) that are

²⁵ Tax Reform Act of 1986 (P.L. 99-514; 10/22/86), House explanation.

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allowable above-the-line, and such expenses that are allowable only as itemized deductions, is not supportable. The reason for allowing these expenses as deductions (i.e., the fact that they may constitute costs of earning income) and the reasons for imposing a percentage floor apply equally to both types of expenses.

Despite the fact that some types of miscellaneous deductions are incurred to produce gross income, in 1986, Congress sought to limit the deductibility of many of these deductions, including non-business attorney fees associated with litigation and settlement awards. At that time, Congress treated all such attorney fees and court costs of producing non-business awards, similarly. However, in 2004, Congress started to treat one type of litigation expenses differently, and again in 2006 with one more type of litigation expense. These changes involving subsets of attorney fees, created an inequity in the tax law regarding the treatment of deductions.

Given that all attorney fees and court costs incurred to generate taxable litigation and settlement awards are costs to produce income and that there is little complexity in tracking these specific and often sizable amounts, the principles of equity and fairness warrant treating all attorney fees and court costs the same regardless of the nature of the taxable damages award. Thus, the change made to section 62(a) in 2004 and 2006 should broaden to include all attorney fees and court costs that relate to taxable awards.

Conclusion/Recommendation

Replace section 62(a)(20) and (21) with one provision to read as follows:

Section 62(a)(20) Attorney fees related to taxable awards

Any deduction allowable under this chapter for attorney fees and court costs paid by, or on behalf of, the taxpayer in connection with any award includible in gross income, with appropriate adjustments for amounts previously deducted. The preceding sentence shall not apply to any deduction in excess of the amount includible in the taxpayer's gross income for the taxable year on account of such award.

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Proposal: Provide parity for employees and self-employed individuals

Present Law

The Self-Employment Contributions Act (SECA) imposes tax on the net earnings from self-employment. The tax is composed of two parts: old-age, survivors and disability insurance (OASDI) tax and hospital insurance (HI) tax. Section 162(l)(4) provides that self-employed individuals are not allowed to deduct their health insurance costs from net earnings from self-employment (within the meaning of section 1402) in determining tax under section 1401(a) and section 1401(b) for old-age, survivors and disability insurance and hospital insurance. However, pursuant to section 3121(a)(2), health insurance costs are excluded from an employee's wages in determining tax under section 3101(a) and 3101(b) for OASDI and HI taxes.

Description of Proposal

Equalize the tax treatment with respect to the deduction for health insurance costs in determining income subject to OASDI and HI taxes as was allowed temporarily under the Small Business Jobs Act of 2010.

Analysis

Deductions allowable in determining a particular tax should remain consistent among taxpayers subject to such tax. Employees subject to OASDI and HI taxes are allowed a deduction for health insurance costs in determining their net income subject to these taxes while self-employed individuals subject to these same taxes are not allowed a deduction in determining their net income subject to these taxes.

Conclusion/Recommendation

We recommend that deductions allowed in determining income subject to OASDI and HI taxes remain consistent amongst taxpayers regardless of whether they are employees or self-employed individuals.

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Proposal: Simplify the provisions for calculating the tax on unearned income of a child by removing the link with the parent's income tax return and by applying the income tax rates for estates and trusts

Present Law

Section 1(g) of the IRC taxes a portion of the unearned income of a child at the parent's marginal tax rate (Kiddie Tax). A child is defined as any child who is (1) under the age of 18; (2) age 18 at the end of the year and who did not have earned income that was more than half of the child's support; or, (3) a full-time student under the age of 24 who did not have earned income that was more than half of the child's support. Specifically, the provision applies in cases where (1) the child's unearned income was more than \$2,000; (2) the child is required to file a tax return; (3) either parent of the child is alive at the close of the year; and (4) the child does not file a joint return for the taxable year.

The marginal tax rate of the individual with the greater taxable income is used in the case of parents filing separately. In the case of parents who are not married, the marginal tax rate of the custodial parent is used to determine the tax liability on net unearned income. Net unearned income is the amount of unearned income above \$1,000 plus the greater of \$1,000 or itemized deductions directly connected to producing unearned income. When the provisions of section 1(g) apply to more than one child in the family, each child's share of the parental tax is apportioned ratably based on the ratio of the child's net unearned income to the total net unearned income of all children.

Section 1(g)(6) requires the parent to provide his/her taxpayer identification number to the child for inclusion on the child's tax return. Parents can elect to include their children's interest and dividend income (including capital gain distributions) on their tax return. However, the election is not available for parents of a child if such child has any earned income, unearned income of \$10,500 or more (for 2017), unearned income other than interest, dividends and capital gain distributions, withholding, or estimated tax payments.

Description of Proposal

We recommend the repeal of the provisions linking a child's taxable income to his/her parents' and siblings' taxable income. Income (other than capital gains) subject to this tax should use the income tax rates for estates and trusts. Income from capital gains should use the capital gains rates with one change; we believe the 0% rate for capital gains should not apply to children's unearned income.

Further, an elimination of the election to include a child's income on the parent's return should take place to facilitate the complete de-coupling of the link between the computation of the child's tax liability and the parent's tax liability.

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Analysis

The Kiddie Tax adds significant complexity to the computation of a child's tax liability. As a result of this complexity, the IRS issued Publication 929, a 27-page booklet that provides worksheets to assist the taxpayer, or return preparer, with calculating the child's taxable income and tax liability. In addition to the complex calculations, several challenges arise in complying with the rules of the statute:

- Difficulty in getting information about the applicable tax rate: Parents may either refuse to provide the tax rate or, if divorced, one parent may refuse to cooperate with the other in providing the information. Without this information, the tax preparer is forced to calculate the child's tax unfairly at the highest rate.
- Qualified dividends or capital gain distributions: The IRS requires qualified dividends and capital gain distributions to allocate between the first \$2,100 (in 2015) of unearned income and the portion of the child's unearned income in excess of \$2,100, thus making the computation burdensome.
- Interrelationship with parents'/siblings' returns: If either the parents or siblings file amended returns, the child must file an amended return. The fact that amended returns have been filed is not readily known information.
- Alternative minimum tax (AMT): The Kiddie Tax provision only considers the regular tax of section 1 and not the AMT of section 55. Therefore, the way the current rules are written, if a parent must pay AMT, the child's income is still taxed at the parent's regular marginal tax rate, while the parent is taxed at the AMT rate without taking into account the child's income or the child's regular tax liability. The result when AMT applies to the parent is the taxation of the child's income at a rate higher than the rate that applies to the parent.

Removing the linkage to parental and sibling returns would allow a child's return to stand on its own. Complications due to missing information on one return, matrimonial issues and unintended AMT problems are likely eliminated.

Conclusion/Recommendation

The AICPA believes the additional tax revenue generated by the Kiddie Tax is most likely insignificant when compared to the complexity of the calculations. Taxing the net unearned income of a child at the tax rates for estates and trusts rather than at a rate linked to that of family members would eliminate a significant amount of complexity and several compliance challenges, while still accomplishing the original intent behind the Kiddie Tax. The Tax Reform Act of 1986 lowered tax rates and broadened the income base by eliminating various tax shelters that were utilized by high income individuals. The Kiddie Tax was one such provision that targeted taxpayers who were attempting to shift income to family members in lower tax brackets. In recommending the Kiddie Tax, the Joint Committee on Taxation's General Explanation of the Tax Reform Act of 1986

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wrote, “The present-law rules governing the taxation of minor children provide inappropriate tax incentives to shift income-producing assets among family members.”

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Proposal: Simplify the tax treatment of Roth individual retirement account contributions

Present Law

The term “Roth IRA” means an individual retirement plan as defined in section 7701(a)(37). For taxable income purposes, no deduction is allowed under IRC section 219 for a contribution to a Roth IRA. Also, contributions to a Roth IRA are affected by modified adjusted gross income as computed for Roth IRA purposes and the modified adjusted gross income limitation reduces the contribution amount to zero for many taxpayers.

If taxpayers are eligible to participate in a workplace retirement account such as a 401(k) or 403(b), they are subject to limitations for deducting the IRA contributions. However, the IRS allows anyone to make an election for nondeductible contributions to a traditional IRA account if the taxpayers are subject to the limitations. These nondeductible IRA contributions are tax-deferred and the contributions are treated as basis when IRA distributions are taken. Therefore, tax is only paid on the growth of the nondeductible IRA contributions. For example, for taxpayers who make a \$5,000 nondeductible IRA contribution that grows to a value of \$50,000, the withdrawal of \$1,000 will only result in a taxable amount of \$900 because 10% ($\$5,000/\$50,000$) is a return of the nondeductible basis.

Prior to 2010, a traditional IRA account could not convert to a Roth IRA account if modified adjusted gross income exceeded \$100,000 or if the taxpayer’s filing status was married filing separately. These limitations were removed as part of the Tax Increase Prevention and Reconciliation Act of 2005.

Description of Proposal

We propose the removal of the adjusted gross income limitation. By removing this limitation, all taxpayers would have the ability to make a direct contribution to a Roth IRA account.

Analysis

As noted above, taxpayers may convert from a traditional IRA account to a Roth IRA account without regard to their level of income. Congress took deliberate action to allow this procedure by changing the law to allow conversions without regard to income level.

Although Congress took action to allow conversions without regard to income level, Congress did not remove the income limitations with respect to contributing directly to a Roth IRA account. Thus, even though Congress has provided an opportunity through the conversion process for all taxpayers to ultimately have a Roth IRA account without regard to income level, taxpayers with income above the specified thresholds must first contribute to a traditional IRA account (where no income limitations apply) and then convert it to a Roth IRA account. Our proposal would eliminate this step by allowing

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taxpayers to contribute directly to a Roth IRA account without regard to income level. This proposal could result in some loss of revenue to the Treasury, due to the fact that taxpayers who convert from a traditional IRA account to a Roth IRA account must recognize income upon the conversion equal in amount to the difference between the account balance and basis in the account. Specifically, if contributions are made directly to a Roth IRA account, there is no conversion income to recognize. However, this effect is mitigated by the fact that under current law, the amount of income recognized upon the conversion is in many cases relatively low, such as in the case of a taxpayer with no traditional IRA accounts other than a nondeductible traditional IRA account that is converted to a Roth IRA account shortly after the nondeductible traditional IRA account is established. In that case, there is little to no growth in the account between the time it is established and the time it is converted, resulting in little to no income recognized upon the conversion.

Conclusion/Recommendation

We propose eliminating the adjusted gross income limitation for contributions to a Roth IRA, which would eliminate the need for higher income taxpayers to use a two-step process in funding these accounts.

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Proposal: Allow a reasonable cause exception to the section 6707A and 6662A penalties for all reportable transactions, and provide for judicial review where such relief is denied

Present Law

Taxpayers who fail to disclose a reportable transaction are subject to a penalty under section 6707A of the IRC. For penalties assessed after 2006, the amount of the penalty is 75% of the decrease in tax shown on the return as a result of the transaction (or the decrease that would have been the result if the transaction had been respected for federal tax purposes). If the transaction is a listed transaction (or substantially similar to a listed transaction), the maximum penalty is \$100,000 for individuals and \$200,000 for all other taxpayers. In the case of reportable transactions other than listed transactions, the maximum penalty is \$10,000 for individuals and \$50,000 for all other taxpayers. The minimum penalty is \$5,000 for individuals and \$10,000 for all other taxpayers.

The section 6707A penalty applies even if there is no tax due with respect to the reportable transaction that has not been disclosed. There is no reasonable cause exception to the penalty. The Commissioner may, however, rescind all or a portion of the penalty, but only in the case of transactions other than listed transactions, where rescinding the penalty would promote effective tax administration, and only after the taxpayer submits a lengthy and burdensome application. In the case of listed transactions, the IRS has no discretion to rescind the penalty. The statute precludes judicial review where the Commission decides not to rescind the penalty.

Under section 6662A, taxpayers who have understatements attributable to certain reportable transactions are subject to a penalty of 20% (if the transaction was disclosed) and 30% (if the transaction was not disclosed) of the amount of the understatement. A more stringent reasonable cause exception for a penalty under section 6662A is provided in section 6664, but only where the transaction is adequately disclosed, there is substantial authority for the treatment, and the taxpayer had a reasonable belief that the treatment was more likely than not the proper treatment. In the case of a listed transaction, reasonable cause is not available, similar to the penalty under section 6707A.

Description of Proposals

Amend section 6707A to provide that no penalty is imposed if it is shown that there was reasonable cause for the failure to disclose and that the taxpayer acted in good faith, for all types of reportable transactions. Allow judicial review if the reasonable cause exception is denied.

Amend section 6664 to provide that no penalty is imposed where there was reasonable cause for the understatement and the taxpayer acted in good faith, for all types of reportable transactions, irrespective of whether the transaction was adequately disclosed, and irrespective of the level of assurance of the treatment.

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Analysis

The current structure of the penalties under sections 6707A and 6662 is not consistent with penalty policies articulated by Congress when the Code was amended in 1989 to reform the penalty structure. In the case of a penalty under section 6707A, no reasonable cause exception is provided, and rescission is available in very limited circumstances and only through a lengthy and burdensome application process. In the case of listed transactions, the penalty is a strict liability penalty with no review or appeal procedures. For penalties under section 6662A, the more stringent reasonable cause provisions are not consistent with the reasonable cause provisions throughout the Code, and no reasonable cause exception is available in the case of a listed transaction.

Moreover, we believe the absence of judicial review when the Service has assessed a penalty under section 6707A is a violation of procedural due process and notions of fair tax administration.

As a fundamental principle, the AICPA is opposed to strict liability penalties because such penalties are unduly harsh and do not allow for abatement due to reasonable cause, such as an inadvertent act of the taxpayer or circumstances beyond the taxpayer's control. We believe that fairness and effective tax administration require the IRS to retain discretion in assessing and abating penalties. Additionally, under the current reportable transaction penalty structure, there is no mechanism to allow taxpayers to bring themselves into compliance once they discover their error after the due date or to otherwise voluntarily come forward. Finally, we note that many taxpayers are exposed to listed transactions indirectly via investments in partnerships. Such taxpayers frequently have no control over the activities of the partnerships in which they invest. And, investing taxpayers are only informed of listed transaction exposure once a year via Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.*, reporting that is frequently very complicated.

Conclusion/Recommendation

We recommend amending section 6707A to allow an exception to the penalty if there was reasonable cause for the failure and the taxpayer acted in good faith for all types of reportable transactions, and to allow for judicial review in cases where reasonable cause was denied. Moreover, we recommend amending section 6664 to provide a general reasonable cause exception, irrespective of whether the transaction was adequately disclosed or the level of assurance, for all types of reportable transactions.

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Proposal: Repeal the section 7122(c)(1) requirement to provide a 20% partial payment with a lump-sum offer in compromise

Present Law

Under section 7122(c)(1) of the IRC, if a taxpayer submits a lump-sum offer in compromise (i.e., an offer of payments involving five or fewer installments) to compromise a tax debt, the taxpayer is generally required to submit a payment equal to 20% of the offer amount to the Service upon submission of the offer application. Low-income taxpayers (persons with incomes below 250% of the federal poverty thresholds) are generally exempt from the 20% payment requirement.

Description of Proposal

To increase accessibility to and effectiveness of the offer in compromise program, repeal the 20% partial payment requirement otherwise imposed by section 7122(c)(1).

Analysis

The efficient resolution of outstanding tax liabilities is necessary for effective tax administration and reduction of the tax gap. The IRS should have the opportunity to review offers and determine whether the acceptance of an offer is in the best interest of the government. The IRS should use an offer in compromise as a tool to collect the proper amount of tax; however, the 20% requirement of current law has discouraged taxpayers from seeking opportunities to settle tax liabilities with the government.

According to the National Taxpayer Advocate's 2007 Annual Report to Congress, the 20% payment amount was not available from the taxpayer's liquid assets in approximately 70% of the offers accepted by the IRS prior to implementation of section 7122(c)(1). Thus, taxpayers are invariably forced to turn to family and friends to raise the necessary funds to cover the 20% payment amount otherwise required for submission of an offer application. Some commentators are concerned that, unfortunately, family and friends of the taxpayer are reluctant to provide the taxpayer with the necessary funds for the partial payment amount, particularly when informed that the payment amount is nonrefundable, even when the offer is not otherwise accepted later (creating a situation that is construed as a barrier to settling tax debts for many taxpayers).

Furthermore, one of the stated objectives of an offer in compromise is to "provide the taxpayer a fresh start toward future voluntary compliance with all filing and payment requirements."²⁶ Requiring the 20% payment for submission with an offer, hinders a significant segment of the population from returning to compliance.

Although proponents of the 20% partial payment amount under section 7122(c)(1) believe the partial payment amount is effective in eliminating the submission of frivolous

²⁶ [Internal Revenue Manual, Part 5, Chapter 8, section 1, 5.8.1.1.4, Objectives](#), dated September 23, 2008.

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offers, it appears that a significant effect of the 20% requirement is to discourage the submission of a large number of legitimate offers.

Conclusion/Recommendation

Repeal of section 7122(c)(1) will provide taxpayers with an effective option for addressing a federal tax liability.

