American Institute of CPAs
1455 Pennsylvania Avenue, NW
Washington, DC 20004-1081

February 19, 2014

The Honorable Ronald L. Wyden, Chairman
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

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

The Honorable Orrin G. Hatch
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: AICPA Compendium of Legislative Proposals – Simplification and Technical Proposals

Dear Chairmen and Ranking Members:

The American Institute of Certified Public Accountants (AICPA) submits for your consideration the enclosed 2014 AICPA Compendium of Legislative Proposals: Simplification and Technical Proposals.

We are the world's largest member association representing the accounting profession, with more than 394,000 members in 128 countries and a 125-year heritage of serving the public interest. 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 has long been an advocate for simplification and fairness in the tax law and is actively pursuing or has published positions on a number of major legislative proposals that are directly related to tax reform. Our focus in this Compendium of Legislative Proposals, however, is on provisions in the Internal Revenue Code that are not unduly controversial, are technical in nature, and perhaps can be more readily resolved.

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 (304) 522-2553, or jporter@portercpa.com; or Melissa Labant, AICPA Director – Tax Advocacy & Professional Standards, at (202) 434-9234, or mlabant@aicpa.org.

Sincerely,

Jeffrey A. Porter
Chair, AICPA Tax Executive Committee

cc: Members of the Senate Committee on Finance
Members of the House Committee on Ways and Means
Members of the Tax Legislative Counsel, Treasury Department
Mr. Thomas A. Barthold, Chief of Staff, Joint Committee on Taxation
The Honorable Mark Mazur, Assistant Secretary for Tax Policy, Treasury Department
The Honorable John Koskinen, Commissioner, IRS
The Honorable William J. Wilkins, Chief Counsel, IRS
Ms. Nina E. Olson, National Taxpayer Advocate, IRS

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Compendium of Legislative Proposals

Simplification and Technical Proposals

Approved by the
Tax Executive Committee

February 2014

FOREWORD

The American Institute of Certified Public Accountants (AICPA) is actively pursuing or has published positions on a number of major legislative proposals that are directly related to tax reform. Our focus in this Compendium of Legislative Proposals, however, is on provisions in the Internal Revenue Code (IRC or "Code") that need attention, are technical in nature, and perhaps can be more readily resolved.

While we intend to continue to submit comments and proposals on major issues in reform efforts, we have asked AICPA Tax Division committees to make recommendations for legislative proposals that correct perceived technical problems in the Code or that would simplify its existing provisions. It is intended that these proposals not be unduly controversial, but instead promote simplicity and fairness. The enclosed proposals were among those proposals received in response to that request.

It is not a comprehensive list of all provisions that we believe should be added back or removed from the reformed Internal Revenue Code. However, these items are focused on improving tax administration, making the tax code fairer, and effectively promoting important policy objectives. We intend to continue our efforts in this area and make further recommendations in the future.

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Proposal: Repeal the requirement that benefits become fully vested upon a partial termination of a qualified retirement plan

Present Law

Section 411(d)(3) of the Internal Revenue Code requires qualified retirement plans to provide for full vesting upon partial plan termination. It was added by section 1012 of the Employee Retirement Income Security Act of 1974 (ERISA) and has not been amended since. The Code does not define "partial termination." The regulations provide that whether a partial termination occurs shall be determined by the Commissioner with regard to all the facts and circumstances in a particular case. Treas. Reg. § 1.411(d)-2(b)(1).

Description of Proposal

Repeal the requirement under section 411(d)(3) that benefits become fully vested upon a partial termination of a qualified retirement plan.

Analysis

The partial termination rules impose significant administrative burdens due to the uncertainty of whether and when a partial termination occurs. Moreover, the benefit to participants of full vesting upon partial termination has diminished over time. The vesting schedule requirements applicable to qualified retirement plans have been greatly accelerated since ERISA was enacted. Section 411(a) originally required either 10-year cliff or 5- to 15-year graded vesting. The current section 411(a) requirement is 5-year cliff or 3- to 7-year graded vesting.

Conclusion/Recommendation

The requirement under section 411(d)(3) that benefits become fully vested upon a partial termination of a qualified retirement plan should be repealed to reduce employers' administrative burdens without significantly affecting employees

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

Present Law

The Internal Revenue Code 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 may be 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 new 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 has been introduced in recent years, further simplification of the confusing array of retirement savings options should be undertaken.

Description of Proposal

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

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 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 would apply, while the same deferral and match formula in a 403(b) plan would result in only the ACP test being applicable.

3. Create a uniform rule regarding the determination of basis in distributions. Depending on the plan type, there are currently different methodologies to be used to 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 different Code sections which each have slight subtleties and 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 percent with compensation of $150,000 or more annually.

6. Eliminate the required minimum distribution rules. Participants must begin taking distributions beginning at age 70 ½ or be 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 must be 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 should be addressed. The rules would be better served if the distributions were 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, while a hardship distribution from a qualified plan is still 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 are able to 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 a small business grows and explores options for establishing a retirement plan, they encounter numerous alternatives subject to various rules which can become overwhelming. We feel that there are too many options available for consideration before a business can decide which plan is appropriate for them. 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 which 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 nations' 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 will be exposed to very different rules governing their benefits. By 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 should be consolidated and the rules governing the plans simplified, with appropriate transition rules as needed.

Proposal: Harmonize and simplify education-related tax provisions

Present Law

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

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

The first category includes provisions that may be divided into three main subcategories: (1) exclusions from taxable income such as scholarships (section[1] 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 Hope Credit (for tax years 2009 through 2017, referred to as 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

S. 1090 and H.R. 2253 are similar proposals and are referred to here as S. 1090. S. 1090 proposes to replace the existing education credits at section 25A with a single credit covering the first four years of post-secondary education. Through 2017 and prior to any change by S. 1090, section 25A provides for the American Opportunity Tax Credit and the Lifetime Learning Credit. Under present law, after 2017, the American Opportunity Tax Credit expires and the Hope Scholarship Credit returns. S. 1090[2] would replace these credits with the "Higher Education and Skills Obtainment Credit."

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

The attached tables provide (1) a summary of current education incentives; (2) details on the S. 1090 revision of section 25A; and (3) a comparison of S. 1090 and the AICPA proposal described next.

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[1] All section references in this letter are to the Internal Revenue Code of 1986, as amended, or the Treasury regulations promulgated there under, unless otherwise specified.
[2] 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.

Description of Proposal

The AICPA recommends that tax benefits for higher education should be simplified and harmonized.[3] Specifically, we recommend the following changes for the existing 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. The credit should be on a "per student" rather than a "per taxpayer" basis, offering a potentially larger tax benefit per family.
   b. The credit should be 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 strongly suggest increasing the limit to six years.[4]
   c. The credit should be 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, amounts claimed over time could be tracked 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. The phase-out limitations should be consistent with any other education-related incentive.
   f. The credit should be claimed on the parent's return as long as the child is a qualifying dependent of the parent.

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

[4] 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 percent 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.

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.

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. Education benefits will be further harmonized 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. Since no more section 135 bonds would be issued, 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 AGI limitations. The concern for excessively high marginal rates resulting from coordinating phase-out provisions should be alleviated by substituting one credit for the several benefits that exist today. In addition, any remaining concerns could be addressed 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 Government Accountability Office (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 would be 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 reported[5] 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

[5] The GAO Report to the Chairman, Committee on Finance, U.S. Senate on "Higher Education: A Small Percentage of Families Save in 529 Plans."