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Proposal: Repeal section 6306(c)(1) requiring the Secretary of the Treasury to enter into qualified tax collection contracts with private debt collection agencies to collect outstanding “inactive tax receivables”

Present Law

The Fixing America’s Surface Transportation Act (FAST) (P.L. 114-94) added Code section 6306(c)(1) requiring the Secretary of the Treasury to enter into qualified tax collection contracts with private debt collection agencies to collect outstanding “inactive tax receivables.” These “inactive tax receivables” are tax receivables that meet one of the three following criteria:

- The IRS has removed the receivable from the list of collectible inventory at any time after assessment due to either lack of resources or the inability to locate the taxpayer;
- The tax receivable has not been assigned for collection to any IRS employee and more than one-third of the applicable limitations period has passed; or
- There has been no contact for more than 365 days between the IRS and the taxpayer or a third party for the purpose of collecting on the tax receivable that has been assigned for collection.

Private debt collection agencies are to collect outstanding inactive tax receivables identified after December 4, 2015.

Description of Proposal

Congress should repeal section 6306(c)(1) requiring the Secretary of the Treasury to enter into qualified tax collection contracts with private debt collection agencies to collect outstanding receivables.

Analysis

We disagree with the policy to use private collection agencies as it is an ineffective and costly means of collecting tax debts while opening up the potential to violate taxpayer rights. Furthermore, private collection agencies create unnecessary anxiety and confusion for taxpayers in a time of rampant identity theft. All these factors lead to further mistrust in the voluntary tax compliance system.

From 2006 to 2009, the IRS employed private debt collection agencies to assist in locating and contacting taxpayers, and requesting installment agreements for unpaid tax liabilities. In 2009, the IRS announced that it would not renew the private collection agencies’ contracts because it found that the Service’s internal collection activities were

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more successful and cost effective. A study by the Taxpayer Advocate²⁷ supports the Service's decision to suspend the use of private collection agencies.

As in the past, taxpayers already have concerns about the actions of the private collection agencies and their rights. For example, the current program does not recognize taxpayers with economic hardship and does not offer taxpayers the same relief as the IRS is required to offer under statutory and administrative rules. The IRS will not have the ability to actively ensure consistent and fair treatment of taxpayers across multiple private collection agencies. Keeping all collection efforts within the IRS allows employees to receive specialized training and to efficiently supervise collection efforts to ensure the law is followed and taxpayer rights are protected.

Additionally, due to the proliferation of fraudulent tax return scams, we believe the use of private collection agencies will add security, authentication, verification, and complexity issues to an already overburdened system. Inevitably, once the private debt collection plan is relaunched, numerous scam artists will develop fraudulent letters and increase their phone efforts to deceive taxpayers. We note that in October of 2016, seventy people at a network of call centers in Mumbai were arrested and roughly 600 others were placed under investigation for engaging in a massive tax collection fraud targeting U.S. taxpayers. This scam was estimated to generate at least \$33M/year in fraudulent collections from U.S. taxpayers.²⁸ U.S. taxpayers already have difficulty distinguishing between legitimate IRS collection efforts and fraudsters. The use of private debt collection agencies will make it even more difficult for U.S. taxpayers to distinguish between legitimate collection efforts and scams. Taxpayers will look towards the IRS to authenticate private collectors creating an additional administrative and costly burden for the IRS.

Overall, the use of private collection agencies is inconsistent with the Taxpayer Bill of Rights. Given the climate of identity theft and the need to safeguard taxpayer data, we do not see how the use of private collection agencies enhances tax administration for the IRS or, more importantly, the trust taxpayers have in the voluntary tax compliance system. We oppose the use of private collection agencies and support the repeal of section 6306(c)(1).

Conclusion/Recommendation

We urge Congress to repeal section 6306(c)(1) as it will likely harm taxpayers and further degrade the trust in our voluntary tax compliance system while increasing the costs of collections. We do not believe that the renewed private debt collection policy has been well-conceived or adequately addresses the balance between fair tax collection practices and helping taxpayers, particularly those in economic hardship, meet their obligations to

²⁷ National Taxpayer Advocate, 2013 Annual Report to Congress – Volume Two, [The IRS Private Debt Collection Program – A Comparison of Private Sector and IRS Collections While Working Private Collection Agency Inventory](#), 2013.

²⁸ Luca Gattoni-Celli, Tax Analysts, [Indian Call Center Raid Sheds Light on Scope of IRS Scam Calls](#), 2016 TNT 195-5, October 6, 2016.

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pay their taxes. We also believe a more cost effective policy is to improve the collection efforts within the IRS that have historically outperformed private debt collection agencies.

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Proposal: Allow the transfer of any partnership suspended losses to his/her spouse when spousal transfers under section 1041(a) take place

Present Law

Section 1366(d)(2)(B) of the IRC permits an S corporation shareholder to transfer any suspended losses to his/her spouse when a section 1041(a) exchange takes place between spouses or incident to a divorce. No such transfer between spouses or former spouses is permitted for the suspended losses of partners in partnerships.

Description of Proposal

Spouses engaged together in the operation of a partnership may transfer partnership units or interests to each other under section 1041(a) while married or incident to a divorce. When such a transfer occurs, the suspended loss associated with the partnership interest should also transfer to the transferee spouse. Section 1041 should include a new subsection, section 1041(f).

We suggest for section 1041(f) to read as follows:

(f) Carryover of disallowed losses and deductions

(1) In general

Any loss or deduction which is disallowed for any taxable year shall be treated as incurred by the partnership in the succeeding taxable year with respect to that partner.

(2) Transfers of partnership interest between spouses or incident to divorce

In the case of any transfer described in subsection (a) of an interest in a partnership, any loss or deduction described in subparagraph (1) with respect to such interest shall be treated as incurred by the partnership in the succeeding taxable year with respect to the transferee.

Analysis

Spouses and former spouses who transfer partnership interests between themselves find that they are in the same position in which spousal shareholders of an S corporation were prior to the addition of section 1366(d)(2)(B). That is, after the transfer, they find that suspended losses of the transferor are now trapped and forever unusable.

Conclusion/Recommendation

The spouse (or former spouse) who actually owns the partnership interest should have access to the suspended losses, regardless of who was entitled to this loss prior to the

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transfer of ownership interest. This recommendation furthers the tax policy goals of simplicity and equity.

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Proposal: Clarify that spousal partnerships that are recognized under state law are eligible to elect Qualified Joint Venture status under section 761(f)

Present Law

The Small Business and Work Opportunity Tax Act of 2007, P.L. 110-28 added section 761(f) to simplify the tax reporting requirements of a spousal partnership by treating it as two sole proprietorships. The only statutory requirements are that (1) both spouses materially participate in the business, (2) they file a joint return, (3) they are the only members of the joint venture and (4) they elect to not have partnership treatment.

On its website, the IRS has published a definition of a Qualified Joint Venture (QJV) under 761(f), which indicates that it “includes only businesses that are owned and operated by spouses as co-owners, and not in the name of a state-law entity (including a general or limited partnership or a limited liability company)....” and also notes that “...mere joint ownership of property that is not a trade or business does not qualify for the election.”

Description of Proposal

The spousal joint venture election under section 761(f) needs clarification to cover state law general and limited partnerships and limited liability companies. To accomplish this result, a modification to section 761(f)(2) can occur by adding a flush sentence after subparagraph (C) that reads:

The qualified joint venture shall not be disqualified from making the election of the subsection merely because the ownership interests are held through a state law entity such as a partnership or limited liability company.

Analysis

The administrative limitation on state law entities makes it hard to imagine which, if any, spousal partnerships are able to take advantage of this potential simplification. The state law rules governing partnerships and limited liability companies are typically based on the Revised Uniform Partnership Act, the Revised Uniform Limited Partnership Act or the Uniform Limited Liability Company Act as adopted by a particular state but which typically defines a partnership as two persons engaged in an activity for profit and treats even a general partnership as a state law entity. Such a definition would bring virtually all spousal business operations under state law jurisdiction and would thus disqualify them from electing QJV status.

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Conclusion/Recommendations

Congressional clarification of section 761(f) is needed. If Congress desires to achieve the simplification it contemplated when it enacted this election, it must specifically allow spousal partnerships (including the limited liability company, but minimally the general partnership) to make this election.

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Proposal: Repeal section 708(b)(1)(B) relating to the technical terminations of partnerships

Present Law

Section 708(b)(1)(B) of the Code provides that a partnership is considered terminated if, within a 12-month period, there is a sale or exchange of 50% or more of the total interest in a partnership's capital and profits. When a partnership is technically terminated, the legal entity continues but, for tax purposes, the partnership is treated as a newly formed entity. The current law requires the partnership to select new accounting methods and periods, restart depreciation lives, and make other adjustments. Furthermore, under the current law, the final tax return of the "old" partnership is due the 15 day of the third month after the month end in which the partnership underwent a technical termination. For example, a partnership that technically terminated on April 30 of the current year due to a transfer of 80% of the capital and profits interests in the partnership must file its tax return for that final tax year on or before July 15 of the current year.

Description of Proposal

Congress should repeal section 708(b)(1)(B) relating to the technical terminations of partnerships.

Analysis

In tax compliance, the earlier filing of the old partnership often goes unnoticed because companies are unaware of the accelerated filing deadline due to the equity transfer. Penalties are often assessed upon the business as a result of the missed deadline. Although ignorance is not an acceptable excuse, most taxpayers misunderstand and misapply this technical termination area. The acceleration of the filing date of the tax return, the reset of depreciation lives, and the selection of new accounting methods combine together to arguably serve more as a trap for the unwary than a process to help prevent tax abuse.

Conclusion/Recommendation

In order to promote simplicity, we recommend the repeal of section 708(b)(1)(B) relating to the technical terminations of partnerships.

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Proposal: Allow an offset to the built-in gains (BIG) tax for charitable contribution and foreign tax credit carryforwards from a C year

Present Law

Generally, section 1371(b) prohibits the carryover of deductions and credits from a C year to an S year. However, sections 1374(b)(2) and (b)(3)(B) allow certain exceptions in order for net operating loss and capital loss carryforwards, as well as section 39 general business and section 53 minimum tax credit carryforwards from C years are permitted to offset the net recognized built-in gain of an S corporation. No such deduction from or credit against the net unrecognized built-in gain of an S corporation is permitted for charitable contribution or foreign tax credit carryforwards.

Description of Proposal

Modify section 1374(b)(2) to add charitable contribution carryforwards from a C year to the items that are deducted against the net recognized built-in gain of an S corporation.

Modify section 1374(b)(3)(B) to add section 27 foreign and possessions tax credit carryforwards to the items allowed as a credit against the net recognized built-in gain of an S corporation. An alternative way to achieve the same result is to modify section 39(b) to include the foreign tax and possession tax credits among the current year general business credits permitted for carryforward from a C year to an S year.

Analysis

It would seem equitable that all deduction and credit carryforwards arising in a C year are allowed to reduce the corporate-level built-in gain tax of an S corporation since both the carryforwards and the BIG tax relates to a liability integrally related to the former C corporation. It appears that the foreign credits may have been omitted simply as an oversight due to their lack of inclusion in the general business credit regime.

Conclusion/Recommendation

The law should allow deductions and credits against the section 1374 BIG tax for charitable contribution and foreign and possessions tax credit carryforwards arising in a C year.

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Proposal: Add a new 120 day post-termination transition period beginning on the date that a taxpayer files an amended Form 1120S, *Income Tax Return for an S Corporation*

Present Law

Section 1377(b) defines a post-termination transition period in one of three ways, each of which occurs after a termination of the S election. The first post-termination transition period (PTTP) begins the day after the last S year ends and ends the later of one year or the extended due date of the return. The second period begins on the date an IRS adjustment is made and lasts for 120 days. The third period begins on the date an IRS determination is made that the S election had terminated for a previous year and lasts for 120 days. Sections 1366(d)(3) and 1371(e) describe the major benefits of the PTTP as allowing a shareholder to adjust stock basis, utilize suspended losses and take tax-free distributions to the extent of both accumulated adjustment account (AAA) and basis through the end of the PTTP as though the S corporation election were still valid.

Description of Proposal

A fourth PTTP is added such that a 120 day PTTP would begin on the date that an amended return (Form 1120S) is filed if (1) the filing occurs after the S period ends; (2) if such 120 day period would lengthen the initial [generally] one-year PTTP and (3) if the amended return adjusts any item of income, loss or deduction arising during the S period. This new PTTP is accomplished by the addition of new subparagraph 1377(b)(1)(D) as follows:

- (D) the 120 day period beginning on the date an amended return has been filed for any S year, having been so filed after the termination of the corporation's election, and which amended return adjusts a subchapter S item of income, loss, or deduction of the corporation arising during the S period (as defined in section 1368(e)(2)).

Conforming amendments are made to subparagraphs (A) and (B) of section 1377(b)(3) by replacing the language "Paragraph (1)(B)" with "Paragraphs (1)(B) and (D)" each place it appears. In addition, modify the heading for section 1377(b)(3) to read "Special rules for audit and amended return related post-termination transition periods."

Analysis

We believe the source of adjustments to S items, whether by IRS audit or by the taxpayer, is immaterial when it comes to obtaining the benefits of a PTTP. When a tax return is corrected because of taxpayer oversight, error, judicial clarification, or another reason, the corrected return should remain as the basis for determining AAA, the taxability of distributions, shareholder basis and other items that are relevant during the PTTP and, therefore, the filing of an amended return should also trigger the beginning of a new PTTP, as occurs in the case of an audit adjustment.

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Conclusion/Recommendation

The reason for adjustments to S items, whether by audit or taxpayer redetermination on an amended Form 1120S, is immaterial to the policy behind a PTP. Accordingly, a 120 day PTP should begin upon the filing of an amended Form 1120S.

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Proposal: Allow S corporations to have nonresident aliens as shareholders

Present Law

Section 1361(b)(1)(C) of the IRC provides that a nonresident alien is not eligible as a shareholder of an S corporation. Reg. section 1.1361-1(m)(1)(ii)(D) and - 1(m)(5)(iii) require that an eligible S corporation shareholder is a potential current beneficiary (PCB) of an electing small business trust (ESBT). Thus under current statute, nonresident aliens are not permitted shareholders and under current regulations, they are not permitted PCBs. If a nonresident alien becomes a PCB of an ESBT, the S corporation's election will terminate.

Description of Proposal

Allow nonresident aliens to have shareholder status of an S corporation and require the S corporation to withhold and pay a withholding tax for nonresident alien shareholders.

Analysis

Nonresident aliens should have permission to hold shareholder status of electing small business trusts. Nonresident aliens are able to contribute capital to and participate in the benefits and obligations of an S corporation indirectly in instances where the S corporation is aware that such result is obtainable and is willing and able to pay a professional to restructure the operations of the S corporation through partnerships; the operating partnerships, in turn, permit nonresident aliens to hold ownership interests and thus nonresident aliens indirectly receive pass-through items from the S corporation's operations. If nonresident aliens were permitted to have direct ownership of S corporations, they are subject to withholding just as nonresident alien partners are, thus protecting against revenue loss at the individual level. The smaller, struggling S corporations, particularly those in border states, should also have the freedom to raise capital from these individuals.

Conclusion/Recommendation

We recommend amending section 1361(b) to allow a nonresident alien to hold an eligible shareholder status of an S corporation. In conformity with that change, we recommend amending section 1446 to require the S corporation to withhold and pay a withholding tax on effectively connected income allocable to the corporation's nonresident alien shareholders.

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Proposal: Allow S corporations to have nonresident aliens as potential current beneficiaries of electing small business trusts

Present Law

Section 1361(b)(1)(C) of the IRC provides that a nonresident alien is not eligible as a shareholder of an S corporation. Section 1361(c)(2)(B)(v) requires that a PCB of an ESBT is an eligible S corporation shareholder. Thus under current statute, nonresident aliens are not permitted shareholders or PCBs. If a nonresident alien becomes a PCB of an ESBT, the S corporation's election will terminate.

Description of Proposal

Permit nonresident aliens to have nonresident aliens to become PCBs of an ESBT.

Analysis

Nonresident aliens should have potential current beneficiary statuses of electing small business trusts.

Nonresident aliens are able to contribute capital to and participate in the benefits and obligations of an S corporation indirectly in instances where the S corporation is aware that such result is obtainable and is willing and able to pay a professional to restructure the operations of the S corporation through partnerships; the operating partnerships, in turn, permit nonresident aliens to hold ownership interests and thus nonresident aliens indirectly receive pass-through items from the S corporation's operations.

Conclusion/Recommendation

Because the trust pays tax at the highest rates, there is no policy reason for restrictions on the types of allowable ESBT potential current beneficiaries. An electing small business trust should permit a nonresident alien to have a potential current beneficiary status.