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.

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 Internal Revenue Service (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 adjusted gross income (AGI) level of the parents (or possibly the student). Further, in a given year, a parent may be entitled to different credits for different children, while in subsequent years credits may be available for one child but not another. Both types of credits are dependent on the income levels of the parents or the child attempting to claim them. Further complicating the statutory scheme, the Code precludes use of the Lifetime or Hope (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 there are so many individual tests that must be satisfied for each benefit, taxpayers may inadvertently lose the benefits of a particular incentive because they either do not understand the provision or because they pay tuition or other qualifying expenses during the wrong tax year.

In addition to the complexity described above, there is evidence that erroneous application of education credits contributes to the "Tax Gap." A report issued by the Treasury Inspector General for Tax Administration (TIGTA) in 2011 states that education credits of approximately $3.2 billion ($1.6 billion in refundable credits and $1.6 billion in nonrefundable credits) appear to be erroneous.[6] Over four years, erroneous education credits could potentially reach $12.8 billion.[7]

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

[6] Treasury Inspector General for Tax Administration Report 2011-41-083, Billions of Dollars in Education Credits Appear to Be Erroneous, dated September 16, 2011.
[7] *Id.*

Congress to consider all of these programs together to determine if the desired goals are being met in an effective and efficient manner. Consideration should be given to where assistance can best be 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 return is filed). Consideration should also be given to identifying the targeted income group to whom the federal government should be providing financial assistance for higher education expenses. When assessing whether this goal is met, aid distributed through scholarships, grants or tax provisions should be considered. 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 needs to be made 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

Education-related tax provisions should be simplified as suggested above so that taxpayers 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."

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; does not have to be 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: $60,000 - $75,000 MAGI MFJ: $125,000 - $155,000 MAGI MFS: No deduction

Code §	Provision	Summary	Qualified Education Expenses Definition	AGI Phase-Out
222	Qualified tuition and fees deduction (expires 12/31/13)	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 must be paid to the institution as a condition of enrollment	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 MFJ: If AGI is not more than $130,000, may deduct $4,000; if between $130,000 and $160,000, may deduct $2,000 MFS: No deduction

Education Incentives – Credits				
Code §	Provision	Summary	Qualified Education Expenses Definition	AGI Phase-Out
25A	American Opportunity Tax Credit (for tax years 2009 through 2017) Hope Credit after 2017	Credit of up to $2,500 per student: 100% of first $2,000; 25% of next $2,000 Must be enrolled at least half-time 40% of modified credit is refundable (but not for child subject to section 1(g) "Kiddie Tax") If parent pays the expenses, must be able to claim exemption for student on tax return No felony drug conviction Regulations explain who gets credit in special circumstances	Tuition, fees, and course materials including books, during first four years of post-secondary education; but not room and board Courses must be associated with degree program or recognized education credential Athletic fees, insurance, activity fees are not eligible unless required as a condition of enrollment and paid directly to the institution	S: $80,000 - $90,000 MFJ: $160,000 - $180,000 MFS: No credit
25A	Lifetime Learning Credit	Credit of up to $2,000 per return: 20% on up to $10,000 A non-refundable elective credit If parent pays the expenses, must be able to claim exemption for student on tax return Regulations explain who gets credit in special circumstances	Tuition and fees including for graduate courses/continuing education; but not room and board Available for all post-secondary education–not necessarily associated with a degree	S: $52,000 - $62,000 MFJ: $104,000 - $124,000 MFS: No credit

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: $74,700 - $89,700 MFJ: $112,050 - $142,050 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 funds may be withdrawn 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 assets must be withdrawn 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

Education Incentives – Planning for College				
Code §	Provision	Summary	Qualified Education Expenses Definition	AGI Phase-Out
25A	S. 1090 (113rd Congress)	Credit of up to $2,500 per student: 100% of first $2,000; 25% of next $2,000 Must be enrolled at least half-time If parent pays the expenses, must be able to claim exemption for student on tax return No double benefit allowed. Special reporting and recordkeeping requirements specified Lifetime learning credit and section 222 above-the-line deduction for education expenses both repealed	Tuition, fees, and course materials for the first four years of post-secondary education; room and board or equipment costs not covered Costs must relate to attendance of the taxpayer, spouse or dependent at an eligible educational institution, or for course of instruction from an eligible provider to acquire or improve job skills.	Phase-out levels tied to household income and 500% of the poverty line. MFS: No credit

Education Incentives – Planning for College				
Code §	Provision	Summary	Qualified Education Expenses Definition	AGI Phase-Out
25A	AICPA Proposal	Replaces AOTC, Hope Scholarship, and Lifetime Learning credits, as well as the section 222 deduction Covers higher education expenses beyond the first six years of college including graduate and non-degree instruction at a qualified institution Credit is calculated "per student" rather than "per taxpayer" Student must meet definition of "student" under section 25A(b)(3) Existing reporting requirement of section 25A continue IRS should track higher education expenses claimed by the student's SSN or TIN If parent pays the expenses, must be able to claim exemption for student on tax return in order to qualify for the credit 100% refundable (subject to phase-out if necessary)	Tuition, books, fees, supplies and equipment.	Match those for other education provisions.

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 (56 cents per mile beginning January 1, 2014). Further, a standard mileage allowance, also generally determined annually, is allowed to taxpayers for purposes of medical and moving expense deductions (23.5 cents per mile beginning January 1, 2014). When necessary, the IRS (IRS or "Service") has the authority to adjust these rates at any time (as they 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 (Code 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 112th Congress, three bills (H.R. 387, H.R. 499, and H.R. 1212) were 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 non-business rate should be set by the IRS at a percentage of the business rate, rounded to the nearest half cent. The business rate should be adjusted annually and possibly semi-annually in certain circumstances. The starting point would be the business rate in effect at the time of enactment.

Section 170(i) should be modified to state that a standard mileage rate, as established and regularly adjusted by the IRS, may be used. The current language regarding 14 cents per mile should be removed.

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 would be simplified.

Conclusion/Recommendation

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

Proposal: Allow certain attorney fees and court costs as deductions for AGI

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. 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 (PL 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 US Code Title 31; and
- Claim under § 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 (PL 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.

Description of Proposal

Section 62 should be modified 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:[8]

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[8] Tax Reform Act of 1986 (PL 99-514; 10/22/86), House explanation.

> 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 Internal Revenue Service. 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 be permitted 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 Internal Revenue Service 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 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 did so 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 be broadened to include all attorney fees and court costs that relate to taxable awards.

Conclusion/Recommendation

Section 62(a)(20) and (21) should be replaced 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.

Proposal: Clarify and simplify reporting of cancellation of debt income

Present Law

Under section 6050P, certain lenders are required to issue an information return to a debtor by January 31 of the following year if there has been a discharge of indebtedness of $600 or more. The information return must show the name, address and tax identification number of the debtor, the discharge date and amount, and other information required by IRS.

Treasury Reg. § 1.6050P-1(a)(1) provides that "a discharge of indebtedness is deemed to have occurred, except as provided in paragraph (b)(3) of this section, if and only if there has occurred an identifiable event described in paragraph (b)(2) of this section, whether or not an actual discharge of indebtedness has occurred on or before the date on which the identifiable event has occurred."[9]

Per Treas. Reg. § 1.6050P-1(b)(2), an "identifiable event" is any of the following:

(A) A discharge of indebtedness under Title 11 of the United States Code (bankruptcy);
(B) A cancellation or extinguishment of an indebtedness that renders a debt unenforceable in a receivership, foreclosure, or similar proceeding in a federal or State court, as described in IRC section 368(a)(3)(A)(ii) (other than a discharge described in paragraph (b)(2)(i)(A) of this section);
(C) A cancellation or extinguishment of an indebtedness upon the expiration of the statute of limitations for collection of an indebtedness, subject to the limitations described in paragraph (b)(2)(ii) of this section, or upon the expiration of a statutory period for filing a claim or commencing a deficiency judgment proceeding;
(D) A cancellation or extinguishment of an indebtedness pursuant to an election of foreclosure remedies by a creditor that statutorily extinguishes or bars the creditor's right to pursue collection of the indebtedness;
(E) A cancellation or extinguishment of an indebtedness that renders a debt unenforceable pursuant to a probate or similar proceeding;
(F) A discharge of indebtedness pursuant to an agreement between an applicable entity and a debtor to discharge indebtedness at less than full consideration;
(G) A discharge of indebtedness pursuant to a decision by the creditor, or the application of a defined policy of the creditor, to discontinue collection activity and discharge debt; or

[9] As noted in IRS Information Letter 2008-207, "The Internal Revenue Service does not view a Form 1099-C as an admission by the creditor that it has discharged the debt and can no longer pursue collection. Section 1.6050P- 1(a) of the regulations provides that, solely for purposes of reporting cancellation of indebtedness, a discharge of indebtedness is deemed to occur when an identifiable event occurs whether or not an actual discharge of indebtedness has occurred on or before the date of the identifiable event."

(H) In the case of an entity described in section 6050P(c)(2)(A) through (C), the expiration of the non-payment testing period, as described in Treas. Reg. § 1.6050P-1(b)(2)(iv).

Treasury Reg. § 1.6050P-1(b)(3) provides that if there is a discharge before the date of an "identifiable event," the lender may, at its discretion, issue an information return. Thus, with the eight events listed above (A - H), there are nine events that require issuance of Form 1099-C.

Under Treas. Reg. § 1.6050P-1(b)(2)(iv), the expiration of the non-payment testing period is defined as follows:

> There is a rebuttable presumption that an identifiable event under paragraph (b)(2)(i)(H) of this section has occurred during a calendar year if a creditor has not received a payment on an indebtedness at any time during a testing period (as defined in this paragraph (b)(2)(iv)) ending at the close of the year. The testing period is a 36-month period increased by the number of calendar months during all or part of which the creditor was precluded from engaging in collection activity by a stay in bankruptcy or similar bar under state or local law. The presumption that an identifiable event has occurred may be rebutted by the creditor if the creditor (or a third-party collection agency on behalf of the creditor) has engaged in significant, bona fide collection activity at any time during the 12-month period ending at the close of the calendar year, or if facts and circumstances existing as of January 31 of the calendar year following expiration of the 36-month period indicate that the indebtedness has not been discharged. For purposes of this paragraph (b)(2)(iv)—
>
> (A) Significant, bona fide collection activity does not include merely nominal or ministerial collection action, such as an automated mailing;
> (B) Facts and circumstances indicating that an indebtedness has not been discharged include the existence of a lien relating to the indebtedness against the debtor (to the extent of the value of the security), or the sale or packaging for sale of the indebtedness by the creditor; and
> (C) In no event will an identifiable event described in paragraph (b)(2)(i)(H) of this section occur prior to December 31, 1997.[10]

In 2008, the section 6050P regulations were modified. One change included limiting the application of the 36-month non-payment testing period to an applicable financial entity as described in section 6050P(c)(2)(A) to (C). The preamble to the regulations which made this change (TD 9430; 11/10/08) noted that the 36-month non-payment identifiable event can "trigger a reporting requirement even when the entity has not legally or

[10] These events are also required to be noted on Form 1099-C in box 6 using a provided code. *See* http://www.irs.gov/pub/irs-pdf/f1099c.pdf.

practically discharged the debt." The limitation of this event to financial institution lenders was made "in order to avoid premature information reporting of cancellation of indebtedness income." Further, the IRS noted that "doing so will reduce the information reporting burden on entities that were not originally within the scope of the 36-month rule and will protect debtors from receiving information returns that prematurely report cancellation of indebtedness income from such entities."

Description of Proposal

The AICPA proposes changes to section 6050P and the filing requirements for Form 1099-C, Cancellation of Debt. The legislation should be modified to require lenders to issue Form1099-C only upon the legal discharge of a debt, which will occur at the earlier of the expiration of the applicable statute of limitations or when all collection efforts by the lender or surrogate collection organizations have ceased.

Analysis

The Tax Court in *Kleber* noted that "Issuance of a Form 1099-C is an identifiable event, but it is not dispositive of an intent to cancel indebtedness."[11] When a Form 1099-C is issued for a year that does not correspond to the true cancellation of debt, confusion results for the borrower, and there is risk to the government that the income will never be reported. The confusion for the borrower results from not knowing when to report the income or the amount to report. A borrower may not know if a short period of no collection activity is permanent or temporary. Thus, the borrower is unlikely to guess that the debt has been cancelled and report the income (without receipt of a Form 1099-C). In addition, a borrower may receive a Form 1099-C in a year later than that when the debt was cancelled. In these situations, it is possible that the proper year for reporting is "closed" (under the statute of limitations) when the Form 1099-C is received.
For example, in *Kleber, et ux.,* TC Memo 2011-233, the taxpayer received Form 1099-C in 2006 for debt the court determined was discharged in 2002. In this case, outstanding lease payments were converted to a debt in 1999. The debt was referred to collection in 2002, and the lender ultimately determined it was uncollectible in 2004. The lender wrote off the debt in 2005 and issued Form 1099-C in 2006. Under these circumstances, the court held that the 36-month testing period started in 1999 and thus ended in 2002. The court also found that there was no evidence of "any substantive collection activities" after 1999. Thus, cancellation of debt income that was required to be reported in 2002 was likely not reported at all. Similarly, in *Stewart*, TC Summary Opinion 2012-46, a credit card company discharged the taxpayer's debt in 1996 but sold the debt to a collection company. The debt was later sold to another company which issued a Form 1099-C in 2008. The court found that the 36-month testing period ended in 1999. Thus, the Form 1099-C was issued several years too late with the result that the cancellation of debt income could not have been properly reported as the year when the debt actually was eligible for being included in income had long past.

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[11] *Kleber*, *et ux*. TC Memo 2011-233, referring to *Owens*, TC Memo 2002-253.

Conclusion/Recommendation

The 36-month testing period should be removed from the list of "identifiable events" in Treas. Reg. § 1.6050P-1(b)(2)(i). Further, to ensure that cancellation of debt income is properly reported by lenders and borrowers, the section 6050P regulations should be amended to require a lender to issue a Form 1099-C only for the year that a debt is legally discharged. We also encourage the IRS to verify with other government agencies involved with credit card and other debts to ensure that there is consistency between the Form 1099-C rules and those for legal discharge of debt. A borrower should not receive a Form 1099-C if the lender or a third party purchaser of the debt intends to continue collection efforts. In the *Stewart* case (noted above), a second company purchased the credit card debt after the statute of limitations had expired.[12] We encourage the IRS to work with relevant federal agencies to prohibit such activities. Such collaboration will help to reduce confusion and error regarding the issuance of Form 1099-C and proper reporting of cancellation of debt income. We believe that such changes will decrease the burden on both creditors and taxpayers.