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Proposal: Repeal section 1362(d)(3), which terminates an S election due to passive investment income that exceeds a certain threshold, and increase the passive investment income threshold of S corporations under section 1375(a)(2) from 25% to 60%

Present Law

Section 1375 imposes the highest corporate rate of tax (currently 35%) on the royalties, rents, dividends, interest and annuities earned by certain S corporations if such revenue sources, net of allowable deductions, exceed 25% of the corporation's gross receipts and if the corporation has accumulated earnings and profits from a former C year at the close of the tax year. There are exceptions to this rule for certain income of banks and bank holding companies, finance companies, interest from installment sales of inventory and dividends from certain C corporation stock. An S corporation may avoid the tax by distributing its AE&P before the close of the tax year.

Section 1362(d) penalizes an S corporation with involuntary termination of its S election if the corporation has excess passive income for three consecutive years.

Description of Proposals

Eliminating the termination event

Section 1362(d)(3) needs repeal in its entirety, thus preventing the threat of an involuntary termination of the S election related to passive investment income.

Raising the passive investment income thresholds

Sections 1375(a)(2) and (b)(1)(A)(i) (as well as the section 1375 header), and (to the extent not repealed) section 1362(d)(3)(A)(i)(II) (as well as the section 1362(d)(3) header) needs modification to replace "25%" with "60%" each place it appears. This change would have the effect of raising the threshold for the imposition of the tax on excess net passive investment income.

Analysis

The apparent, although unstated, goal of the excess net passive investment income tax and termination of the S election is to penalize an S corporation for a failure to distribute the accumulated earnings and profits of a C corporation predecessor. Given this apparent goal, it is unclear what the connection is between those undistributed earnings and profits and the passive investment income of the S corporation. We recommend that Congress draft a similar regime that is appropriate under subchapter S. If the current regime is maintained, it should at least minimize the differential between a hypothetical, yet correlated tax on accumulated earnings and profits and the uncorrelated tax currently imposed on excess net passive investment income (PII).

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While encouraging distributions of accumulated earnings and profits appear the primary goal of sections 1375 and 1362(d)(3), a logical by-product of the sting tax regime is to discourage the earning of passive investment income by S corporations since the tax is, in fact, imposed on and triggers a termination based on PII. However, it is impossible that discouraging an S corporation from earning PII was the sole goal of the original lawmakers since the regime only applies to S corporations with accumulated earnings and profits. Accordingly, as a matter of fairness, and to better fit the “punishment” with the “crime,” the termination event needs a repeal to affect fewer taxpayers. These measures are a positive first steps.

Conclusion/Recommendation

Repeal section 1362(d)(3) to eliminate a significant uncertainty for S corporation operations, thereby preventing an involuntary termination of S status caused by excess passive investment income. Congress should also eliminate the impact of the “sting tax” by modifying sections 1362(d)(3) and 1375 and replace “25%” with “60%” each time it appears, thereby taxing an S corporation’s passive investment income in an analogous fashion to imposition of the personal holding company tax on C corporations. Enactment of both measures would enable an S corporation to earn large amounts of passive investment income without loss of its S status or fear of a corporate tax.

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Proposal: Repeal section 1372

Present Law

Section 1372(a) provides that, for purposes of applying the provisions of subtitle A of the Code (sections 1 through 1563) which relate to employee fringe benefits, an S corporation is treated as a partnership and any 2% shareholder of the S corporation should have treatment as a partner of such partnership.

Section 1372(b) provides that the term “2% shareholder” means any person who owns (or is considered as owning within the meaning of section 318) on any day during the taxable year of the S corporation more than 2% of the outstanding stock of such corporation or stock possessing more than 2% of the total combined voting power of all stock of such corporation.

Section 162(l) allows as a deduction, in the case of an individual who is an employee within the meaning of section 401(c)(1),²⁹ an amount equal to the amount paid during the taxable year for insurance that constitutes medical care for the individual, the individual’s spouse and dependents, and any child of the individual who has not attained the age of 27. The deduction is an “above the line” deduction, *i.e.*, allowable in arriving at adjusted gross income.³⁰ As originally enacted in 1986 as section 162(m), the provision allowed a deduction for 25% of amounts paid for such insurance, and only for taxable years beginning after December 31, 1986, and before January 1, 1990.³¹ In several amendments over a period of approximately 25 years, the benefit was increased to a deduction for the full amount of the premiums paid, and the provision was made permanent.

Description of Proposal

The proposal would repeal section 1372, simplifying the compliance burden of small business taxpayers and their tax preparers without appreciably affecting the revenues. Developments in other provisions of the Code since the enactment of section 1372 in 1982 have caused this provision to narrow (albeit uncertain) in scope.

Section 1372 has been a source of confusion and significant compliance burdens since its enactment by the Subchapter S Revision Act of 1982.³² No regulations have been proposed or finalized under this provision, and the only published guidance is limited to the treatment of premiums paid for health insurance by S corporations on behalf of 2% shareholders, contributions to health savings accounts, and certain fringe benefits

²⁹ Under section 401(c)(1), the term “employee” includes a self-employed individual for purposes of section 401.

³⁰ The expense is treated as an amount allowable under section 162, which provides a deduction for the ordinary and necessary expenses of carrying on a trade or business. Section 62(a)(1) generally provides for a deduction, in arriving at adjusted gross income, for allowed deductions attributable to a trade or business carried on by the taxpayer, other than the trade or business of being an employee.

³¹ Tax Reform Act of 1986, Pub. L. No. 99-514, section 1161.

³² Pub. L. No. 97-354, section 3.

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described in section 132. No published guidance identifies what the Service considers to include within the scope of the term “fringe benefit” for purposes of this provision.

Moreover, the post-1982 enactment of predecessor versions of section 162(*l*) and the subsequent expansion of those provisions have all but eliminated any disparity in the treatment of self-employed individuals, partners, 2% shareholders, and other employees with respect to employer-provided medical insurance. As indicated above, the exclusion of certain fringe benefits does not depend on an employer-employee relationship, and is thus unaffected by the application of section 1372(a). In the few areas that remain affected by the application of section 1372(a), the costs of compliance could easily exceed any revenue that is derived from partner-like treatment of the specific fringe benefit.

Analysis

Rev. Rul. 91-26³³ provides guidance to both S corporations and partnerships on the treatment of premium payments made on behalf of 2% shareholders and partners, respectively, which perform services for the entity. In the case of 2% shareholders of an S corporation, the Service concluded that the premiums were generally deductible by the S corporation under section 162 and includible in the gross income of the shareholder-employee under section 61. As such, the premiums must exist as wages on the employee’s Form W-2. However, the employee is entitled to deduct the cost of the premiums to the extent provided by section 162(*l*).³⁴

Neither section 1372 nor any other authority defines the term “fringe benefit” for purposes of this provision. Several other provisions of the Code, however, confer an exclusion on an individual taxpayer only if the individual is an employee and the benefit is provided by an employer. In addition to the exclusion of premiums paid for health insurance, these provisions include exclusions for group-term life insurance,³⁵ medical reimbursement (accident and health) plans,³⁶ and meals and lodging provided for the convenience of the employer.³⁷ The Service has also concluded that section 1372(a) prevents a 2% shareholder from excluding contributions by an S corporation to a health savings account under section 106(d).³⁸

In contrast, provisions for the exclusion of other fringe benefits are not contingent on the existence of an employer-employee relationship under the Code. For example, while a 2% shareholder may not qualify for the exclusion of qualified transportation fringe

³³ 1991-1 C.B. 184.

³⁴ In Ann. 92-16, 1992-5 I.R.B. 53, the Service clarified Rev. Proc. 91-26 by providing guidance on the treatment of such premiums for social security and Medicare tax purposes. In general, subject to compliance with the provisions of section 3121(a)(2)(B), such premiums are not treated as wages for purposes of these taxes, even though the premiums are treated as wages for income tax purposes.

³⁵ Section 79(a).

³⁶ Section 105.

³⁷ Section 119.

³⁸ Notice 2005-8, 2005-4 I.R.B. 368.

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benefits,³⁹ these and other benefits may have exclusion as working condition fringe benefits⁴⁰ or as *de minimis* fringe benefits.⁴¹ Moreover, provisions relating to qualified plans have minimized the differences between the treatment of employees and the treatment of self-employed individuals.⁴² Accordingly, it is generally unnecessary to determine whether a 2% shareholder is treated as an employee or a self-employed individual for purposes of these provisions. Finally, leading authors conclude that it is unclear whether section 1372(a) applies to incentive stock options or employee stock purchase plans.⁴³

Conclusion/Recommendation

Developments in other provisions of the Code since the enactment of section 1372 in 1982 have caused this provision to narrow (albeit uncertain) in scope. The modification suggested here will simplify the compliance burden of small business taxpayers and their tax preparers without appreciably affecting the revenues.

³⁹ Section 132(a)(5) provides an exclusion for any fringe benefit which qualifies as a “qualified transportation fringe.” Section 132(f)(1) provides that the term “qualified transportation fringe” includes several types of transportation-related benefits “provided by an employer to an employee”, and section 132(f)(5)(E) provides that, for purposes of section 132(f), the term “employee” does not include an individual who is an employee within the meaning of section 401(c)(1). Treas. Reg. § 1.132-9(b), A-24(a), provides that an individual who is a 2% shareholder and a common law employee of an S corporation is not eligible for the exclusion of a qualified transportation fringe.

⁴⁰ Section 132(a)(3) provides an exclusion for any fringe benefit which qualifies as a “working condition fringe.” Section 132(d) provides that the term “working condition fringe” means any property or services provided to an employee of the employer to the extent that, if the employee paid for such property or services, such payment is allowable as a deduction under section 162 or 167. Treas. Reg. § 1.132-9(b), A-24(b), provides that the working condition fringe exclusion is available for transit passes provided to individuals who are 2% shareholders.

⁴¹ Section 132(a)(4) provides an exclusion for any fringe benefit which qualifies as a “de minimis fringe.” Section 132(e) provides that the term “de minimis fringe” means any property or service the value of which is (after taking into account the frequency with which similar fringes are provided by the employer to the employer’s employees) so small as to make accounting for it unreasonable or administratively impracticable. Treas. Reg. § 1.132-9(b), A-24(b) and (c), provides that the de minimis fringe exclusion is available for transit passes and commuter parking provided to individuals who are 2% shareholders.

⁴² Such plans are generally described in section 401(a), and include pension, profit-sharing, and stock-bonus plans of an employer for the exclusive benefit of its employees or their beneficiaries. As noted above, for purposes of section 401, section 401(c)(1) provides that a self-employed individual and a partner in a partnership with earned income is treated as an employee. In addition, section 401(c)(4) provides that a partnership shall be treated as the employer of each partner who is an employee within the meaning of section 401(c)(1).

⁴³ J. Eustice and J. Kuntz, *Federal Taxation of S Corporations* ¶ 11.04 (WG&L).

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Proposal: Treat the return of an S corporation as the return of any related qualified subchapter S subsidiary for purposes of any relevant period of limitations

Present Law

In general, the assessment of tax can occur at any time within three years after the return was filed (whether or not the return was filed on or after the date prescribed).⁴⁴ However, if no return is filed, tax assessment can occur at any time.⁴⁵ If a corporation files Form 1120S, but does not qualify as an S corporation, the return filed by the corporation is treated as a return filed by the taxpayer for purposes of chapter 66 (relating to limitations).⁴⁶

If an S corporation makes an election to treat a subsidiary as a qualified subchapter S subsidiary (“QSub”), the QSub is not treated as a separate corporation, and all of the items of income, deduction, and credit of the QSub are treated as items of the S corporation.⁴⁷ The QSub does not file its own tax return, but instead the S corporation includes all of the QSub’s items as its own. If the subsidiary does not qualify as a QSub for a particular taxable year, it is subject to the risk that the Service can assess tax for the year against the subsidiary at any time because the subsidiary had never filed a tax return for that year.

Description of Proposal

The proposal would eliminate any uncertainty regarding the determination of the period of limitations on assessment in cases where a corporation did not qualify as a QSub. If enacted, the proposal would modify sections 6012 and 6037, as appropriate, to treat the return of the S corporation for any taxable year as the return of any subsidiary of the S corporation for purposes of chapter 66, provided the S corporation has made a QSub election with respect to the subsidiary and treats the subsidiary as a QSub for such taxable year.

Analysis

The general policy of the period of limitations on assessment of tax is that a requirement should exist for the tax collector to make a final determination of tax owed within a reasonable period of time after the return was filed, while records are still available, and while the personal knowledge and recollections of relevant individuals are still fresh and reliable. Where a tax return reasonably reflects the taxpayer’s own self-assessment of its items of income, deduction, and credit, it is reasonable to expect that the Service should complete its assessment within three years after filing. That policy, however, does not (and should not) limit the Service where no return is filed and no information regarding the taxpayer’s self-assessment has been provided to the Service.

⁴⁴ Section 6501(a).

⁴⁵ Section 6501(c)(3).

⁴⁶ Section 6037(a).

⁴⁷ Section 1361(b)(3)(A).

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In other cases where an incorrect basis for filing was used by a taxpayer but the taxpayer's information was otherwise provided to the Service, the normal period of limitations will apply. For example, if a consolidated return is filed by a group for a taxable year but the tax liability of a corporation whose income is included in that return should have been included in a separate return, the filing of the consolidated return by the group is considered as the making of a return by the corporation for the purpose of computing any period of limitation.⁴⁸ Similarly, as indicated above, if a corporation files as an S corporation but it is later determined that the corporation should have filed as a C corporation, the Form 1120S is treated as the making of a return on Form 1120 for purposes of computing any period of limitation. Accordingly, unless another exception under section 6501(c) applies, the Service could only assess tax against the corporation within three years after the return is filed.

Conclusion/Recommendation

The policies that apply in these other circumstances should also apply to an S corporation that treats another corporation as a QSub and includes the QSub's items of income, deduction, and credits as its own items on its own return. In order to prevent any inappropriate application of this provision, the rules should limit the provision to only apply to those corporations for which the S corporation has made (and has not revoked) a QSub election and which are disclosed as QSubs on the S corporation's tax return for the year.

Accordingly, we recommend amending the Code to start the running of the period of limitations under section 6501 for a subsidiary where the S corporation has filed a tax return and treats that subsidiary as a qualified subchapter S subsidiary.

⁴⁸ Treas. Reg. § 1.1502-75(g)(1).

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Proposal: Modify the deadline for estate basis reporting

The AICPA urges Congress to modify the reporting provisions for estate basis statements to require such reporting by February 15 following the end of a calendar year in which an estate distributes assets to a beneficiary, rather than 30 days after an estate files the Federal estate tax return.

Present Law

Section 2004 of the [Surface Transportation and Veterans Health Care Choice Improvement Act of 2015](#) provided rules for consistent basis reporting between estates and beneficiaries.

In July 2015, as part of the Act, Congress amended IRC section 1014 to provide for the consistent use of the value of property passing from a decedent's estate and the value subsequently used by the beneficiary to determine gain or loss upon the disposition of such property acquired from a taxable estate.

The Act also added section 6035, which requires the executor of any estate required to file a return under section 6018(a) to furnish to the Secretary and to each person acquiring an interest in property included in the decedent's gross estate for Federal estate tax purposes a statement identifying the value of each interest in such property as reported on such return and such other information with respect to such interest as the Secretary may prescribe. Section 6035(a)(3) states that the time for filing such statement is 30 days from the earlier of the date of the due date for filing the return (including extensions, if any) or the date the return was actually filed.

Section 6035(b) authorizes the Secretary to prescribe regulations necessary to carry out the provisions of section 6035(a), including applying these provisions to estates that are not otherwise required to file a return ([Form 706](#), *United States Estate (and Generation-Skipping Transfer) Tax Return*).

Section 2004(c) of the Act adds statements under section 6035 to the list of information returns and payee statements subject to the penalties under section 6721 and section 6722, respectively. Specifically, the Act adds new paragraph (D) to section 6724(d)(1) to provide that the term *information return* means any statement that the executor is required to file with the Secretary under section 6035. The Act also adds new paragraph (II) to section 6724(d)(2) to provide that the term *payee statement* means any statement that the executor is required to furnish under section 6035 (other than a statement described in section 6724(d)(1)(D)).

Section 2004(d) of the Act states that the above rules shall apply to property with respect to which an estate tax return is filed after the date of enactment of the Act (July 31, 2015). IRS [Notice 2015-57](#) delayed until February 29, 2016, the due date, which otherwise would have begun August 30, 2015, and provided transition relief as well as time for IRS and Treasury to issue the needed guidance to taxpayers and practitioners to

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comply with that provision. [IRS Notice 2016-19](#), issued February 11, 2016, further extended the due date to March 31, 2016, pending issuance of proposed regulations. As the AICPA [requested](#), the March 31, 2016 due date was further extended to June 30, 2016 by [Notice 2016-27](#).

Description of Proposal

We urge Congress to modify the reporting provisions for estate basis statements to require such reporting by February 15 following the end of a calendar year in which an estate distributes assets to a beneficiary, rather than 30 days after an estate files the Federal estate tax return.

Congress should revise the section 6035(a)(3) due date for providing statements to beneficiaries and the IRS to February 15 following the end of a calendar year in which the property is distributed to the beneficiaries in order to streamline the process and make the reporting more accurate and useful to the beneficiaries and the IRS.⁴⁹

Analysis

Our suggestion would:

- Continue the reporting of estate basis to beneficiaries and the IRS;
- Maintain the intent of the provision;
- Simplify and improve the administrative process:
- Result in more accurate reporting; and
- Provide more meaning to the information provided by the executor to beneficiaries.