[12] Per the court in *Stewart,* "Although aware that a state statute of limitations period for commencing collection activity in regard to the debt had expired on February 15, 2001, a third party began making automated attempts to collect payments from petitioner."

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 the cost of 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 be consistent amongst 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

It is recommended that deductions allowed in determining income subject to OASDI and HI taxes be consistent amongst taxpayers regardless of whether they are employees or self-employed individuals.

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 Internal Revenue Code 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 $10,000 or more (for 2013), unearned income other that 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 be taxed using the income tax rates for estates and trusts. Income from capital gains should be taxed at the capital gains rates with one change; we believe the 0% rate for capital gains should not apply to children's unearned income.

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

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 37-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 may be 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 be allocated between the first $2,000 (in 2013) of unearned income and the portion of the child's unearned income in excess of $2,000, 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 may not be readily known.

- 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 end result 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 would be 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 which were utilized by high income individuals. The Kiddie Tax was one such provision which 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

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

Proposal: Simplify the tax treatment of Roth IRA Contributions

Present Law

The term, "Roth Individual Retirement Account," (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 makes a $5,000 nondeductible IRA contribution that grows to be worth $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 making contributions 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 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 will be no conversion income to recognize. However, this effect would be mitigated by the fact that under current law, the amount of income recognized upon the conversion would in many cases be 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 would be 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

The tax treatment of Roth IRA contributions needs simplification to be made similar to the treatment of nondeductible contributions to a regular IRA account. 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.

Proposal: Remove reference to section 332 from section 367(a)(i)

Present Law

Section 367(a)(1) of the Internal Revenue Code states, "if, in connection with any exchange described in section 332, 351, 354, 356, or 361, a United States person transfers property to a foreign corporation, such foreign corporation shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered to be a corporation."

Description of Proposal

We recommend that Congress remove the reference to section 332 from section 367(a)(1), since it is no longer relevant.

Analysis

The reference to section 332 as currently included in the language of section 367(a)(1) is no longer needed, since the effects of section 332 liquidations as they relate to foreign corporations are addressed in section 367(e)(2).

Conclusion/Recommendation

Since the reference to section 332 in section 367(a)(1) is no longer relevant, it should be removed to simplify the Internal Revenue Code.

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 Internal Revenue Code. 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 shall be imposed if it is shown that there was reasonable because 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 shall be 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.

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.

Conclusion/Recommendation

Section 6707A should be amended 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, section 6664 should be amended 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.

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 Internal Revenue Code, 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 may be 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 could be construed as a barrier to settling tax debts for many taxpayers).

Furthermore, one of the stated objectives of an offer in compromise is to "[p]provide the taxpayer a fresh start toward future voluntary compliance with all filing and payment requirements."[13] Requiring the 20% payment to be submitted 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

[13] Internal Revenue Manuel, Part 5, Chapter 8, Section 1, 5.8.1.1.4, Objectives, dated September 23, 2008.

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, particularly during the current period of economic downturn.

Proposal: Amend the section 6051 reporting requirement to permit truncation of employee SSNs and increase penalties on tax return preparers in certain cases of a fraudulent understatement of a taxpayer's liability

Present Law

Under section 301.6109-4 of the proposed regulations, an IRS TTIN is defined as an "individual's SSN, IRS individual taxpayer identification number (ITIN), or IRS adoption taxpayer identification number (ATIN) that is truncated by replacing the first five digits of the nine-digit number with X's or asterisks." However, the preamble of REG-144873-09 expressly states that the IRS's ability to extend the truncation program to a greater number of payee statements by regulation is limited by statute. Thus, the proposed regulations do not extend truncation of taxpayer identification numbers beyond certain types of information returns already permitted under the pilot program.

Description of Proposal

Make permanent REG-148873-09, IRS Truncated Taxpayer Identification Numbers (TTINs) or a similar truncation program to permit the use of truncated social security numbers (SSN) on all types of tax forms and returns provided to a taxpayer, employee or other recipient and extend the scope of IRS truncation program to permit filers to furnish payee statements electronically.

Analysis

With the dramatic upturn in identity theft cases, there are a number of actions CPAs and other tax professionals can take up-front to inform clients regarding the threat posed by tax identity theft. For example, as a trusted advisor, tax return preparers can inform their clients that if they receive an e-mail or other communication that looks unusual that: (1) the IRS *never* uses e-mail or social media to contact taxpayers directly; and (2) the IRS provides numerous ways for taxpayers to identify possible identity theft and telephone numbers to report it. However, some actions that tax professionals believe would reduce the threat of identity theft would require legislative or regulatory changes.

The AICPA applauds the IRS's issuance of REG-148873-09, IRS Truncated Taxpayer Identification Numbers (TTINs). The proposed regulations implement the pilot program announced in Notices 2009-93 and 2011-38, which authorize filers of certain information returns to voluntarily truncate an individual payee's nine digit identifying number on specified paper payee statements furnished for calendar years 2009-2012.

We believe the proposed regulations are a positive step towards protecting the privacy and security of personal information. Over the last few years, we urged the IRS to make the taxpayer identification number truncation initiative permanent, as opposed to remaining a pilot program.[14] We appreciate that the proposed regulations: (1) make the

[14] AICPA, Comment Letter: Reg-148873-09, IRS Truncated Taxpayer Identification Numbers, dated February 20, 2013.

truncation program permanent; and (2) extend the scope of the IRS truncation program to permit filers to furnish payee statements electronically. However, we support an extension of the truncation program to permit the use of truncated social security numbers (SSN) on all types of tax forms and returns provided to a taxpayer, employee or other recipient. Unfortunately, as described in more detail below, there may be current statutory or other limits placed upon the IRS's ability to expand the truncation initiative.

We understand that limitations exist currently with regards to truncation on a Form W-2, *Wage and Tax Statement*. Under IRC section 6051(a)(2), employers are required to provide employees a written statement (i.e., Form W-2) with certain information including the employee's SSN.

In the General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals, a revision to section 6051 is proposed to require employers to include an "identifying number" for each employee, rather than an employee's SSN, on a Form W-2. We generally support this concept, but strongly believe there is a need for more extensive legislation to extend the use of truncated SSNs to all types of tax forms and returns provided to a taxpayer, employee or other recipient. For example, tax preparers are required to obtain a Form 8879, *IRS E-file Signature Authorization*, from their clients in order to e-file their tax returns. This form is not submitted to the IRS, but merely retained in the tax preparer's records. However, the tax preparer must list a client's full social security number on the form and send the document to the client for signature. Then, the client will sign the form and return it to their tax preparer often through the U.S. mail or by scanning the document and submitting it via e-mail. Either process makes the client's SSN susceptible to theft. Because the form is not submitted to the IRS, or any agency for that matter, we do not believe a SSN should be required on the form.

Clearly, the need for this expansive legislation is supported by the growing concern over identity theft in general and the growth in the number of such cases being handled by the IRS. This important change to the current law will not solve all of our country's growing problems with identity theft; however, it will likely help tax practitioners from inadvertently providing criminals access to clients' identification numbers merely by sending their clients completed IRS forms.

Finally, the AICPA supports civil penalties for tax-related identity theft, including penalties on fraudulent tax preparers.[15] In the 112th Congress, Representative Erik Paulsen introduced H.R. 5630, Fighting Tax Fraud Act of 2012, which would have amended section 6694 subsections (c), (d), (e) and (f) to provide an increased penalty in certain cases of a fraudulent understatement of a taxpayer's liability by a tax return preparer. This bill was in response to the National Taxpayer Advocate's 2011 Annual Report to Congress (pages 558-561), which noted a small number of tax return preparers defraud taxpayers and the IRS by altering the taxpayers' returns without their knowledge. In many cases, preparers claimed increased refunds – that the taxpayers were not entitled

[15] AICPA, Comment Letter: HR 5630, Fighting Tax Fraud Act of 2012, dated July 16, 2012.

to receive – in order to pocket the extra money themselves. The AICPA fully supports efforts, such as H.R. 5630, to deter such outrageously unethical behavior. More recently, the Administration has proposed a similar provision which would assess a civil penalty in the amount of $5,000 on an individual who files a fraudulent tax return in tax identity theft cases.[16]

Conclusion/Recommendation

We urge Congress to consider a legislative proposal to change the section 6051 reporting requirement to permit truncation of employee SSNs on all copies other than the copy filed with the U.S. Social Security Administration (SSA). Also to extend the scope of the IRS truncation program to permit filers to furnish payee statements electronically. And increase penalties on tax return preparers in certain cases of a fraudulent understatement of a taxpayer's liability.

[16] Department of the Treasury, General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals, page 212, 2014

Proposal: Allow transfer of partnership suspended losses to one another when spousal transfers under section 1041(a) take place

Present Law

Section 1366(d)(2)(B) of the Internal Revenue Code permits an S corporation shareholder to transfer 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

Husbands and wives engaged together in the operation of a partnership may transfer partnership units to each other under section 1041(a) or incident to a divorce. When such a transfer occurs, suspended losses of the transferor spouse will now be treated as incurred by the partnership in the succeeding taxable year with respect to the transferee spouse.

Analysis

Spouses and former spouses who transfer partnership interests between themselves find that they are in the same position in which husband and wife 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, forever unusable.

Conclusion/Recommendation

Suspended losses should be made available to the spouse who actually owns the partnership interest, regardless of who was entitled to the suspended loss prior to the transfer of ownership interest. This recommendation furthers the tax policy goals of simplicity and equity.

Proposal: Clarify that husband and wife partnerships that are recognized under state law are eligible to elect Qualified Joint Venture (QJV) 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 husband and wife partnership by treating it as two sole proprietorships. The only statutory requirements are that (1) the husband and wife both 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 not to be treated as a partnership.

On its website, the IRS has published a definition of a Qualified Joint Venture 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 husband and wife joint venture election under section 761(f) should be clarified to cover state law general and limited partnerships and limited liability companies. To accomplish this result, a modification to section 761(f)(2) could be made 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, husband-wife 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 husband and wife business operations under state law jurisdiction and would thus disqualify them from electing QJV status.

Conclusion/Recommendations

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

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 so that 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

Section 1374(b)(2) would be modified to add charitable contribution carryforwards from a C year to the items that can be deducted against the net recognized built-in gain of an S corporation.

Section 1374(b)(3)(B) would be modified 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 to be carried forward from a C year to an S year.

Analysis

It would seem equitable that all deduction and credit carryforwards arising in a C year be 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.

Proposal: Add a new 120-day Post-Termination Transition Period (PTTP) beginning on the date that a taxpayer files an amended Form 1120S

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 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 AAA and basis through the end of the PTTP as though the S corporation election were still valid.

Description of Proposal

A fourth PTTP would be 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 would be 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 would be 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, the heading for section 1377(b)(3) would be modified 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, should be 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 be 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.

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 PTTP. Accordingly, a 120-day PTTP should begin upon the filing of an amended Form 1120S.

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

Present Law

Section 1361(b)(1)(C) of the Internal Revenue Code provides that a nonresident alien is not eligible to be a shareholder of an S corporation. Reg. section 1.1361-1(m)(1)(ii)(D) and -1(m)(5)(iii) require that a potential current beneficiary (PCB) of an electing small business trust (ESBT) must be an eligible S corporation shareholder. 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 be shareholders of an S corporation and require the S corporation to withhold and pay a withholding tax for its nonresident alien shareholders. Also permit nonresident aliens to become PCBs of an ESBT.

Analysis

Nonresident aliens should be allowed as shareholders and as potential current beneficiaries 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 can be obtained 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 be direct owners of S corporations, they would be subject to withholding just as nonresident alien partners are, thus protecting against revenue loss at the individual level. Such direct ownership benefits should not be available only to the sophisticated taxpayer. The smaller, struggling S corporations, particularly those in border states, should also be free to raise capital from these individuals.

With regard to nonresident aliens as PCBs of an ESBT, 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.

Conclusion/Recommendation

Section 1361(b) should be amended to allow a nonresident alien to be an eligible shareholder of an S corporation. In conformity with that change, section 1446 should be amended to require the S corporation to withhold and pay a withholding tax on effectively connected income allocable to the corporation's nonresident alien shareholders. A nonresident alien should also be a permitted potential current beneficiary

of an electing small business trust.

Proposals: Repeal section 1362(d)(3), which terminates an S election due to passive investment income that exceeds a certain threshold, or increase the passive investment income (PII) 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 tax under section 1375 is imposed for three consecutive years.

Description of Proposals

Eliminating the termination event

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

Raising the PII 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) would be modified 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. If the tax is intended to encourage distributions of C corporate earnings and profits, then why not tax the earnings and profits under a concept similar to the accumulated earnings tax of sections 531-537? We recommend that Congress draft a similar regime that is appropriate under subchapter S. If the current regime is to be 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 PII.

While encouraging distributions of accumulated earnings and profits appears to be 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 should be repealed or made to impact fewer taxpayers. These measures would be a positive first step.

Conclusion/Recommendation

Section 1362(d)(3) should be repealed to eliminate a significant uncertainty for S corporation operations, thereby preventing an involuntary termination of S status caused by excess passive investment income. If repealing section 1362(d)(3) is not feasible, Congress should 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 either measure 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.

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-percent shareholder of the S corporation shall be treated as a partner of such partnership.

Section 1372(b) provides that the term “2-percent 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 two percent of the outstanding stock of such corporation or stock possessing more than two percent 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),[17] 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.[18] 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.[19] 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 be 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.[20] 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-percent shareholders, contributions to health savings accounts, and certain fringe benefits

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

[18] 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.

[19] Tax Reform Act of 1986, Pub. L. No. 99-514, § 1161.

[20] Pub. L. No. 97-354, § 3.

described in section 132. No published guidance identifies what the Service considers to be included 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-percent 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. 91-26[21] provides guidance to both S corporations and partnerships on the treatment of premium payments made on behalf of 2-percent shareholders and partners, respectively, which perform services for the entity. In the case of 2-percent 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 be included 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*).[22]

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,[23] medical reimbursement (accident and health) plans,[24] and meals and lodging provided for the convenience of the employer.[25] The Service has also concluded that section 1372(a) prevents a 2-percent shareholder from excluding contributions by an S corporation to a health savings account under section 106(d).[26]

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-percent shareholder may not qualify for the exclusion of qualified transportation fringe

[21] 1991-1 C.B. 184.
[22] 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.
[23] Section 79(a).
[24] Section 105.
[25] Section 119.
[26] Notice 2005-8, 2005-4 I.R.B. 368.

benefits,[27] these and other benefits may be excludible as working condition fringe benefits[28] or as de minimis fringe benefits.[29] Moreover, provisions relating to qualified plans have minimized the differences between the treatment of employees and the treatment of self-employed individuals.[30] Accordingly, it is generally unnecessary to determine whether a 2-percent shareholder would be 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.[31]

Conclusion/Recommendation

Developments in other provisions of the Code since the enactment of section 1372 in 1982 have caused this provision to be 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.