For many estates, the executor does not know *within thirty days after filing the estate tax return* which beneficiary will receive what asset. In fact, it is customary that many, if not most, executors do not fully distribute estate assets until after they have received the IRS closing letter to ensure that there are sufficient funds in the estate to meet its federal and state tax obligations.

Because the executor usually does not know which assets the estate will distribute to each beneficiary 30 days after the time the estate tax return is filed (before the executor has settled the estate), the information provided to each beneficiary at that time, due to the filing requirement, includes all the assets in the estate that the executor could possibly distribute to that beneficiary. The beneficiary may receive pages and pages listing almost

⁴⁹ See AICPA comment letter on proposed legislative language modification, [Request for Further Extension of 60 Days to May 31 of the March 21 Filing Deadline for Consistent Basis Reporting Between Estates and Beneficiaries as noted in IRS Notice 2016-19 and IRS Proposed and Temporary Regulations](#), dated March 4, 2016.

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all of the estate's assets. The beneficiary will need to keep these pages to determine the basis of the assets that the beneficiary actually receives, perhaps several years later. Each beneficiary also gains knowledge of all the assets in the estate, even though the beneficiary may receive a small share of those assets and is not entitled to know the extent of the estate's holdings. Such disclosure of information has the potential to cause family disputes and discord.

The beneficiary needs the basis of the assets that the beneficiary actually receives; the executor should provide that information contemporaneously with the distribution of the respective assets. This information would help the IRS as well. The proposed regulations provide that executors may, but are not required to, file supplemental statements after the assets are distributed, while the current IRS instructions for Form 706 require executors to submit supplemental filings once the assets are distributed. Requiring executors to file supplemental statements places an additional administrative burden on the estates. Even if executors are merely given the option to file supplemental statements, the problem is resolved by moving the original due date of the returns until after it is known which beneficiary will receive which assets.

Another advantage of moving the due date is that the statements are more likely to reflect the final value of the assets for Federal estate tax purposes. Because the executor generally waits to distribute most of the assets until after the estate receives its IRS closing letter, the value of the assets on the statements will reflect any adjustments in value made during the estate tax audit. In these situations, moving the due date would eliminate the need to file the supplemental return required by section 6035(a)(3)(B) when the value of assets changes upon audit.

This legislative proposal would provide more administrable reporting deadlines for executors and provide more accurate and relevant information on basis to the beneficiaries and IRS because under the proposal the reporting is required after the property is actually distributed to a beneficiary. Because an annual post-distribution filing deadline will produce more accurate reporting, we believe this reporting regime is preferable to the current system, despite the inconvenience of more frequent filings.

Our suggestion of a February 15th filing requirement has the following advantages:

- Post-distribution reporting of actual assets distributed (and not over-reporting of assets that the executor might distribute);
- Only one [Form 8971](#), *Information Regarding Beneficiaries Acquiring Property From a Decedent*, filing per year (regardless of how often the executor makes distributions during that year);
- Executors would file Form 8971 the same time as any consolidated Form 1099 reporting (if any required by the estate executor or corporate trustee/fiduciary for interest, dividends, sales proceeds and basis for their accounts under management) and two weeks after the January 31st deadline for any Form 1099-INT, *Interest Income*, filed by estate executors;

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- Basis reporting to a beneficiary with sufficient time prior to the beneficiary's annual tax compliance (i.e., Form 1040, due April 15).

We considered the possibility of an annual Form 8971 filing based on an estate's fiscal year; however, we concluded that annual reporting based on a calendar year is preferable to fiscal year reporting because of the reasons below.

- If the requirement were to file Form 8971 with the estate's [Form 1041](#), *U.S. Income Tax Return for Estates and Trusts*:
 - The estate could obtain an extension to file Form 1041, resulting in the return due eight and a half months after the end of the fiscal year. If Form 8971 is due with Form 1041, the beneficiary might have to wait 19½ months after receiving a distribution of an asset before the basis of that asset is reported to him or her. For example, if a distribution is made in the first month of an estate's fiscal year, an additional 11 months exists until the fiscal year end, and potentially eight and a half months before Form 1041 and Form 8971 are filed. In the meantime, the beneficiary may have already sold the asset and needed the basis information to file properly his or her income tax return.
- If the requirement were to file Form 8971 within 30 days after the end of the estate's fiscal year:
 - The executor would provide basis information more timely than if it were filed with Form 1041, but the reporting would not align with the beneficiary's income tax reporting schedule and may arrive too late for the completion of the beneficiary's individual income tax return if the asset was sold shortly after the beneficiary received it.

Conclusion/Recommendation

We urge Congress to revise the section 6035(a)(3) due date for providing statements to beneficiaries and IRS to February 15 following the end of the calendar year in which specific property is distributed to the respective beneficiaries in order to streamline the process and make the reporting more accurate and useful to the beneficiaries and the IRS.

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Proposal: Allow administrative relief for late portability, inter vivos qualified terminable interest property, and qualified revocable trust elections

Present Law

Section 9100 Relief

The IRS has the authority to provide taxpayers relief from certain missed or late elections by granting extensions of time to make those elections. This relief, known as “section 9100 Relief,” requires the taxpayer to establish to the satisfaction of the IRS Commissioner that the taxpayer acted reasonably and in good faith, and the grant of relief will not prejudice the interests of the Government. Section 9100 Relief is available for elections, the timing of which is prescribed by regulation (Treas. Reg. § 301.9100-3(a)), rather than by statute.

Portability Election

Effective for decedents dying after 2010, a portability election is an election under IRC section 2010(c)(5)(A) to transfer a decedent’s unused exclusion amount (known as a deceased spousal unused exclusion (DSUE) amount) to the decedent’s surviving spouse. If a portability election has been made, the surviving spouse may use their own exclusion amount (\$5.49 million for deaths in 2017 less certain lifetime gifts) plus the DSUE amount.

Section 2010(c)(5)(A) provides that the portability election is made by the executor not later than the time prescribed for filing the estate tax return (determined with regard to extensions).

Because the time for making the portability election is prescribed by statute, we think that the IRS does not have the authority to grant relief for late elections if the estate is required to file a Federal estate tax return. The IRS has the authority to grant an extension of time to make the portability election only if the estate is not otherwise required to file an estate tax return because the estate is below the filing threshold. Estates that are above the filing threshold for the Federal estate tax return and that fail to make a timely portability election have no recourse to cure the problem and are disadvantaged because of the errors committed by their advisors.

Qualified terminable interest property election

Transfers of property interests that meet the requirements as qualified terminable interest property (QTIP) are eligible for the marital deduction for gift and estate tax purposes if the QTIP election is made. For QTIP transfers made when an individual dies in a year other than 2010, the QTIP election is made by the decedent’s executor on the Federal estate tax return. For an inter vivos QTIP transfer, the QTIP election is made on the Federal gift tax return for the calendar year in which the interest is transferred. A QTIP election, once made, is irrevocable.

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Section 9100 relief has been available for failures to make a QTIP election on a Federal estate tax return for over two decades, since the deadline for making that election is prescribed by regulation (Treas. Reg. § 20.2056(b)-7(b)(4)(i)). For an inter vivos QTIP, section 2523(f)(4)(A) provides that the QTIP election is made on or before the date prescribed by section 6075(b) for filing a gift tax return with respect to the transfer. The statutory language of the gift tax and estate tax QTIP provisions is different. The IRS has determined that the deadline for making the gift tax QTIP election is statutory, and, therefore, section 9100 relief is not available. See [PLR 201109012](#) (March 4, 2011), [PLR 200314012](#) (April 4, 2003), and PLR 9641023 (July 10, 1996). The present situation imposes a hardship on taxpayers as it provides no remedy – other than a malpractice action – for a taxpayer who loses the gift tax marital deduction due to an error on the part of the taxpayer’s advisor.

Qualified revocable trust election

Effective with respect to estates of decedents who die after August 5, 1997, an election is made to have certain revocable trusts treated and taxed as part of the decedent’s estate. If both the executor (if any) of an estate and the trustee of a qualified revocable trust (QRT) elect the treatment provided in section 645 (originally enacted as section 646), the trust is treated and taxed for income tax purposes as part of the estate (and not as a separate trust) during the election period. Section 645(c) provides that the election to treat a QRT as part of the decedent’s estate is made not later than the time prescribed for filing the income tax return for the first taxable year of the estate (determined with regard to extensions).

Because the time for making the election to treat the QRT as part of the estate is prescribed by statute, we think that the IRS does not have the authority to grant relief for late elections. Estates of decedents that fail to make a timely election do not have recourse to cure the problem and are disadvantaged because of the errors committed by their tax advisors.

Description of Proposal

Congress should authorize the IRS to grant section 9100 relief for late portability elections, for certain late or defective lifetime (i.e., inter vivos) QTIP elections, and for late elections by QRTs to treat such trust as part of a decedent’s estate. Congress could accomplish this by revising the IRC to provide that the due dates for (1) the portability election, (2) the inter vivos QTIP election, and (3) for the QRT election are treated as if not prescribed by statute. These proposals would make the same sort of statutory change in section 2010(c)(5)(A), section 2523(f)(4), and section 645(c) as the change made to IRC section 2642(g)(1)(B) by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) with respect to generation-skipping transfer (GST) exemption (and extended through 2012 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, and extended permanently by the American Taxpayer Relief Act of 2012). The provisions would apply to requests for relief pending on or filed after the date of enactment with respect to elections due before, on, or after such date. These

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proposed prospective effective dates are similar to the prospective effective date provision applicable to the generation skipping transfer exemption relief in EGTRRA.

Analysis

The problems for late portability, inter vivos QTIP, and QRT elections are similar to the problem that existed with the allocation of GST exemption prior to EGTRRA. The time for making an allocation of GST exemption was fixed by statute, and numerous taxpayers were being penalized for the failures of their tax advisors and tax return preparers to properly make the allocation. EGTRRA added section 2642(g)(1)(B) of the Code, which states “[f]or purposes of determining whether to grant relief under this paragraph, the time for making the allocation (or election) is treated as if not expressly prescribed by statute.” That language opened up the possibility of section 9100 relief for missed allocations of GST exemption. Given that statutory authority, the IRS has granted 9100 relief in hundreds of cases.

This proposal would make the same type of statutory change in section 2010(c)(5)(A), section 2523(f)(4), and section 645(c) as was made by EGTRRA in section 2642(g)(1)(B) (and extended through 2012 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, and extended permanently by the American Taxpayer Relief Act of 2012), in order to not penalize taxpayers for the errors of their lawyers or accountants in failing to make the portability election on a timely filed Federal estate tax return, the QTIP election on a timely filed Federal gift tax return, or a QRT election to treat the trust as part of an estate on the estate’s first Federal income tax return.

We note that legislation to provide administrative relief for inter vivos QTIP elections was introduced previously and was reported by the Senate. Specifically, in the 109th Congress, on June 28, 2006, [S. 1321](#), the Telephone Excise Tax Repeal Act of 2005, as reported by the Senate, included section 713, Administrative Relief for Certain Late Qualified Terminable Interest Property Elections (see Report [109-336](#) and [JCX-28-06](#)). In addition, on July 25, 2006, [H.R. 5884](#) was introduced in the House of Representatives to authorize the Secretary of the Treasury to extend the date for making a gift tax QTIP election.

In addition, we point out that a QTIP election does not forgive estate or gift tax; it merely defers imposition of the tax until the death of the donee spouse. Therefore, this provision would have minimal cost (estimated in 2006 at \$2 million over 10 years per [JCX-29-06](#)). Similarly, the QRT election does not forgive tax, it just treats the trust during the election period as part of the estate for income tax purposes, rather than as a separate trust, therefore, we expect this proposal as well would have minimal cost. The portability election provides the same tax consequences as are available to taxpayers with proper estate planning.

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Conclusion/Recommendation

We urge the enactment of legislative provisions stating that the due dates for the portability election, inter vivos QTIP election, and the QRT election are part of the estate are treated as if not prescribed by statute, thus allowing the IRS to grant administrative relief for late portability, inter vivos QTIP, and QRT elections.⁵⁰

⁵⁰ The AICPA submitted letters requesting legislation permitting administrative relief for certain late lifetime qualified terminable interest property elections and certain late qualified revocable trust elections on [October 14, 2013](#), [July 30, 2013](#), [November 18, 2011](#) and [November 16, 2010](#).

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Proposal: Treat consistently all federal tax payments of trusts and estates

Present Law

Currently, the ability of a trust or estate to allocate its tax payments to its beneficiaries is different for estimated federal tax payments, backup withholding, and regular withholding, and the different treatment becomes confusing and unnecessarily complex to taxpayers and tax practitioners. In some instances, estimated tax payments are allocated by the fiduciary to the beneficiaries, but only if an election to do so is made within 65 days after the close of the trust or estate's tax year. Backup withholding follows its corresponding income, and the beneficiary's share is reported to the beneficiary on the Schedule K-1 (Form 1041), *Beneficiary's Share of Income, Deductions, Credits, etc.*, which is filed with the Form 1041. Regular withholding may not have allocation to the beneficiary, but requires reporting by the trust or estate even if its corresponding income is reported by the beneficiary.

Specifically, for estimated tax payments, a trust or, for its final tax year, a decedent's estate may elect under section 643(g) to have any part of its estimated tax payments allocated to beneficiaries. The fiduciary makes this election by filing Form 1041-T, *Allocation of Estimated Tax Payments to Beneficiaries*, by the 65th day (i.e., generally March 5 for calendar year taxpayers) after the close of the tax year. Absent a timely election, the estimated tax payments are reported by the trust or estate on its [Form 1041](#) and cannot have allocation to beneficiaries on Schedule K-1 (Form 1041).

For backup withholding, the tax credit under section 31(c) for payments subject to section 3406 (backup withholding) is allocated between the trust or estate and its beneficiaries on the basis of their respective shares of payment, which is subject to backup withholding under section 643(d). Schedule K-1 (Form 1041) is used to report the beneficiaries' share of the backup withholding.

For regular withholding, the credit under section 31(a) for amounts withheld as tax under chapter 24 (regular withholding) may not have allocation by the trust or estate to a beneficiary. See [Chief Counsel Advice 200644018](#) (Dec. 25, 2005), in which the IRS stated that neither section 643(d) nor section 643(g) is relevant to the treatment of the withholding credit under section 31(a), and neither Form 1041-T nor any other form or schedule is allowed for use to allocate this credit, except in two situations. Those situations involve (1) a trust that is a grantor trust, in which case the credit appears on the grantor's income tax return, and (2) the recipient of income in respect of a decedent, who is entitled to any section 31 credit associated with the income taxed to the recipient. Also, the [instructions to Form 1041](#) state that withheld income tax (other than backup withholding) cannot pass through to beneficiaries on either Schedule K-1 or Form 1041-T.

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Description of Proposal

We propose that the fiduciary of a trust or estate have permission to allocate estimated tax payments, including payments made with extension requests, to the trust's or estate's beneficiaries on Schedule K-1 (Form 1041) attached to a timely filed Form 1041 (including extensions) and that regular withholding is treated the same as the current treatment of backup withholding. This proposal would allow estimated tax payments (including any tax payment made with an extension request) to have allocation to the beneficiary on the Schedule K-1, which is the same way that backup and regular withholding is reported to the beneficiaries. We believe that having all such taxes attributed to the beneficiaries reported on the Schedule K-1 is much less confusing and reduce complexity to the fiduciaries.

With respect to regular withholding, the title of section 643(d) could change to "Coordination with withholding" and section 643(d)(1) could have an amendment to include a reference to section 31(a) in order for it to read: "...(1) by allocating between the estate or trust and its beneficiaries any credit allowable under section 31(a) or 31(c) (on the basis of their respective shares of any such payment taken into account under this subchapter)...."

With respect to estimated tax payments and extension payments, we suggest that estates are added to the general rule of section 643(g)(1) with the result that section 643(g)(3) is repealed and that Congress amend section 643(g)(1) and (2) to read as follows:

- (g) Certain payments of tax treated as paid by beneficiary.
 - (1) In general. In the case of trust or estate—
 - (A) The trustee or fiduciary of the estate may elect to treat any portion of a payment of estimated tax (including a tax payment with an extension request) made by such trust or estate for any taxable year of the trust or estate as a payment made by a beneficiary of such trust or estate,
 - (B) Any amount so treated shall be treated as paid or credited to the beneficiary on the last day of such taxable year of the trust or estate, and
 - (C) For purposes of subtitle F, the amount so treated—
 - (i) Shall not be treated as a payment of tax made by the trust or estate, but

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(ii) Shall be treated as a payment of estimated tax made by such beneficiary on the fifteenth day of the first month following the close of the trust or estate's taxable year.

(2) Time for making election. An election under paragraph (1) shall be made on the tax return of the trust or estate filed on or before its due date (including extensions of time actually granted) and in such manner as the Secretary may prescribe.