[27] 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-percent shareholder and a common law employee of an S corporation is not eligible for the exclusion of a qualified transportation fringe.

[28] 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 would be 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-percent shareholders.

[29] 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-percent shareholders.

[30] 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).

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

Proposal: Allow administrative relief for certain late QTIP and QRT 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 Internal Revenue Service 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.

QTIP election

Transfers of property interests that meet the requirements to be a 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 must be made by the decedent's executor on the Federal estate tax return. For an inter vivos QTIP transfer, the QTIP election must be made on the Federal gift tax return for the calendar year in which the interest is transferred. A QTIP election, once made, is irrevocable.

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 shall be made on or before the date prescribed by section 6075(b) for filing a gift tax return with respect to the transfer. Because 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.

QRT election

Effective with respect to estates of decedents who die after August 5, 1997, an election may be 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 shall be made not later than the time

prescribed for filing the return of tax imposed 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 believe that the IRS would take the position that it does not have the authority to grant relief for late elections. Decedent's estates that do not make the election timely have no 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 certain late or defective lifetime (i.e., inter vivos) QTIP elections and for late elections by certain QRTs to treat such trust as part of a decedent's estate. Congress could accomplish this revising the IRC to provide that the due dates for (1) the inter vivos QTIP election, and (2) for the QRT election to be part of the estate are treated as if not prescribed by statute. These proposals would make the same sort of statutory change in 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 tax (GSTT) (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 proposed prospective effective dates are similar to the prospective effective date provision applicable to the generation skipping transfer (GST) exemption relief in EGTRRA.

Analysis

The problems for late 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) shall be treated as if not expressly prescribed by statute." That language opened up the possibility of section 9100 relief for failed 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 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 for taxpayers not to be penalized for the errors of their lawyers or accountants in

failing to make a QTIP election on the 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 has been introduced previously and was even 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.

Conclusion/Recommendation

We urge the enactment of legislative provisions stating that the due dates for the inter vivos QTIP election and for the QRT election to be part of the estate are treated as if not prescribed by statute, thus allowing the IRS to grant administrative relief for certain late QTIP and QRT elections.[32]

[32] 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 July 30, 2013, November 18, 2011, and November 16, 2010.

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 very confusing and unnecessarily complex to taxpayers and tax practitioners. In some instances, estimated tax payments may be 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 be allocated to the beneficiary, but must be reported 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 IRC 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, U.S. Income Tax Return for Estates and Trusts, and cannot be allocated to beneficiaries on Schedule K-1 (Form 1041), Beneficiary's Share of Income, Deductions, Credits, etc.

For backup withholding, the tax credit under IRC section 31(c) for payments subject to IRC 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 IRC 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 IRC section 31(a) for amounts withheld as tax under chapter 24 (regular withholding) may not be allocated by the trust or estate to a beneficiary. See Chief Counsel Advice 200644018 (Dec. 25, 2005), in which the Internal Revenue Service 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 can be used 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 be passed through to beneficiaries on either Schedule K-1 or Form 1041-T.

Description of Proposal

We propose that the fiduciary of a trust or estate be permitted 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 be 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 be allocated to the beneficiary on the Schedule K-1, which would be the same way that backup and regular withholding would be reported to the beneficiaries. We believe that having all such taxes attributed to the beneficiaries reported on the Schedule K-1 would be much less confusing and reduce complexity to the fiduciaries.

With respect to regular withholding, the title of section 643(d) could be changed to "Coordination with withholding" and section 643(d)(1) could be amended to include a reference to section 31(a) so that it would 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 be added to the general rule of section 643(g)(1) with the result that section 643(g)(3) would be repealed and that amendments be made to 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

(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 be treated 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 would be 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 great 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 Forms 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 must be refunded to the fiduciary. Regular withholding payments must always be refunded 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 so 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 can be applied only to a later year's tax or refunded to the fiduciary.

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.

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 trusts.[33]

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-percent of the taxpayer's adjusted gross income. This is known as the "2-percent 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 percent of AGI. Congress's purpose was to reduce recordkeeping for numerous small expenditures and eliminate deductions for many, essentially personal expenditures claimed in error.[34] Because estates and nongrantor trusts[35] are taxed in the same manner as individuals, Congress provided an exception to the 2-percent 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. The proposed regulations require trustees' fees and other single commission fees to be unbundled and separated between costs that are commonly incurred by individuals and those that are not. The IRS and Treasury have been unsuccessful in drafting regulations that are clear and administrable, without subjecting nearly all administrative costs to the 2-percent floor. Doing so eliminates the exemption under section 67(e). Expressing similar frustration over section 67(e), Chief Justice Roberts commented:

[33] The AICPA submitted a similar proposal on September 8, 2008 to the 110th Congress.
[34] 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.
[35] 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.

> 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,[36] make it easier to administer, and provide a consistent definition of AGI for estates and nongrantor trusts throughout the Internal Revenue Code. We do not think the proposal would encourage individuals to create nongrantor trusts to merely avoid the 2-percent 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 his/her fees into the portion an individual would have incurred (subject to the 2-percent floor) and the portion that is fully deductible. The proposed regulations indicate "any reasonable method" is to be 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 predicting whether

[36] 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.

individuals would commonly incur a particular expense that the trust or estate incurred, it will result in uncertainty, inconsistent treatment from trust to 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 Internal Revenue Code 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 will be 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 Internal Revenue Code 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.[37] 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 Internal Revenue Code 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 be incurred by a hypothetical individual in order to determine the costs not subject to the 2-percent floor. In order to avoid the cost, complexity, and recordkeeping required to determine which costs would not commonly be incurred by a hypothetical individual, many small trusts and estates might simply subject all their costs to the 2-percent floor, forfeiting their

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

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 fiduciaries will likely be 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 would be 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 Internal Revenue Code'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 be loyal and impartial, 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 Internal Revenue Code. The Internal Revenue Code 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 Internal Revenue Code should be simplified to provide a single definition of AGI for estates and trusts, which should be 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.

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

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 be distributed 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

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 regulations[38]; a charitable trust described in section 4947(a)(1)[39]; and for tax years beginning after 2006, a split-interest trust described in section 4947(a)(2).[40] 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 Internal Revenue Service 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 will be deemed to be 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 be exempt from the information reporting requirements of section 6034(b) and therefore not be required to file Form 1041-A. Such trusts are not accumulating any income that may be distributed to 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.

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[38] See section 6034(b)(2)(A).

[39] See section 6034(b)(2)(B).

[40] See section 6034(a).

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 Internal Revenue Service. 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 an exception should be created 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) be 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 Internal Revenue Code 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). We look forward to working with you on this issue to achieve simplicity, effectiveness and efficiency as Congress considers this and other simplification legislation.

Proposal: Allow a single six-month automatic extension for entire Form 990 series and other information, excise and income tax returns of exempt organizations

Present Law

Currently, most of the forms in the Form 990 (Return of Organization Exempt From Income Tax) series (e.g., Form 990, Form 990-PF, etc.) are only permitted a three-month automatic extension on the Form 8868 (Application for Extension of Time to File an Exempt Organization Return). Exempt organizations that need additional time must then submit another request on Form 8868 and demonstrate reasonable cause in order to receive approval by the IRS for up to another three-month extension. However, while Form 990-T filings by a corporation are currently permitted an automatic six-month extension, other entities that file the extension for a Form 990-T are limited to two separate three-month extensions.