Adding estates to the general rule will allow the estate's tax payments to have treatment as paid by estate beneficiaries in years other than just the estate's last tax year if the executor so chooses. We believe these proposals will simplify processing for the IRS as well as taxpayers. We think that any revenue cost for this proposal is negligible as it only deals with allocating tax payments between taxpayers.

Analysis

There are many professional fiduciaries and trust companies facing the present law inconsistency in the reporting treatment of the various types of tax payments. In addition, trusts and probate estates frequently are administered by family members or other individuals, for whom this inconsistent treatment causes confusion and unnecessary complexity. With regard to the election for estimated tax payments, fiduciaries frequently miss making this election because of its due date. Fiduciaries often are unable to determine whether federal taxes have been overpaid by the 65th day of the next year, especially when Forms 1099 (the information returns reporting various types of income) are not available to the trust or estate until the 46th day of the next year and many Schedules K-1 (the information returns reporting income from partnerships, S corporations and trusts) are not available to the trust or estate until much later in the following year, well past the 65-day period.

The treatment of regular withholding and estimated payments becomes most critical in the final year of the trust or estate. If the fiduciary misses the 65 day period for making the election for estimated tax payments, then those payments need refunding to the fiduciary. Regular withholding payments must always refund to the fiduciary. Since the refund is made after the close of the trust or estate's final year, the fiduciary may already have been discharged and is no longer able to act on behalf of the entity. The fiduciary also may have closed all financial accounts in connection with the final distribution of assets and therefore has no way to cash the check or make a further distribution.

A related issue arises with respect to federal tax payments submitted with a fiduciary's request for an extension of time to file the trust or estate's income tax return. It is not possible to allocate any of those payments to the beneficiaries, rather they are applied only to a later year's tax or refunded to the fiduciary.

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Conclusion/Recommendation

We continue to encourage Congress to pass legislation that simplifies the tax compliance burden of taxpayers. To further this mission, we request that Congress enact legislation that would permit consistent treatment of all federal tax payments of trusts and estates, including estimated tax payments, backup withholding and regular withholding. We urge Congress to enact this tax simplification and consistency proposal.

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Proposal: Amend section 67(e) to simplify the law and allow estates and nongrantor trusts to fully deduct the cost of complying with fiduciary duties in administering estates and trusts⁵¹

Present Law

The current law denies a deduction for the cost of complying with many fiduciary duties to the extent that their aggregate cost does not exceed 2% of the taxpayer's adjusted gross income. This rule is known as the "2% floor."

By way of background, Congress enacted section 67(a) in 1986 to limit deductions for miscellaneous itemized deductions to those in excess of 2% of AGI. Congress's purpose was to reduce recordkeeping for numerous small expenditures and eliminate deductions for many, essentially personal expenditures claimed in error.⁵² Because estates and nongrantor trusts⁵³ are taxed in the same manner as individuals, Congress provided an exception to the 2% floor in section 67(e) for fiduciary administrative costs that would not have been incurred "if the property were not held in such trust or estate."

Because of the statute's unusual wording, there have been numerous judicial battles over its meaning. In 2008, the U.S. Supreme Court held in [Knight v. CIR](#), 552 U.S. 181, 128 S. Ct. 782 (2008), that the statute allows a full deduction for "only those costs that it would be uncommon (or unusual, or unlikely) for such a hypothetical individual to incur." To make that determination, the Court held that the trustee must "predict" whether a hypothetical person with the trust property would have incurred the cost. Unfortunately this interpretation imposes significant uncertainty, complexity, recordkeeping and enforcement burdens on both the trustee and the government. In short, it raises more questions than it answers.

We have worked together with the American Bankers Association, the American Bar Association, the American College of Estate and Trust Counsel and other groups to provide the IRS and Treasury input on [July 27, 2007 proposed regulations](#) section 1.67-4. On September 7, 2011, the IRS withdrew those regulations and issued a replacement set of [proposed regulations](#) section 1.67-4 attempting to implement the Supreme Court's decision. On May 9, 2013, the IRS issued the [final regulations](#). The proposed and final regulations require trustees' fees and other single commission fees are unbundled and separated between costs that are commonly incurred by individuals and those that are not. The IRS and Treasury are unsuccessful in drafting regulations that are clear and administrable, without subjecting nearly all administrative costs to the 2% floor. Doing so eliminates the exemption under section 67(e). Expressing similar frustration over section 67(e), Chief Justice Roberts commented:

⁵¹ The AICPA submitted a similar proposal on [September 8, 2008](#) to the 110th Congress.

⁵² [Sen. Rep. No. 99-313](#), 1986-3 C.B. Vol. 3, p. 78; [House Rep. No. 99-426](#), 1986-3 C.B. Vol. 2, p. 109.

⁵³ A nongrantor trust is a trust that is treated as a separate taxable entity from its grantor or beneficiary. By contrast, a grantor trust is one whose grantor or beneficiary is treated as the owner of all or part of the trust property for income tax purposes.

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While Congress's decision to phrase the pertinent inquiry in terms of a prediction about a hypothetical situation inevitably entails some uncertainty, that is no excuse for judicial amendment of the statute.

Description of Proposal

The solution, in our view, is to amend the statute. We think the proposed amendment below would simplify the statute, would modernize it for the prudent investor rule,⁵⁴ make it easier to administer, and provide a consistent definition of AGI for estates and nongrantor trusts throughout the IRC. We do not think the proposal would encourage individuals to create nongrantor trusts merely to avoid the 2% floor. The associated costs of creating such trusts would likely exceed any tax benefit. Creating a separate trust requires giving the money away, not to mention the extra management cost and liability associated with creating a separate legal entity.

As amended, the statute would provide:

67(e). DETERMINATION OF ADJUSTED GROSS INCOME IN CASE OF ESTATES AND TRUSTS. For purposes of this section, the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual, except that (1) the deductions for costs which are paid or incurred in connection with the administration of the estate or trust ~~and which would not have been incurred if the property were not held in such trust or estate,~~... shall be treated as allowable in arriving at adjusted gross income.

Analysis

We support this measure for the following reasons:

1. The present statute is overly complex and burdensome. The trustee must predict whether an ordinary individual with the same property would have incurred the same cost or a portion thereof, under the Supreme Court's reading of the statute. The trustee must then separate its fees into the portion an individual would have incurred (subject to the 2% floor) and the portion that is fully deductible. The proposed regulations indicate "any reasonable method" is used for the determination. Such recordkeeping complexity is contrary to sound tax policy.
2. A legislative change would eliminate uncertainty, inconsistencies and errors arising from the requirement to predict what individuals commonly do. Because section 67(e) requires the extraordinarily difficult task of determining whether individuals would commonly incur a particular expense that the trust or estate incurred, it will result in uncertainty, inconsistent treatment from trust to

⁵⁴ The prudent investor rule requires a trustee to invest trust funds as a prudent investor would for the account of another. Prior to the Uniform Prudent Investor Act of 1992, trustees were only required to follow the prudent man rule, which required the trustee to invest trust funds as he would for himself.

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trust, errors of judgment, and potential penalties on both the trustee and tax preparers.

3. The present statute requires extensive recordkeeping. The Supreme Court's interpretation of section 67(e) requires the trustee to keep additional records to determine whether and how its expenses are different from those incurred by hypothetical individuals with the same property. This additional recordkeeping is contrary to Congress's original purpose for section 67, which was to simplify recordkeeping and limit individuals from deducting personal expenses (i.e., safe deposit box fees, investment magazines, home office expenses, etc.).
4. The present statute is out of date. The present statute was enacted eight years before the [Prudent Investor Act \(1994\)](#) was adopted by nearly every state. The Prudent Investor Act raised the investment standard from the "prudent man" to the more demanding "prudent investor" rule, requiring many trustees to obtain specialized expertise to fulfill their fiduciary duties. Thus, the IRC denies a full deduction for costs incurred to comply with the Act merely because individual investors sometimes incur the same costs.
5. The present statute penalizes compliance with fiduciary duties. The present statute penalizes trustees for incurring costs to carry out their mandatory fiduciary duties. Trustees who hire professional advisors to comply with their duty to invest prudently are denied some or all of their deductions. However, if they forgo the professional advice, they risk a breach of fiduciary duty. Such tension should not exist between the IRC and other regulatory acts.
6. Trusts are small taxpayers. According to IRS Statistics of Income for 2010, over 96% of all trusts report less than \$100,000 of total income, including capital gains.⁵⁵ These trusts are often maintained for minors, disabled individuals, and the elderly. This \$100,000 threshold is significantly below the amount generally used to define "wealthy taxpayers" for whom benefits are limited. The IRC should reflect that estates and trusts are generally small taxpayers burdened with mandatory duties that require extra costs to administer.
7. Cost of compliance does not justify the tax collected. As section 67(e) is presently interpreted, trusts and estates must determine on an item-by-item basis which costs would not customarily incur by a hypothetical individual in order to determine the costs not subject to the 2% floor. In order to avoid the cost, complexity, and recordkeeping required to determine which costs would not commonly incur by a hypothetical individual, many small trusts and estates might simply subject all their costs to the 2% floor, forfeiting their right to the full deduction because they cannot justify the compliance cost. Large trusts and estates may decide to incur the extra cost of recordkeeping in order to obtain a full deduction. The additional compliance cost for both the government and

⁵⁵ Table 1. [Fiduciary Income Tax Returns, Income Source, Deductions, and Tax Liability, by Tax Status and Size of Total Income](#), Filing Year 2010.

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fiduciaries is likely significant compared to the incremental revenue. Sound tax policy should not limit the availability of legitimate tax deductions to only those who can afford the cost to comply.

8. The proposed change is simple. The bill proposes to simply delete the phrase at the end of section 67(e)(1) – “and would not have been incurred if the property were not held in such trust or estate.” Such change would allow a full deduction for all costs “incurred in connection with the administration of the trust or estate.” It is administrable, fair and consistent with Congress’s intent to simplify recordkeeping. It would also eliminate the tension between the Prudent Investor Act’s mandate to invest prudently and the IRC’s denial of a full deduction for the costs of complying with the Act.
9. Trustees are already heavily regulated. Trustees are heavily scrutinized on how they invest property entrusted to them compared to individuals who are free to manage their own property. Trustees must comply with the Uniform Trust Code, the Uniform Prudent Investor Act, the Uniform Principal and Income Act, and numerous other federal and state laws. These laws require them to have loyalty and impartiality, to diversify, to contain costs and to consider numerous other circumstances unique to a trust. Trusts and estates were not the original target of section 67(e) when Congress sought to reduce recordkeeping and deductions for personal expenses.
10. The proposed change would provide a single definition of AGI for an estate or trust in the IRC. The IRC contains two different definitions of AGI for an estate or trust. Section 67(e) provides that AGI is determined after deducting costs “paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate.” However, section 165(h)(4)(C) provides that AGI is determined after deducting “costs paid or incurred in connection with the administration of the estate or trust.” These two distinctly different definitions of AGI serve no purpose. The IRC needs simplification to provide a single definition of AGI for estates and trusts, which is identified in the definition contained in section 165(h)(4)(C).

Conclusion/Recommendation

Congress should amend section 67(e) to simplify the law and allow estates and nongrantor trusts to fully deduct the cost of complying with fiduciary duties in administering estates and trusts.

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Proposal: Exempt trusts with only charitable deductions from flow-through entities from the information return filing requirement of section 6034(a)

Present Law

The AICPA continues to encourage Congress to pass legislation that simplifies the tax compliance burden of taxpayers. To further this mission, we request that Congress enact legislation that would exempt from complying with the information reporting requirements of IRC section 6034(b)(1) trusts whose only charitable deductions are passed through to them from a flow-through entity (e.g., an S corporation, limited liability company (LLC), or partnership).

Section 6034(b)(1) provides that every trust that is not a split-interest trust described in section 4947(a)(2) but that is claiming a deduction under section 642(c) for the taxable year shall furnish the information with respect to the taxable year as the Secretary may by forms or regulations prescribe, including:

1. The amount of the deduction taken under section 642(c) within the year;
2. The amount paid out within the year which represents the amount for which deductions under section 642(c) have been taken in prior years;
3. The amount for which the deductions have been taken in prior years but which has not been paid out at the beginning of the year;
4. The amount paid out of principal in the current and prior years for the purposes described in section 642(c);
5. The total income of the trust within the year and the expenses attributable thereto; and
6. A balance sheet showing the assets, liabilities and net worth of the trust as of the beginning of the year.

Section 6034(b)(2)(A) provides an exception to the reporting requirement of section 6034(b)(1) for a trust for any taxable year if all the income for the year, determined under the applicable principles of the law of trusts, is required to distribute currently to beneficiaries.

Under section 6652(c)(2)(A), a penalty is imposed for failure to file the information return required by section 6034(b). The penalty is \$10 a day with a maximum of \$5,000.

Trusts use Form 1041-A, *U.S. Information Return Trust Accumulation of Charitable Amounts*, to satisfy their reporting obligation under section 6034(b). According to the instructions, the trustee must file Form 1041-A for a trust that claims a charitable deduction or other deduction under section 642(c) unless an exception applies. The

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instructions provide exceptions for a trust that is required to distribute currently to the beneficiaries all the income for the tax year determined under section 643(b) and the related regulations⁵⁶; a charitable trust described in section 4947(a)(1)⁵⁷; and for tax years beginning after 2006, a split-interest trust described in section 4947(a)(2).⁵⁸ Section 642(c)(1) provides that a trust is allowed a deduction in computing its taxable income for any amount of the gross income, without limitation, that pursuant to the terms of the governing instrument is, during the taxable year, paid for a purpose specified in section 170(c). For a trust to claim a charitable deduction under section 642(c) for amounts of gross income that it contributes for charitable purposes, generally the governing instrument of the trust must give the trustee the authority to make charitable contributions.

Analysis

Often trusts invest in partnerships that make charitable contributions. If the partnership makes a charitable contribution from its gross income, that income is never available to the trust. For federal tax purposes, however, the trust must take into account its distributive share of the partnership's income, gain, loss, and deductions, and credits. These items include the amount of income given to charity and the corresponding deduction for that contribution. The IRS has recognized the trust's ability to claim a charitable deduction in this situation despite the fact that the trust's governing instrument does not authorize the trustee to make charitable contributions. See Rev. Rul. 2004-5, 2004-3 I.R.B. 295.

A similar situation arises with respect to electing small business trusts (ESBTs) that own stock in an S corporation if the S corporation makes a contribution to charity from its gross income. Treasury Reg. § 1.641(c)-1(d)(2)(ii) provides that if an ESBT is required to take into account a deduction attributable to an amount of the S corporation's gross income that is paid by the S corporation for a charitable purpose, the contribution is deemed to paid by the S portion of the ESBT pursuant to the terms of the trust's governing instrument within the meaning of section 642(c)(1).

For many trusts that claim a charitable deduction under section 642(c), the contribution is made by partnerships or S corporations in which the trust owns an interest, and no contributions are actually made by the trust. In these situations, we recommend that the trust is exempt from the information reporting requirements of section 6034(b) and therefore not required to file Form 1041-A. Such trusts are not accumulating any income that may distribute to a charity in the future. The current charitable deductions are based solely on the current income of a flow-through entity, which contributes it directly to charity, and are not from any prior year's accumulation of income by the trusts.

⁵⁶ See section 6034(b)(2)(A).

⁵⁷ See section 6034(b)(2)(B).

⁵⁸ See section 6034(a).

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As discussed above, the trusts themselves never received the amounts that were given to charity and never made any direct charitable contributions. Under these circumstances, being required to file Form 1041-A places an unnecessary burden on these trusts and does not yield any additional useful information for the IRS. Moreover, trustees and preparers frequently are unaware of this filing requirement if the trust itself normally does not make any charitable contributions but in some years has charitable contributions passed through to it from their partnership, LLC, or S corporation investments. For these trusts, the failure to file penalty can easily run to its maximum \$5,000 amount, an amount that frequently is much greater than the amount of the claimed charitable deduction. For those trustees who are aware of this filing requirement, they sometimes choose to forego claiming the deduction rather than having to file an additional tax return. We believe that the creation of an exception is needed for these trusts because charitable deductions passed through to trusts from partnerships, LLCs, or S corporations do not appear to fall within the scope and purpose of the information reporting requirement of section 6034(b).

Description of the Proposal

We suggest that an additional exception (C) is added to section 6034(b)(2) to read as follows:

(2) Exceptions. Paragraph (1) shall not apply to a trust for any taxable year if – ...

(C) the trust's only deductions under section 642(c) are those attributable to charitable contributions taken into account by the trust under section 1366(a)(1) and section 702(a)(4).

Conclusion/Recommendation

We urge Congress to enact this tax simplification proposal to exempt from complying with the information reporting requirements of the IRC section 6034(b)(1), trusts whose only charitable deductions are passed through to them from a flow-through entity (e.g., S corporation, LLC, or partnership).

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Proposal: Subject estates, certain qualified revocable trusts, and qualified disability trusts to the income tax and net investment income tax in the same manner as married persons filing separate returns

Present Law

Historically, estates and trusts were taxed at the highest income tax rates/brackets applicable to individual taxpayers – those rates/brackets pertaining to married persons filing separate returns. However, the Tax Reform Act of 1986 compressed the income tax rate brackets for trusts and estates. The Revenue Reconciliation Acts of 1990 and 1993 further compressed the rate brackets for these entities.

The General Explanation of the Tax Reform Act of 1986, prepared by the Joint Committee on Taxation (May 4, 1987, at page 1245) explained Congress' reasons for the initial compression of tax rates for trusts and estates. According to the report, "the prior rules ... permit reduction of taxation through the creation of entities that are taxed separately from the beneficiaries or the grantor of the trust or estate. This result arises because any retained income of the trust or estate was taxed to the trust or estate under a separate set of rate brackets ... from those of its grantor and beneficiaries."⁵⁹ According to the report, Congress believed that it should eliminate or significantly reduce the benefits that result from the ability to split income between a trust or estate and its beneficiaries, and Congress accomplished this result by reducing the amount of income that a trust or estate must accumulate before it was taxed at the highest bracket.⁶⁰

While the change in income tax rates was primarily aimed at trusts, estates were also subjected to the higher rates imposed on trusts. As a result, for the taxable year 2017, the top tax rate of 39.6% would apply to an individual who is married and filing separately only if his or her taxable income exceeds \$235,350. However, if that individual dies in 2017, his or her estate is subject to the top income tax rate of 39.6% on income in excess of \$12,500.

The net investment income tax places an additional burden on estates. Beginning in 2013, section 1411 imposes a tax of 3.8% on the lesser of net investment income or the excess of modified adjusted gross income over a threshold amount. For an individual who is married and filing separately, the threshold amount is \$125,000. Therefore, the net investment income tax would apply only if that individual has a modified adjusted gross income in excess of \$125,000. However, if that individual dies in 2017, his or her estate is subject to the 3.8% net investment income tax if the estate's adjusted gross income exceeds \$12,500.

Certain trusts established for the benefit of disabled individuals have received special tax treatment since 2001. Section 642(b)(2)(C)(i) provides that qualified disability trusts may claim a personal exemption in the amount that is based on the personal exemption

⁵⁹ [The General Explanation of the Tax Reform Act of 1986](#), prepared by the Joint Committee on Taxation (May 4, 1987, at page 1245).

⁶⁰ *Ibid.*

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for individuals under section 151(d) (\$4,050 for 2017), rather than the \$300 or \$100 personal exemption allowed for regular trusts. This provision applies to taxable disability trusts described in 42 U.S.C. section 1396p(c)(2)(B)(iv) (relating to the treatment, for purposes of determining eligibility for medical assistance under the Social Security Act, of assets transferred to a trust established solely for the benefit of a disabled individual under 65 years of age). The Commissioner of Social Security must determine that all the beneficiaries of the trust are considered disabled for some portion of the year. A trust does not fail to meet this requirement merely because the corpus of the trust may revert to a person who is not disabled after the trust ceases to have any beneficiary who is disabled. While qualified disability trusts are entitled to the same personal exemption allowed to an individual rather than a regular trust, qualified disability trusts are subject to income tax and the tax on net investment income at the same rates as regular trusts.

Analysis

The AICPA believes, as a matter of fairness and equity, Congress should adjust the income tax and net investment income tax rates/brackets applicable to estates. In order for an individual (taxed at the highest level as married filing separately) to reach the highest income tax rate of 39.6% in 2017, he or she would need to report taxable income in excess of \$235,350. As a result of this threshold, so-called lower to middle class individuals may never pay tax on any of their taxable income at that rate. However, once an individual dies, the individual's estate is subject to the income tax rate of 39.6% on its annual taxable income in excess of \$12,500. An individual with taxable income of \$12,500 in 2017 would have a top income tax rate of 15%. Similarly, with respect to the section 1411 net investment income tax, no tax would apply on the individual's net investment income unless (in the case of a married individual filing a separate return) modified adjusted gross income exceeds \$125,000. Therefore, many individuals will never reach the \$200,000 single, \$250,000 married filing jointly, and \$125,000 married filing separately thresholds and never pay the net investment income tax during their lifetimes, but because of the tax inequalities applicable to estates, this net investment income tax will almost certainly apply to their estates after their deaths. For purposes of these tax rates, Congress should treat estates as if they were a continuation of the deceased individual and tax them at the highest applicable individual rate.

An estate serves a unique role as being the successor to an individual for a limited period of time during which it winds up the affairs of the individual and then distributes the assets to the individual's heirs. The fiduciary of the estate is responsible for collecting all the assets of the decedent, paying off the decedent's creditors, filing federal and state estate tax returns, if necessary, and finally distributing the remaining assets to the beneficiaries. Unlike trusts, a person has to die in order to create the estate, and one individual cannot create multiple estates.

Unlike trusts that now can exist in perpetuity in some states, an estate is in existence for only a limited period of time. Most probate courts strive to expedite the collection and disposition of assets, frequently requiring explanations for any delay in distributing the assets and closing the estate. In addition, the IRS will not continue to consider an estate

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that is unnecessarily kept open as an estate for purposes of the IRC. Treasury Reg. §1.641(b)-3 provides that the executor cannot unduly prolong the period of administration of an estate. If the administration of the estate is unreasonably prolonged, the estate is considered terminated for federal income tax purposes after the expiration of a reasonable period for the performance by the executor of all the duties of administration. For qualified revocable trusts that the trustee elects to treat and tax as part of the estate under section 645, the statute itself provides a termination date for such treatment. Under section 645(b), the trustee can treat the qualified revocable trust as part of the estate for no longer than two years after the date of the decedent's death if the filing of a federal estate tax return is not required. If the filing of a federal estate tax return is required, the trustee can no longer consider the qualified revocable trust as part of the estate after six months after the date of the final determination of the estate tax liability.

The only way an estate could eliminate exposing the estate's income to the high income tax rates of section 1(e) and to the net investment income tax is by making distributions of current income to the estate's beneficiaries in order for the lower individual tax rates to apply. There are, however, numerous non-tax reasons that can serve to limit or prohibit the estate's fiduciary from making current distributions to beneficiaries. For example, an executor of an estate may not have the ability to distribute to beneficiaries because of the following reasons: (1) in some situations, the executor faces challenges in probating the will quickly; (2) the executor needs to retain the assets to pay specific bequests and debts (including income and estate taxes); (3) state law prohibits the executor from making distributions until after the claims period for debts expires (imposing personal liability on the executor) and some states require court approval prior to making any distributions; (4) executors of smaller estates frequently do not understand their fiduciary income tax filing responsibility and the income tax consequences of not distributing income before the end of the tax year or within the 65 day period following the close of the tax year; and (5) pending litigation or will contests delays the estate's closing. In addition to needing court approval for distributions, estates often cannot pay some necessary expenses (such as executor and attorney fees) until there is court approval. This additional judicial hurdle pushes most of the estate's income tax deductions into the final fiduciary return. Estates generally pay expenses and distribute assets to beneficiaries as soon as possible because all parties are anxious for the process to complete and for the estate to close. We believe that the federal tax laws should not penalize the estate and its beneficiaries by imposing very low thresholds before the highest income tax rate and the net investment income tax apply to the estate's temporarily retained income.

Because of their unique role as successor to an individual, estates are treated differently and more favorably than trusts in several important areas of the IRC. Estates are permitted to adopt a fiscal year, while trusts are required to use the calendar year under section 644(a). All estates are permitted as shareholders of an S corporation under section 1361(b)(1)(B), while only certain trusts described in section 1361(c)(2) are permitted S corporation shareholders. Estates are permitted a charitable deduction for amounts of gross income that pursuant to the terms of the governing instrument are permanently set aside for charitable purposes under section 642(c)(2). Since 1969, the

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IRC has not permitted this set-aside deduction for trusts. Rather, trusts are allowed a charitable deduction only if gross income is paid for a charitable purpose during the taxable year. Section 469(i) allows an individual to deduct up to \$25,000 of losses from rental real estate activities in which the individual actively participates. Under section 469(i)(4), this deduction is also permitted to the individual's estate for taxable years ending less than 2 years after the date of the individual's death. The throwback rules (sections 665-668, which taxed beneficiaries of trusts on distributions of accumulated income) were applicable only to trusts and not estates before they were repealed for domestic trusts in 1997. Because trusts and estates are not always treated the same for federal income tax purposes, there is no policy reason for Congress to treat them the same for purposes of the income tax rate schedule and the net investment income tax. Just as estates receive more favorable treatment than trusts in the cited situations above, allowing estates more favorable tax rates than trusts is justified because of the unique nature of estates.

Qualified disability trusts are frequently established by a parent or grandparent for the benefit of a disabled child. Often these trusts are funded at the death of the parent or grandparent. The assets are placed in trust because the child is not capable of handling the set aside funds personally. Congress concluded in 2001 that these trusts deserved the same treatment as individuals for purposes of the amount of the personal exemption. We believe Congress should similarly treat these qualified disability trusts as individuals for purposes of the federal income tax rates and the net investment income tax. If all the income from the trust was distributed to the disabled individual, the individual – not the trust – would pay the income tax on the trust's income. It is very likely that the individual, who is taxed at the lower individual rates, would pay substantially less income tax on the trust's income than the trust would pay if no distributions were made. It is also very likely that the individual will owe no section 1411 tax on the net investment income because the individual's adjusted gross income is below the threshold amount. However, trustees make discretionary distributions from these trusts based on the needs of the disabled individuals and not to lower taxes. Because these trusts serve to manage funds for beneficiaries who are not capable of managing funds for themselves, Congress should treat these qualified disability trusts as if they were married individuals filing separately for purposes of the income tax rates and the section 1411 tax on net investment income.

Description of the Proposal

The proposal would subject estates and qualified revocable trusts for which the election under section 645 is made (collectively referred to as "estates" in this letter) and qualified disability trusts described in section 642(b)(2)(C) to income tax and the net investment income tax in the same manner as a married person filing a separate tax return.

We propose taxing estates in the same manner as a married person filing a separate tax return for income tax and net investment income tax purposes. This proposal would restore estates to the federal tax position they were in historically from 1954-1986. In addition, we believe that Congress should subject qualified disability trusts established

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for the benefit of disabled individuals to income tax and the net investment income tax in the same manner as a married person filing a separate tax return.

Conclusion/Recommendations

Congress should restore the income tax rate/bracket schedule for estates to the pre-1986 approach, in which estates have the same income tax rate/bracket schedule as that applicable to the highest income tax rate/bracket schedule for individuals (i.e., the married filing separate income tax rate/bracket schedule). In addition, Congress should make the estate's threshold for imposition of the section 1411 net investment income tax the same as for married individuals filing separately (i.e., \$125,000). Congress also should treat qualified disability trusts described in section 642(b)(2)(C) as subject to income tax and the tax on net investment income as if the qualified disability trust were a married individual filing a separate return.

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Proposal: Require Form 1099 reporting of interest and dividends paid to charitable remainder trusts

Present Law

Section 6042 defines the conditions under which persons that pay dividends must report the payment of such dividends and identifying the person to whom such dividends were paid. This information return is [Form 1099-DIV](#), *Dividends and Distributions*. Section 6042(b)(2)(B) excludes from the definition of a reportable dividend “any distribution or payment . . . to any person described in section 6049(b)(4),” except to the extent otherwise provided in the regulations.

Similarly, section 6049 defines the conditions under which persons that pay interest must report the payment of such interest and identifying the person to whom such interest was paid. This information return is Form 1099-INT. Section 6049(b)(2)(B)(i) excludes from the definition of interest any amounts paid to a “person” described in section 6049(b)(4), except to the extent otherwise provided in the regulations.

A person described in section 6049(b)(4) includes trusts exempt from tax under section 664(c), i.e., charitable remainder trusts (section 6049(b)(4)(L)(i)). Thus, persons who pay dividends or interest to charitable remainder trusts are not required to file Form 1099-DIV or Form 1099-INT with respect to those payments.

Under section 664(c)(1), a charitable remainder annuity trust or charitable remainder unitrust (together “charitable remainder trusts”) is exempt from the tax imposed by Subtitle A of the Code (i.e., income tax). However, the annuity or unitrust beneficiaries of a charitable remainder trust are generally taxed on the distributions they receive from the charitable remainder trust. Under section 664(b), the character of those distributions is determined by assigning the trust’s income to one of three categories – ordinary income, capital gains, and other (tax-exempt) income. Treasury Reg. § 1.664-1(d)(1)(i)(b)) provides that income within each category is further assigned to a class within the category based on the tax rate applicable to that type of income. For example, non-qualified dividends are assigned to higher tax rate class than qualified dividends, as defined in section 1(h)(11).

The distributions are treated as coming first from ordinary income, second from capital gains, third from other (tax-exempt) income, and finally from corpus. Within each category of income, distributions are treated as coming from income subject to the highest tax rate until the category is exhausted. For example, distributions are treated as carrying out non-qualified dividends before any qualified dividends are treated as distributed.

Description of the Proposal

Repeal section 6049(b)(4)(L)(i) to remove the exemption for reporting income payments to charitable remainder trusts. Congress would then include charitable remainder trusts

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among the recipients of interest and dividend payments to whom Form 1099-DIV and Form 1099-INT are issued.

Analysis

Under current law, an investment firm is not required to issue tax reporting information to a charitable remainder trust. Accordingly, the trustee of the charitable remainder trust is left to make tax character determinations without the benefit of the information that the investment firm has in its possession. Without accurate information, the trustee may report too little or too much income of a given tax rate class to the annuity or unitrust beneficiaries, thereby causing the beneficiary to under-report or over-report income of a given type. Such under-reporting or over-reporting has the consequence of causing the beneficiary to overpay or underpay his or her individual income tax liability. In short, this proposal is essential to the fair and efficient administration of the tax system as it applies to charitable remainder trusts and their income beneficiaries.

This proposal will assist trustees of charitable remainder trusts to comply with the requirements of section 664(b) and the regulations thereunder. A trustee of a charitable remainder trust must maintain a set of records that assigns the income of the trust to the three categories and to tax-rate classes within each category for the purpose of reporting the character of distributions to annuity or unitrust beneficiaries. A trustee reports the tax character of the trust's distributions by issuing to each beneficiary a Schedule K-1 (Form 1041).

Many trustees of charitable remainder trusts are individuals as opposed to corporate trustees. Consequently, many trustees invest the trust corpus in investment accounts at brokerage firms and mutual fund firms. Those firms are in the best position to know the proper tax classification of the income from securities in the portfolios they manage. A primary example of such a tax classification is the distinction between non-qualified ordinary dividends and qualified dividends described in section 1(h)(11).

Furthermore, the proposed reporting requirements will not trigger a significant administrative burden on the brokerage firms or mutual fund firms. These firms already comply with Form 1099 tax reporting for thousands of individuals and other trust clients.

Conclusion/Recommendation

We urge Congress to require information reporting of interest and dividends paid to charitable remainder trusts in order to assist the trustees of these trusts in performing their duties.

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Proposal: Modify Form 3520-A due date from March 15th to April 15th

Present Law

The [Form 3520-A](#), *Annual Information Return of Foreign Trust with a U.S. Owner*, is due by the 15th day of the third month after the end of the trust's tax year (i.e., March 15th for a calendar year trust). An automatic six month extension is allowed by filing [Form 7004](#), *Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns*, by the due date (i.e., September 15th for a calendar year trust).

The original tax due date, for [Form 1041](#), is the 15th day of the fourth month following the close of the tax year (i.e., April 15th for calendar year taxpayers). Starting in 2017, the extended due date for Form 1041 is five and a half months after the original due date (i.e., September 30th for calendar year taxpayers).

Description of Proposal

Congress should change the Form 3520-A deadline to the April 15th due date of Form 1041. The current automatic extension of six months should remain in place.

Congress should instruct the Secretary of the Treasury or his delegate to expeditiously modify the appropriate regulations to provide that the due date of Form 3520-A, which is currently prescribed under Administrative authority, is changed from March 15th to April 15th (with a maximum six month extension to October 15th).

Analysis

Foreign trusts are required to file Form 3520-A to report the annual information of a foreign trust with at least one U.S. owner. The form provides information about a number of parties, namely the foreign trust, its U.S. beneficiaries, and any U.S. person who is treated as an owner of any portion of the foreign trust under the grantor trust rules (sections 671 through 679).⁶¹

By changing the deadline for Form 3520-A to April 15th, Congress would align the due date with the general due date for trust income tax returns (i.e., Form 1041). For consistency purposes, Congress should provide that all tax returns for trusts, including the foreign trust information return, are due the 15th day of the fourth month after the trust year end (i.e., April 15th). Moreover, by keeping the current six month automatic extension for Form 3520-A, it would provide taxpayers an additional two weeks past the new extended deadline for Forms 1041. These additional two weeks would align the due date of Form 3520-A to the extended due date of individuals. Given that beneficiaries of trusts may report information from the Form 3520-A on an individual's income tax return due to the grantor trust rules found in Subchapter J of the Code, the additional two weeks

⁶¹ See [Instructions](#) to Form 3520-A.

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provides additional time to ensure accuracy and consistency for reporting the taxpayer's reportable income.