Description of Proposal

We recommend that tax-exempt organizations also be allowed a single, automatic six-month extension of time to file all information, excise and income tax returns on Forms 990 (complete series), 4720 (Return of Certain Excise Taxes Under Chapters 41 and 42 of the Internal Revenue Code), 5227 (Split-Interest Trust Information Return), 6069 (Return of Excise Tax on Excess Contributions to Black Lung Benefit Trust Under Section 4953 and Computation of Section 192 Deduction) and 8870 (Information Return for Transfers Associated With Certain Personal Benefit Contracts).

The AICPA previously submitted a comment letter recommending modification to Treas. Reg. § 1.6081-9(a) on May 21, 2010 for all of the above referenced forms. In addition, it was also referenced in the AICPA's October 8, 2010 comment letter to Congress on due dates in footnote 10.

Analysis

Complying with the tax law should be straightforward so that taxpayers understand the rules and can comply with them correctly and in a cost-efficient manner. The principles of tax simplification would be advanced by the creation of one automatic extension as opposed to two extensions (one of which requires a detailed disclosure of the reason(s) why additional time is requested to file) that are used to achieve the same result. According to the National Taxpayer Advocate's 2012 Annual Report to Congress, "individuals and businesses spend about 6.1 billion hours a year complying with the filing requirements of the Internal Revenue Code."[41] It also noted "the costs of complying with the individual and corporate income tax requirements for 2010 amounted to $168 billion – or a staggering 15% of aggregate income tax receipts."[42]

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[41] National Taxpayer Advocate's 2012 Annual Report to Congress, Volume One, MSP #1 "The Complexity of the Tax Code."
[42] *Id.*

Good tax policy also suggests that similarly situated taxpayers should all receive fair and equitable treatment. Current law allows individuals and corporations an automatic six-month extension of time to file their tax returns. See Treas. Reg. §§ 1.6081-3(a) and 1.6081-4(a). Tax-exempt corporations, many of which are organized exclusively for religious, charitable, scientific, testing for public safety, literary or educational purposes, should not be subjected to a heightened administrative burden compared to for-profit corporations.

The allowance of an automatic six-month extension would also promote efficiency and effectiveness of tax administration. A single automatic extension would save processing time at the IRS and eliminate the need for IRS approval of a second extension request. According to the Treasury Inspector General for Tax Administration Semiannual Report to Congress for the period ending September 30, 2009, "The IRS has experienced workforce challenges over the past few years, including recruiting, training and retaining employees, as well as an increasing number of employees who are eligible to retire." It has been our experience as practitioners that second extensions are rarely denied on returns for exempt organizations and, therefore, the underlying concern for requiring a second extension request apparently is not warranted. The small benefit derived from the second extension process, if any, does not justify the burden to the IRS and taxpayers. As such, any reduced administrative burden on the IRS should be heavily considered, since it would promote a more efficient use of its already-limited resources.

Furthermore, implementation of one automatic extension would result in an immediate cost savings for both the Federal government and taxpayers. The elimination of the second extension request, and the acceptance or denial of the request, would decrease the preparation and processing costs for all parties involved. While a taxpayer can electronically file a second extension, the process requires the same written authorization as the Form 990, thus making the process impracticable.

One argument that might be made in opposition to the proposed revision to the regulations is that the public desires to view completed returns for exempt organizations as soon as possible after the organizations' year-ends. However, many government and non-government organizations require a copy of an exempt organization's Form 990 as a condition of making a grant. As such, there is an incentive to not delay filing in such instances.

Organizations often have financial statement audits either because of state law requirements or as a matter of good overall financial policy. Delays in completing and filing Form 990 often arise from the practicality of dealing with board and audit committee schedules to review and/or approve the financial statements and Form 990. Also, while the automatic six-month extension is available for the Form 990-T, amounts from Form 990-T flow to page one of the Form 990, where the automatic six-month extension is not provided. Further, organizations with alternative investment portfolios are at the mercy of the release of Form K-1s by investment partnerships. The final extended due date of partnership returns is September 15. Therefore, tax-exempt investors are often waiting until September 15 to receive their Form K-1s, compute their

unrelated business taxable income and assess other tax information reporting requirements. This is a significant issue for calendar year tax-exempt organizations.

Many of the large tax-exempt organizations need additional time to complete financial statement audits and correctly report amounts reported on investment Forms K-1. We are unaware of any evidence that requiring the filing of a second extension form would encourage taxpayers to file any sooner.

Conclusion/Recommendation

We propose that tax-exempt organizations be allowed an automatic six-month extension of time to file all information, excise and income tax returns. The single extension approach would promote tax simplification, IRS efficiency, a decrease in preparation and processing costs, and a reduction in the administrative burden on taxpayers.

Proposal: Make permanent the fair market value exception under section 512(b)(13) and remove the binding contract requirement

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 of such by the controlled organization reduced its net unrelated income (or increased a net unrelated loss), determined as if the controlled entity were tax-exempt.

The Pension Protection Act of 2006 modified section 512(b)(13) to provide that such payments would be treated as unrelated business income only to the extent that they exceeded the amount of any payment that would have been paid or accrued if such payment had been determined under the fair market value principles of section 482. Additionally, section 512(b)(13)(E)(i) imposed a tax addition for valuation misstatements. This provision applied only to payments made pursuant to 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 finally sunset on December 31, 2013.

Description of Proposal

AICPA recommends that the expired provisions of section 512(b)(13) be made permanent. We also recommend that the binding contract requirement be removed.

Analysis

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

Conclusion/Recommendation

As long as fair market value rules are followed, there is no genuine and substantial reason to differentiate, for purposes of these types of transactions, between related and unrelated entities. Therefore, we urge Congress to make permanent the fair market value exception under section 512(b)(13). We also recommend the deletion of the binding contract requirement.

Proposal: Expand the exception from section 509(f)(2), which prohibits an organization from qualifying for section 509(a)(3) status if it accepted certain gifts, to be consistent with the technical change made to section 4958(c)(3)(C)

Present Law

The Pension Protection Act of 2006 (PPA) made numerous changes to the rules governing section 509(a)(3) "supporting organizations," providing for tighter, more restrictive operations by these types of charitable entities – focusing particularly on potentially abusive transactions between supporting organizations and their controllers and/or substantial contributors. Exceptions were carved out for certain transactions between supporting organizations and the organizations they support; however, the wording of these exceptions created uncertainty as to their applicability to certain types of non-charitable organizations that are afforded "supported organization" status under section 509(a)(2).

The restrictions (and exceptions) created by the PPA were these:

- A change to section 4958(c)(3) by the PPA provided in two separate subsections (sections 4958(c)(3)(A)(i)(II) and 4958(c)(3)(C)(ii)) for an exception to the general rule imposing automatic excess benefit treatment to loans paid by supporting organizations to disqualified persons and to grants, loans, compensation or other similar payments paid by supporting organizations to substantial contributors. The exception provided in each of those subsections was for "an organization described in paragraph (1), (2), or (4) of section 509(a)."

- New section 509(f)(2), as added by the PPA, prohibited an organization from qualifying for section 509(a)(3) "Type I" or "Type III" status if it accepted a gift from a person who directly or indirectly controlled the organization being supported – but provided "exception" language with regard to the "controlling person" restriction for "an organization" described in paragraph (1), (2), or (4) of section 509(a).

Description of Proposal

The AICPA recommends that Congress amend section 509(f)(2)(B)(i) to read as follows (change in italics):

> 509(f)(2)(B)(i)
> a person (other than an organization described in paragraph (1), (2), or (4) of section 509(a), *or any organization which is treated as described in such paragraph (2) by reason of the last sentence of section 509(a) and which is a supported organization (as defined in section 509(f)(3)) of the organization to which subparagraph (A) applies)* who directly or indirectly controls, either alone or together with persons described in clauses (ii) and (iii), the governing body of such supported organization . . .

Analysis

Unfortunately, the PPA changes outlined above could be arguably interpreted as not applicable to section 501(c)(4), (5), and (6) organizations that may qualify as "supported" organizations by virtue of the flush language of section 509(a). This language provides that non-charitable organizations may be supported by section 509(a)(3) organizations if their financial profile matches that of a charitable section 509(a)(2) entity. Accordingly, post-PPA, there was concern that greater restrictions under section 4958(c)(3) and 509(f)(2) could be imposed on non-charitable supported organizations, than on charitable supported entities.

The Tax Technical Corrections Act of 2007 (TCCA), as signed by President Bush on December 29, 2007, rectified one of these concerns, by making a technical change to section 4958(c)(3)(C). TCCA struck this language:

> Section 4958(c)(3)(C)(ii) EXCEPTION.—Such term shall not include any organization described in paragraph (1), (2), or (4) of section 509(a).

And substituted the following language:

> Section 4958(c)(3)(C)(ii) EXCEPTION—Such term shall not include—
>
> > (I) any organization described in paragraph (1), (2), or (4) of section 509(a), and
> >
> > (II) any organization which is treated as described in such paragraph (2) by reason of the last sentence of section 509(a) and which is a supported organization (as defined in section 509(f)(3)) of the organization to which subparagraph (A) applies.

The amendment made by TCCA 2007 expanded the exception to the term "substantial contributor" to encompass transactions between a supported section 501(c)(4), (5) or (6) organization and its section 509(a)(3) supporting organization. This had the effect of exempting supported non-charitable organizations from the excess benefit transaction rule of section 4958(c).

Conclusion/Recommendation

An amendment is needed for section 509(f)(2). We suggest that such an amendment would reduce confusion with regard to transactions between supporting organizations and their non-charitable supported organizations.

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 be used to 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-percent" shareholder as opposed to a "5-percent" 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 hire 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 to be 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 change, or result in

a cumulative ownership change percentage where a subsequent transaction (e.g., sale by a five percent shareholder, issuance of stock options to employees, etc.) will likely result in a future ownership change. 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 percent or greater shareholders should also alleviate the burden placed upon corporations that exceed the de minimis threshold. This change alone would virtually eliminate 90 percent of the work that is done on an ongoing basis 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 percent of a loss corporation.

Recommendation/Conclusion

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-percent or greater shareholder as opposed to a 5-percent shareholder.

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, the total charitable contribution deduction for any taxable year shall not exceed 10 percent of a corporation's taxable income ("the 10 percent 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 percent 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 –

(i) 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;
(ii) the property is not transferred by the donee in exchange for money, other property, or services;
(iii) 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 (i) and (ii); and
(iv) 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."

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 --

(i) one-half of the amount of the reduction computed under paragraph (1)(A), and

(ii) 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."

Description of Proposal

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 so that only the enhanced deduction is treated as a charitable contribution subject to the 10 percent taxable income limitation under section 170(b)(2).

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 percent 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 percent 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.

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 percent 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. 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 percent taxable income limitation under section 170(b)(2) but the basis of the contributed inventory (not subject to the 10 percent taxable income limitation) is included in cost of goods sold for the year of contribution.

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

Present Law

Enacted in 1993, section 197 of the Internal Revenue Code 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.

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).

Proposal: Modify the definition of W-2 wages for purposes of section 199

Present Law

Section 199(a) allows a taxpayer to deduct an amount equal to 9% of the lesser of the qualified production activities income (QPAI) of the taxpayer for the taxable year, or taxable income for the taxable year. However, such deduction is limited to 50% of the W-2 wages of the taxpayer for the taxable year. For this purpose, section 199(b)(2)(A) provides that "the term W-2 wages means, with respect to any person for any taxable year of such person, the sum of the amounts described in section 6051(a)(3) and (8) paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year."

Description of Proposal

Modify the definition of W-2 wages in section 199(b)(2)(A) to provide that such term refers to amounts described in section 6051(a)(3) and (8) paid by such person with respect to employment of employees by such person during such taxable year.

Analysis

A taxpayer with a certain short taxable year is unfairly precluded from claiming the deduction under section 199 although the taxpayer is eligible to claim such deduction.

Final regulations under section 199 provide guidance to taxpayers in determining the amount of W-2 wages that are properly allocable to domestic production gross receipts (DPGR). The final regulations also provide rules for determining W-2 wages in the case of a taxpayer with a short taxable year. In this regard, the final regulations provide that the W-2 wages of a taxpayer for a short taxable year include:

- Only those wages paid during the short taxable year to employees of the taxpayer,
- Only those elective deferrals made during the short taxable year by employees of the taxpayer, and
- Only compensation actually deferred under section 457 during the short taxable year with respect to employees of the taxpayer.

In addition, the final regulations provide Treasury and the IRS authority to publish guidance setting forth the method that is used to calculate W-2 wages in the case of a taxpayer with a short taxable year.

Pursuant to this authority, the IRS issued Rev. Proc. 2006-22 to provide that the W-2 wages of a taxpayer with a short taxable year is determined under the tracking wages method. Under the tracking wages method, the total amount of wages subject to Federal income tax withholding and reported on Form W-2 includes only those wages subject to Federal income tax withholding that are actually paid to employees during the short taxable year and reported on Form W-2 for the calendar year ending with or within that

short taxable year. Accordingly, a short taxable year that does not include a calendar year-end does not have W-2 wages for purposes of section 199.

Example

Company X is a fiscal year taxpayer with a September 30 year-end. Company X is spun off from Company Y on April 1, 2012. Company X files a tax return for the short taxable year beginning April 1, 2012 and ending September 30, 2012. Company X has QPAI eligible for a section 199 deduction in the short taxable year.

Under this scenario, Company X does not have W-2 wages for purposes of section 199 because its short taxable year does not include a calendar year-end. Accordingly, Company X cannot claim a section 199 deduction for its short taxable year because the W-2 wage limitation would limit the allowable deduction to zero. In other words, the statute unfairly precludes Company X from having W-2 wages for purposes of section 199 deduction, even though eligible W-2 wages were paid during the short taxable year.

Conclusion/Recommendation

The AICPA recommends modifying the definition of W-2 wages in section 199(b)(2)(A) to provide that such term refers to amounts described in section 6051(a)(3) and (8) paid by such person with respect to employment of employees by such person during such taxable year. This modification would provide a section 199 deduction for taxpayers that are otherwise eligible to claim the section 199 deduction, with a short taxable year.

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 $10 million or less 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 less 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 almost 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 only $5 million or less; especially 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 less than $5 million of average annual inventory from the section 263A requirements, instead of utilizing average annual gross receipts.[43]

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[43] 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.