Conclusion/Recommendation

We urge Congress to instruct the modification of the regulations to conform the original due date for Forms 3520-A to April 15th for calendar year end taxpayers (the 15th day of the fourth month for other taxpayers).

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Proposal: Remove the binding contract requirement under section 512(b)(13)(E)(iii)

Present Law

Prior to the passage of the Pension Protection Act of 2006 (PPA), section 512(b)(13) treated otherwise excluded rent, royalty, annuity and interest income received by an exempt organization as unrelated business income if such income was received from a taxable or tax-exempt organization controlled by that parent organization (50% or more control, as computed both by direct ownership and by the constructive ownership rules of section 318). Such income was includible in the parent exempt organization's unrelated business income, and was subject to the unrelated business income tax, to the extent payment by the controlled organization reduced its net unrelated income (or increased a net unrelated loss), determined as if the controlled entity was tax-exempt.

The PPA modified section 512(b)(13) to provide that such payments are treated as unrelated business income only to the extent they exceeded the amount of any payment that would have been paid or accrued if the payment had been determined under the fair market value principles of section 482. This provision applied only to payments made under a binding written contract in effect before December 31, 2005. Originally designed to sunset on December 31, 2007, this provision was re-extended several times and made permanent on December 18, 2015.

Description of Proposal

AICPA recommends removal of the binding written contract requirement under section 512(b)(13)(E)(iii).

Analysis

Inter-organizational transactions are a normal and necessary part of modern business operations, both for nonprofit and for-profit entities. When conducted at arm's length for fair value, such transactions are in line with the "prudent investment" standard that generated the original exceptions to taxation of rents, royalties, annuities and interest under section 512(b)(1).

Conclusion/Recommendation

With the permanent extension of the PPA's modification of 512(b)(13), Congress has reinforced the concept that as long as fair market value rules are followed, there is no genuine or substantial reason to differentiate, for purposes of these types of transactions, between related and unrelated entities. However, the binding contract exception limits the application of this common sense modification to section 512(b)(13) to contracts that were entered into over ten years ago. There is no basis to restrict this treatment to such contracts. As long as such transactions are determined under the fair market value principles of section 482, there is no potential for abuse; making it available to all contracts regardless of whether they were entered into before the original date of

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enactment. Therefore, we urge Congress to delete the section 512(b)(13)(E)(iii) binding written contract requirement.

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Proposal: Amend section 501(r)(2)(A)(i) to allow the Internal Revenue Service and Treasury to issue guidance that allows for flexibility in the application of section 501(r)(2)(A)(i).

Present Law

The current language in the Code states that section 501(r) is applicable to organizations that operate a facility “which is required by a State to be licensed, registered, or similarly recognized as a hospital”⁶² and “any other organization which the Secretary determines has the provision of hospital care as its principal function.”⁶³

Description of Proposal

AICPA recommends Congress amend section 501(r)(2)(A)(i) to allow the IRS and Treasury to issue guidance that allows for flexibility in the application of section 501(r)(2)(A)(i). This guidance will exclude certain organizations, which do not function as or operate what is commonly considered a hospital, from the requirements of section 501(r).

Analysis

In practice, there are situations where an organization is licensed under state law as a hospital, or an organization may maintain licensed hospital beds, but does not actually function as or operate what is commonly thought of as a hospital. Therefore, we do not believe the requirements of section 501(r) should apply to these types of organizations.

Rather than specifically defining the term “hospital,” section 501(r) is, by statute, applicable to facilities “required by a State to be licensed, registered or otherwise recognized as a hospital.”⁶⁴ However, since each state regulates hospitals in a different manner, there is inconsistency in the application of the language of the Code. A state may require licensing, registration or recognition as a hospital of organizations such as research institutes, nursing homes, and skilled nursing facilities. For example, in at least one state, acute care organizations and nursing facilities are licensed as hospitals. Also, in at least one state, school clinics are licensed as hospitals. These organizations are not commonly considered hospitals.

Compliance with section 501(r) is arguably burdensome for most organizations to which it applies. Therefore, those organizations that are not traditional hospitals should receive an exemption from the requirement to comply with a law that was not intended to apply to them.

⁶² See IRC section 501(r)(2)(A)(i).

⁶³ See IRC section 501(r)(2)(A)(ii).

⁶⁴ See IRC section 501(r)(2)(A)(i).

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Conclusion/Recommendation

We request that Congress amend 501(r)(2)(A)(i) to allow the IRS and Treasury to issue guidance that will allow for a facts and circumstances test to determine whether an organization is a true hospital. This test should place the burden on the organization to substantiate that, despite state licensing requirements, operating a hospital is not the organization's principal function. If these facts and circumstances are established, then section 501(r) should not apply to the organization.

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Proposal: Enact legislation to mandate the electronic filing of the Internal Revenue Service exempt organization forms (all Form 990 series returns, including Form 990-PF and Form 990-T), as proposed in the Fiscal Year 2017 Budget of the United States Government and accompanying Treasury Explanations.⁶⁵

Present Law

Exempt organizations are required to annually file one of the IRS Form 990 series returns. The Form 990 series provides information about an exempt organization's activity for each tax year.

In early 2004, the IRS announced the ability to accommodate filing most Form 990 series returns electronically. Since then, both the largest and smallest exempt organizations have become subject to mandatory electronic filing requirements while all other exempt organizations have the option of filing using either an electronic or paper format. For tax years after December 31, 2006, exempt organizations with more than \$10 million in total assets that file at least 250 returns with the IRS during the year are required to electronically file the Form 990. Private foundations filing Form 990-PF must file electronically if at least 250 returns are filed with the IRS during the year, regardless of the amount of assets held. Additionally, qualifying organizations are required to electronically file a Form 990-N, *Annual Electronic Filing Requirement for Small Exempt Organizations* (also known as an e-Postcard).

Description of Proposal

The AICPA requests that Congress enact legislation to mandate the electronic filing of exempt organization forms, as proposed in the Fiscal Years 2015, 2016 and 2017 Budget of the United States Government and accompanying Treasury Explanations.

Analysis

Despite the current requirement for electronic filing, many exempt organizations do not file electronically because:

- Electronic filing is not available for several IRS exempt organization forms (e.g., Form 990-T);
- Many exempt organizations opt to file all of their information tax returns utilizing one filing method; and

⁶⁵ See "Budget of the U.S. Government, Fiscal Year 2017," Office of Management and Budget, Summary Tables, Table S-9, "[Mandatory and Receipt Proposals – Continued](#)," Page 155 of 165 and "General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals," Department of the Treasury, "[Enhance Electronic Filing of Returns](#)," Page 227 of 272.

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- There is a lack of awareness of the availability of the option to file electronically, particularly by smaller organizations that are not eligible to file Form 990-N.

The AICPA endorses the passage of a provision for mandatory electronic filing of all IRS Form 990 series returns.⁶⁶ Mandating electronic filing for all IRS exempt organization forms will create an awareness among exempt organizations of the availability to file electronically. Also, it will require the IRS to make the Form 990-T available for electronic filing. Additionally, it will enable organizations that utilize one filing method for all of their information returns to file all of their Form 990 series returns electronically.

In IR-2016-87, the IRS announced that the publicly available data on electronically filed Forms 990 is now available for the first time in a machine-readable format through Amazon Web Services (AWS). A requirement that all exempt organizations file the Form 990 series returns electronically will allow the IRS to release data in a machine-readable format in a timely fashion.

Electronic filing also increases the level of accuracy for all returns, and provides a more cost-efficient method of processing the returns. In addition to streamlining the filing process, the higher level of timely access to more accurate information will lead to greater transparency and a better understanding of the exempt organizations sector.

Conclusion/Recommendation

We request that Congress mandate the electronic filing of the IRS exempt organization forms.

⁶⁶ *Id.*

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Proposal: Provide small business relief by creating a *de minimis* threshold for applying the section 382 loss limitation rules and increasing the level of shareholder ownership to which the section 382 loss limitations rules apply

Present Law

Section 382 limits a loss corporation's ability to use its tax net operating losses and tax attribute carryforwards following an ownership change. Loss corporations that undergo an ownership change may also have limitations placed on the ability to utilize certain future losses that arise if the company is in a net unrealized built-in loss position at the time of the ownership change under section 382(h). Loss corporations in a net unrealized built-in loss position at the time of the ownership change may have further tax loss limitations on their recognized built in losses. Section 382(h)(3)(B)(i) provides that a loss corporation with a net unrealized built-in gain or net unrealized built-in loss that is not greater than the lesser of i) 15% of the fair market value of the assets or ii) \$10,000,000 does not have a net unrealized built-in gain or built-in loss.

Congress enacted section 382 to prevent the trafficking in tax attributes where one corporation acquired all of the stock, or a controlling interest, in a corporation with net operating losses in hopes of using such losses to offset future taxable income generated by the acquiring or target corporations. To prevent such abuse, Congress enacted section 382 to police such transaction by causing a limitation upon the amount of future taxable income that could offset net operating loss carryforwards or certain losses recognized after an ownership change that existed immediately before the acquisition.

Description of Proposal

Create a *de minimis* threshold for loss corporations' net operating losses to create parity with the *de minimis* rule already applicable for net unrealized built-in losses contained in section 382(h)(3)(B)(i) and provide them with relief from the myriad of complex section 382 rules. In addition, amend section 382 to track a "10%" shareholder as opposed to a "5%" shareholder currently included in the statute.

Analysis

Section 382 provides a complex set of rules that limits a loss corporation's ability to use its operating losses and tax attribute carryforwards. All taxpayers, both large public companies and small loss corporations, are faced with the same complex set of rules. Many loss corporations generally need to consult with a tax advisor with specialized knowledge of the section 382 rules. In most cases, the cost of hiring such an advisor to apply the complex section 382 rules outweighs the value of applying the tax loss to offset future taxable income. The complexity and consequences of section 382 has led companies with tax attributes down a road that does not appear as what Congress intended when section 382 was enacted. In addition, many financially distressed companies are all too often constrained by a fear that a rationale economic transaction (e.g., stock offering, share redemption, stock for debt exchanges) will cause an ownership

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change, or result in a cumulative ownership change due to a subsequent transaction (e.g., sale by a 5% shareholder, issuance of stock options to employees, etc.). However, a majority of transactions involving the stock of a loss corporation are wholly outside of the loss corporation's control and are not the kind of transactions that Congress considered as "loss trafficking."

Extending the existing built-in loss *de minimis* threshold to net operating losses would eliminate this burden and provide simplification to more small loss corporations. In addition, by amending section 382 to track ownership changes by 10% or greater shareholders (rather than 5%) should also alleviate the burden placed upon corporations that exceed the *de minimis* threshold. We anticipate that this change alone would eliminate 90% of the efforts required to track ownership changes. However, such a change should not result in an increase in the type of loss trafficking Congress feared when section 382 was enacted. In our experience, we have never seen what we would consider a "loss trafficking" transaction by a shareholder that owns less than 10% of a loss corporation.

Conclusion/Recommendation

The AICPA recommends that Congress provide small loss corporations relief by creating a *de minimis* threshold for loss corporations' net operating losses to create parity with the *de minimis* rule already applicable for net unrealized built-in losses contained in section 382(h)(3)(B)(i) and provide small loss corporations with relief from the myriad of complex section 382 rules. In addition, we recommend that Congress provide all taxpayers with relief by increasing the level at which section 382 applies by tracking changes in ownership of a 10% or greater shareholder as opposed to a 5% shareholder.

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Proposal: Provide small businesses relief by creating a *de minimis* threshold for applying the section 384 loss limitation rules

Present Law

Section 384 limits the use of certain preacquisition losses and other tax attributes when a corporation acquires control of another corporation or acquires the assets of another corporation in an A, C, or D reorganization. If one of the corporations has a net unrealized built-in gain, then any income attributable to the unrealized built-in gain cannot offset preacquisition losses of the other corporation to the extent that such gain is recognized within the five-year period after the date of the acquisition. Section 384(c)(8), by reference to section 382(h)(3)(B)(i), provides that a corporation with a net unrealized built-in gain or net unrealized built-in loss that is not greater than the lesser of i) 15% of the fair market value of the assets or ii) \$10,000,000 does not have a net unrealized built-in gain or built-in loss.

Similar to the purpose of section 382 to prevent the trafficking of tax attributes, section 384 was intended to address certain abusive transactions, namely those involving burnt-out leasing tax shelters. Congress enacted section 384 to prevent a loss corporation from using its losses or other attributes to shelter built-in gains of another corporation that are recognized within the statutory period. Section 384 applies concurrently with section 382, subjecting a transaction to the complex loss limitation rules of section 382 in addition to those under section 384.

Description of Proposal

Create a *de minimis* threshold for preacquisition losses under section 384 to create parity with the *de minimis* rule already applicable section 382(h)(3)(B)(i) through section 384(c)(8) and provide relief from the burdensome compliance with section 384.

Analysis

Section 384 limits an acquiring corporation's ability to use preacquisition losses and tax attributes of its own or of a target corporation against gains subsequently recognized on sales of the other corporation's assets to the extent of unrealized appreciation in the assets at the time of the acquisition. The restriction apply to all taxpayers, whether a large public company or a small corporation, and generally requires the costly assistance of a specialized tax advisor. Furthermore, section 384's application extends well beyond the shelter transactions with which Congress was originally concerned.

To extend the existing built-in loss *de minimis* threshold to preacquisition losses would eliminate the burdens of section 384 compliance for many small corporations. Yet the change would not lead to an increase of the type of abusive transactions Congress feared upon enactment, as the vast majority of acquisitions subject to the broad language of section 384 do not resemble the tax shelter transactions the provision was intended to prevent. In addition, the change is consistent with the proposed change related to section

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382, wherein the *de minimis* threshold would similarly extend to a loss corporation's net operating losses.

Conclusion/Recommendation

The AICPA recommends that Congress provide small corporations relief by creating a *de minimis* threshold for preacquisition losses under section 384. This suggestion will create parity with the *de minimis* rule already applicable for net unrealized built-in gain or loss contained in section 382(h)(3)(B)(i), as incorporated under section 384(c)(8), and thereby ease the burdens of compliance for such small corporations.

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Proposal: Modify the enhanced deduction rules for charitable contributions of inventory

Present Law

Section 170(b)(2) provides that, except for qualified conservation contributions by corporate farmers and ranchers and contributions of food inventory under section 170(e)(3)(C), the total charitable contribution deduction for any taxable year shall not exceed 10% of a corporation's taxable income ("the 10% taxable income limitation").

Under section 170(d)(2), if a corporation is unable to deduct charitable contributions in the taxable year the contributions are made due to the 10% taxable income limitation, the corporation is permitted to deduct the excess amount during the five succeeding tax years ("five-year carryover period"), subject to additional limitations.

Under section 170(e)(1)(A), the charitable contribution deduction for ordinary income property is equal to the fair market value of the property at the time of the contribution reduced by the amount of gain which would not have been long-term capital gain if the property contributed had been sold by the taxpayer at its fair market value (determined at the time of contribution).

Section 170(e)(3) provides a special rule for qualified contributions of inventory and other property. Under section 170(e)(3), a qualified contribution is "a charitable contribution described in paragraph (1) or (2) of section 1221(a) by a corporation (other than an S corporation) to a 501(c)(3) organization exempt under section 501(a) (other than a private foundation, as defined in section 509(a), that is not an operating foundation, as defined in section 4942(j)(3)), but only if –

1. The use of the property by the donee is related to the purpose or function constituting the basis for its exemption under section 501 and the property is to be used by the donee solely for the care of the ill, needy, or infants;
2. The property is not transferred by the donee in exchange for money, other property, or services;
3. The taxpayer receives from the donee a written statement representing that its use and disposition of the property will be in accordance with the provisions of (1) and (2); and
4. In cases where the donated property is subject to regulation under the Federal Food, Drug, and Cosmetic Act ("the Act"), the property must fully satisfy the applicable requirements of the Act and related regulations on the date of transfer and for 180 days prior thereto."

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Section 170(e)(3)(B) provides that “the reduction under section 170(e)(1)(A) for any qualified contribution shall be no greater than the sum of --

1. One-half of the amount of the reduction computed under paragraph (1)(A), and
2. The amount (if any) by which the charitable contribution deduction for any qualified contribution (computed by taking into account clause (i) but without regard to this clause) exceeds twice the basis of such property.”

Section 170(e)(3)(C) contains similar rules for the charitable contributions of food inventory.

Description of Proposal

Modify section 170(e)(3) to provide that a corporation making an eligible charitable contribution of inventory and food inventory shall include the basis of the contributed inventory in cost of goods sold, for the year of contribution, so that only the enhanced deduction is treated as a charitable contribution subject to the 10% taxable income limitation under section 170(b)(2) or the 15% of taxable income limitation under section 170(e)(3)(C)(ii)(I).

Analysis

Under section 170(e)(3), a corporation making a qualified charitable contribution of inventory may claim a deduction equal to the fair market value reduced by one-half of the gain which would not have been long-term capital gain if the property contributed had been sold by the corporation at its fair market value (determined at the time of contribution). However, the total charitable contribution deduction may not exceed twice the basis of the contributed property. In other words, if the fair market value of the contributed inventory at the time of the contribution exceeds the basis of the inventory, the amount of the charitable contribution deduction is equal to the basis of the inventory plus 50% of the profit, not to exceed twice the basis of the inventory. The profit is the amount realized if the corporation had sold the inventory at its fair market value, at the time of contribution.

The amount of the deduction in excess of basis is commonly referred to as “the enhanced deduction.” Under present law, the entire amount (basis plus the enhanced deduction) is treated as a charitable contribution, and the basis of the inventory is not included in cost of goods sold (see Treas. Reg. § 1.170A-4A(c)(3)). As a result of the 10% taxable income limitation in section 170(b)(2), some corporations are unable to claim the enhanced deduction and are unable to recover the basis of the contributed inventory in the year of the contribution. Accordingly, a corporation subject to the 10% taxable income limitation may opt to dispose of the inventory instead of contributing the inventory to charity. Such disposition would allow the corporation to obtain a current recovery of the basis through cost of goods sold instead of deferring the deduction to future years.

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The IRS recognized this dilemma and issued Notice 2008-90, giving corporations the option to either claim the enhanced deduction under section 170(e)(3) or apply the rules under section 170(e)(1). Under section 170(e)(1), the basis of inventory contributed to charity generally is included in cost of goods sold instead of being treated as a charitable contribution deduction, but there is no enhanced deduction. Therefore, if a corporation making a qualified charitable contribution of inventory under section 170(e)(3) is subject to the 10% taxable income limitation, the corporation could elect to apply the rules under section 170(e)(1) to recover the basis of the contributed inventory in the year of contribution. However, a corporation electing to apply the rules under section 170(e)(1) would forfeit the enhanced deduction. The same issues apply to the charitable contribution of food inventory, as enhanced by the PATH Act. As a result, this option removes the incentive designed by Congress to encourage charitable contributions of inventory when it enacted section 170(e)(3).

Conclusion/Recommendation

The AICPA recommends that Congress modify section 170(e)(3) to provide that a corporation making an eligible charitable contribution of inventory shall include the basis of the contributed inventory in cost of goods sold for the year of contribution and the charitable contribution deduction shall include only the enhanced deduction (i.e., the amount in excess of basis), if any. Thus, the enhanced deduction, if any, is a charitable contribution subject to the 10% taxable income limitation under section 170(b)(2) but the basis of the contributed inventory (not subject to the 10% taxable income limitation) is included in cost of goods sold for the year of contribution. Likewise, contributions of food inventory subject to the 15% taxable income limitation are affected.

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Proposal: Repeal the anti-churning rules of section 197(f)(9)

Present Law

Enacted in 1993, section 197 of the IRC permits the amortization of certain acquired intangibles (such as goodwill and going concern value). These intangibles were not amortizable prior to the enactment of section 197. Referred to as the anti-churning rules, section 197(f)(9), was enacted to prevent related taxpayers from converting previously non-amortizable intangibles into intangibles subject to the allowance for amortization by buying and selling intangible assets amongst themselves. Pursuant to the anti-churning rules, an intangible is excluded from the definition of amortizable section 197 intangibles if:

1. The intangible was held or used at any time on or after July 25, 1991, and on or before August 10, 1993 (“the transition period”), by the taxpayer or related person;
2. The taxpayer acquired the intangible from a person who held it at any time during the transition period, and as part of the transaction, the user of the intangible does not change; or
3. The taxpayer grants the right to use the intangible to a person (or a person related to that person) who held or used the intangible at any time during the transition period.

Description of the Proposal

Repeal of the anti-churning rules under section 197(f)(9) in their entirety.

Analysis

Congress enacted the anti-churning rules to prevent taxpayers from transacting with related taxpayers to convert non-amortizable intangibles into amortizable intangibles. Most intangibles that exist today did not exist 20 years ago when section 197 was enacted. Therefore, applying the rules to the current economic environment is outdated and unfitting. In addition, the anti-churning rules are complex and require taxpayers to perform a burdensome analysis to determine if non-amortizable intangibles existed during the transition period. Furthermore, the anti-churning rules treat taxpayers who possessed intangibles during the transition period distinctly different from taxpayers that did not hold intangibles until after the enactment of section 197.

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Conclusion/Recommendation

We recommend the enactment of legislation that simplifies taxpayers' compliance burden and consistently treats similarly situated taxpayers. The complexity and administrative burden associated with the anti-churning rules outweighs the need for the provision. Furthermore, the anti-churning rules create inequity among similarly situated taxpayers solely based on the date taxpayers came into possession of intangible assets. Therefore, we support legislation that would entirely repeal the anti-churning rules of section 197(f)(9).

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Proposal: Modify the rules for capitalization and inclusion in inventory costs for certain expenses under section 263A

Present Law

The Tax Reform Act of 1986 enacted the uniform capitalization rules, which require capitalization of certain direct and indirect costs allocable to real or tangible personal property produced by the taxpayer into either inventory or into the basis of such property. For real or personal property acquired by the taxpayer for resale, section 263A generally requires capitalization of certain direct and indirect costs allocable to such property into inventory.

However, section 263A exempts certain taxpayers from applying the general capitalization requirements. Specifically, section 263A exempts certain small taxpayers who acquire property for resale and have no more than \$10 million of average annual gross receipts from the general capitalization requirements.

Description of the Proposal

Modify section 263A to exempt producers in addition to resellers who meet the small taxpayer exemption and define the exemption to include taxpayers with no more than \$5 million of average annual inventory, rather than by reference to \$10 million of average annual gross receipts.

Analysis

The gross receipts test was implemented 30 years ago. The AICPA believes the gross receipts test no longer accurately represents a small taxpayer. Moreover, it fails to address a small producing taxpayer in the context of what the exception relates to, namely, ending inventory. For example, a taxpayer could have average annual gross receipts for the test period that significantly exceed \$10 million while its average ending inventory for the test period is no more than \$5 million. This may be the case if its gross receipts are derived from activities in the ordinary course of business other than the sale of inventory (e.g., service, lease, or royalty revenue).

Conclusion/Recommendation

We recommend that Congress modify section 263A to exempt businesses with no more than \$5 million of average annual inventory from the section 263A requirements, instead of utilizing average annual gross receipts.⁶⁷

⁶⁷ AICPA submitted written statement to the House Committee on Ways and Means Subcommittee on Select Revenue Measures: [Small Business and Pass-Through Entity Tax Reform Discussion Draft](#), dated May 15, 2013.

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Proposal: Expand the availability of retirement plan contributions for individual taxpayers working overseas

Present Law

Under present law an individual, subject to limitations, can contribute to an Individual Retirement Account (IRA) or qualified employer sponsored plan (e.g., 401(k)) up to the amount of their taxable compensation for the year. Taxpayers that live and work overseas for a non-U.S. employer can also request their employer set up a trust account for their benefit under the Rabbi Trust rules or under a foreign country's retirement plan rules.

The contributions to a qualified plan, deductible and nondeductible, are subject to annual limits which are either reduced or eliminated for active participation in a qualified employer sponsored plan or due to the taxpayer exceeding certain Modified Adjusted Gross Income (MAGI) limits. Contributions to Rabbi Trusts and foreign retirement plans have no such limits but are potentially subject to reporting and/or taxation under the foreign trust rules.

Taxpayers who work for a foreign employer are not eligible to contribute to the U.S. social security system. There are a limited number of Social Security Totalization agreements, in force with other countries, which allow a taxpayer to benefit from contributing to the foreign country's system.

Description of Proposal

Repeal the MAGI limitation for taxpayers and spouses that are not otherwise eligible to participate in a qualified retirement plan in order that they can contribute to a traditional nondeductible or ROTH IRA each year, enabling them to create some financial security for themselves and their family.

Analysis

There are millions of U.S. taxpayers that work abroad. Many of them start as teachers or low-skilled workers that have not yet worked in the U.S. and had the opportunity to contribute to Social Security or a retirement plan. In this instance, they are not able to begin to accumulate credits toward qualification for Social Security benefits or funds in a retirement plan, eliminating the power of accumulated tax-free growth. Others leave when they are in middle management wishing to move to the next level; an overseas assignment is often the path that will get them there. At this period in life they are often in a position to contribute substantial amounts to their retirement plan but the move overseas will limit or eliminate this possibility. Foreign assignment compensation packages often do not offer incentives and perks that can help the employee make up for this lack of retirement plan contribution.

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Conclusion/Recommendation

The current MAGI rules impose an unfair limitation on U.S. taxpayers working abroad that prevents them from saving for retirement. Allowing these taxpayers the ability to contribute to traditional nondeductible or ROTH IRA while they work abroad would not prejudice the interests of the government as there is no current tax deferral but creates or enhances their safety net for retirement. Foreign retirement plans are usually not available and those that are do not conform to the U.S. rules for a qualified plan, resulting in burdensome reporting and sometime punitive taxation.

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Proposal: Authorize the Secretary of the Treasury to provide tax and filing relief for certain foreign savings accounts considered equivalent to specified U.S. tax-exempt and tax-deferred savings accounts

Present Law

Many countries maintain tax provisions similar to the U.S. that allow individuals to establish tax-deferred and/or tax-exempt savings accounts which support various social and economic goals of their respective governments.

The U.S. currently does not provide any relief within the IRC for such foreign plans. Further, while many of the income tax conventions that the U.S. has entered into with various foreign governments provides bilateral deferral of tax or inclusion in income for various qualified or registered pension or retirement plans, these conventions do not provide relief from double taxation or current inclusion in income for other plans and accounts such as:

- Education savings plans that are similar to Qualified Tuition Program (529) Plans in the United States.
- Disability savings plans that are similar to Qualified Achieve a Better Life Experience (ABLE) Plans in the United States.
- Tax-exempt savings accounts that are similar to Roth IRAs in the United States.

Description of Proposal

Authorize the Secretary of the Treasury to grant the following types of relief for foreign tax-deferred and tax-exempt savings plans that are judged as the equivalent of a similar U.S. plan in order to reduce the tax and reporting burdens imposed on U.S. citizens and resident aliens.

- Provide tax-deferred or tax-exempt treatment for approved foreign plans identical to the equivalent U.S. plans.
- Exempt approved foreign plans from classification as grantor trusts and exempt U.S. citizens and residents from various onerous statutory filing requirements for foreign trusts and Passive Foreign Investment Companies (PFICs) which currently exist for these plans.

Analysis

It is estimated that over seven million Americans live outside the U.S., and a substantial number of foreign nationals live in the U.S. and are subject to U.S. tax laws. The lack of tax relief from double taxation or current inclusion in income available under the IRC or income tax conventions for these plans and accounts has adverse tax consequences for:

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- Americans living outside the U.S.
- Foreign nationals living in the United States.
- Americans living in the United States who contributed to one or more of these foreign plans while living in a foreign country.

Frequently, a cross-border move will result in adverse tax consequences such as unanticipated inclusion in income of amounts saved in a tax-deferred or tax-exempt account that may require the cross border individual to liquidate the accounts to avoid the adverse tax consequences. Often, the forced liquidation itself can result in unanticipated taxable income. Furthermore, the U.S. imposes complex reporting requirements, such as those regarding foreign trusts and PFIC, for individuals participating in foreign plans. These tax implications can adversely impact the individuals and their families, the social objectives of the countries and cross-border mobility.

The factors considered by the Secretary prior to granting relief could include a requirement that the other country grant reciprocal relief for the equivalent U.S. tax-deferred or tax-exempt savings plan for any individual subject to that countries tax system.

Conclusion/Recommendation

Authorize the Secretary of the Treasury to grant the specified types of relief for foreign tax-deferred and tax-exempt savings plans that are judged as the equivalent of a similar U.S. plan in order to reduce the tax and reporting burdens imposed on U.S. citizens and resident aliens.

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Proposal: Simplify the computation of the section 1291 deferred tax amount

Present Law

A U.S. person who owns an interest in a PFIC but has not made a pedigreed QEF election is subject to the excess distribution regime of Section 1291. Section 1291 requires the calculation of the deferred tax amount related to an excess distribution at the highest tax rate for each year to which the distribution was related and that the corporation was a PFIC. Some excess distributions can contain amounts related to multiple tax years.

Description of Proposal

Allow a shareholder of an un-pedigreed PFIC to elect to have the excess distribution amount taxed at the highest ordinary income tax rate for the current year of the distribution, rather than the highest tax rate for each prior year related to the distribution.

Analysis

Pursuant to current law which requires that the excess distribution amount is taxed at the highest tax rates for the prior years to which the distribution relates creates a significant compliance burden on PFIC shareholders, particularly when the distribution in question is not a material amount. The cost to have the deferred tax amount computed in many cases exceeds the deferred tax amount itself. Allowing PFIC shareholders to elect to apply the highest tax rate for the current year is unlikely to result in a loss of tax revenue to the Treasury since the PFIC rules have been in effect since 1986. The ordinary income tax rate is now at its highest point since 1986.

Conclusion/Recommendation

Allowing PFIC shareholders to elect to apply the highest current year tax rate to an excess distribution will reduce the compliance costs that PFIC shareholders must generally incur to have the deferred tax amount computed, and further encourage taxpayer compliance with Section 1291.

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Proposal: Provide a *de minimis* exception for the application of the section 1291 interest computation

Present Law

Under Section 1291, taxpayers must compute interest on the deferred tax amount (“the interest charge”) for each excess distribution allocated to each tax year.

Description of Proposal

Waive the requirement to compute the interest charge when the aggregate excess distribution received by a PFIC shareholder does not exceed \$1,000 in a tax year.

Analysis

For any given tax year, a U.S. person could have dozens of Section 1291 excess distributions many of which are very minor in amount. The compliance cost to compute the required interest expense on each deferred tax amount could easily exceed the interest and indeed exceed the underlying deferred tax amount itself. Since 1993, the interest rate on underpayments of estimated tax has never exceeded 9%. (As of this writing, the current rate is only 4%.) We believe that this recommendation is a reasonable trade off in order to remove the onerous requirement that U.S. persons with minor amounts of excess distribution income compute an inconsequential interest charge on this income.

Conclusion/Recommendation

Exempt U.S. persons with no more than \$1,000 of excess distribution income from having to compute the interest charge on the excess distribution income. This exception would eliminate hundreds of dollars or more of annual compliance costs for many U.S. persons who own small interests in PFICs as well as further encourage taxpayers to comply with Section 1291.

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Proposal: Allow for annual aggregations of passive foreign investment companies stock purchases for purposes of Section 1291.

Present Law

The deferred tax amount determined under Section 1291 is calculated by computing the tax on an excess distribution for each tax year the distribution originated. The definition of “excess distribution” is applied separately with respect to each share of a PFIC held by a taxpayer, except that a block of stock with a common holding period is treated as a unit.

Description of Proposal

Permit the aggregation of multiple annual purchases of shares of the same PFIC provided the purchases do not exceed 10% of the U.S. person’s total ownership stake. In the year in which the PFIC is first purchased, allow aggregation for any dividend reinvestments or small subsequent additional purchases provided the subsequent purchases do not exceed 10% of the U.S. person’s initial purchase in that year.

Analysis

Some PFICs have dividend reinvestment programs that could result in multiple purchases of the stock in the same tax year by a U.S. person. This situation creates significant complexity with respect to the determination of the excess distribution allocable to each particular tax year. Allowing for the aggregation of minor annual purchases for purposes of the computation of the deferred tax amount would provide relieve for this complexity. For purposes of allocating an excess distribution to a given tax year, treat the aggregated minor purchases as being acquired on January 1, June 30 or December 31, provided these alternate dates were applied consistently throughout the holding period of the U.S. person.

Conclusion/Recommendation

Aggregation of multiple annual purchases of the same PFIC and dividend reinvestments into the same PFIC provided these purchases and reinvestments do not exceed 10% of the owner’s total ownership amount.

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Proposal: Align Section 1298 reporting for indirect ownership with section 6038

Present Law

Under Code Section 1298(b)(5), an indirect owner of a PFIC is treated as having disposed of his interest in the PFIC when the U.S. person or the person owning the PFIC stock engages in a transaction whereby the U.S. person is no longer treated as indirectly owning the PFIC stock. Such dispositions require detailed disclosure on Form 8621, *Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*.

Description of Proposal

Consider an indirect owner of a PFIC to have disposed of his interest in a PFIC if such person indirectly owns stock possessing more than 50% of the total combined voting power of all classes of stock entitled to vote.

Analysis

The proposal would harmonize the Section 1298 indirect disposition rules with the constructive ownership rules of Section 958(b). It is often not possible for the indirect owner of a PFIC to obtain access to the information necessary to comply with the Section 1298 reporting requirements for the disposition of an interest in a PFIC when the direct owner sells its interest in the PFIC. The proposal would limit the 1298 PFIC disclosure provisions to those situations in which the indirect PFIC owner is in a position to have access to the information necessary to completely and accurately comply with these disclosure requirements.

Conclusion/Recommendation

Consider an indirect owner of a PFIC to have disposed of his interest in a PFIC only if the person owns more than 50% of the total combined voting power of the PFIC.