

**IMPACT OF COMPLEXITY IN THE TAX CODE  
ON INDIVIDUAL TAXPAYERS AND SMALL  
BUSINESSES**

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**HEARING**  
BEFORE THE  
SUBCOMMITTEE ON OVERSIGHT  
OF THE  
COMMITTEE ON WAYS AND MEANS  
HOUSE OF REPRESENTATIVES

ONE HUNDRED FIFTH CONGRESS

SECOND SESSION

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JUNE 23, 1998  
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**Serial 105-46**

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**IMPACT OF COMPLEXITY IN THE TAX CODE  
ON INDIVIDUAL TAXPAYERS AND SMALL  
BUSINESSES**

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**TUESDAY, JUNE 23, 1998**

HOUSE OF REPRESENTATIVES,  
COMMITTEE ON WAYS AND MEANS,  
SUBCOMMITTEE ON OVERSIGHT,  
*Washington, DC.*

The Subcommittee met, pursuant to notice, at 3:00 p.m., in room 1100, Longworth House Office Building, Hon. Nancy L. Johnson (Chairman of the Subcommittee) presiding.

[The advisory announcing the hearing follows:]

# **ADVISORY**

FROM THE COMMITTEE ON WAYS AND MEANS

## **SUBCOMMITTEE ON OVERSIGHT**

FOR IMMEDIATE RELEASE

CONTACT: (202) 225-7601

June 16, 1998

No. OV-19

### **Johnson Announces Hearing on the Impact of Complexity in the Tax Code on Individual Taxpayers and Small Businesses**

Congresswoman Nancy L. Johnson (R-CT), Chairman, Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee will hold a hearing on the impact of complexity in the tax code for individual taxpayers and small businesses. The hearing will take place on Tuesday, June 23, 1998, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 2:30 p.m.

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. Witnesses will include representatives from organizations representing individual taxpayers and small businesses. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

#### **BACKGROUND:**

When the Federal tax system was established in 1913, the legislation was only 19 pages long. Today, the Internal Revenue Code has ballooned to nearly 2,300 pages, not counting regulations. The resulting compliance burden on taxpayers is enormous, especially on middle-income taxpayers and on small businesses.

Many studies have been done documenting the impact of this complexity on individuals and small businesses. For example, one study showed that U.S. taxpayers spent more than five billion hours preparing tax returns with compliance costs at more than \$200 billion in 1998. Two-thirds of compliance costs were borne by businesses, and small businesses face the brunt of these costs. Another study has shown that some small businesses may pay more than \$700 in compliance costs for every \$100 that they pay in taxes.

Because of the problems caused by the complexity of the current tax code, there are many efforts in Congress to replace the tax code. However, in the interim, simplification of the most complex provisions of the code may help to significantly reduce the burden on individual taxpayers and small businesses.

In announcing the hearing, Chairman Johnson stated: "The complexity of the tax code is staggering. Every year middle-income taxpayers and small businesses spend more and more time, effort, and money trying to prepare their tax returns. It is time that Congress acts to reexamine the tax code and see if we can simplify or repeal some of its most complex provisions. I believe that this hearing will be a meaningful step toward simplifying the tax code to lessen the burden on middle-income taxpayers and to allow entrepreneurs to concentrate on their businesses and not their tax returns."

**FOCUS OF THE HEARING:**

The Subcommittee will review current law to identify the impact of complexity, in particular, on middle-income taxpayers and small businesses, including: (1) the Alternative Minimum Tax (AMT) for individuals, (2) small business expensing including computer software, and (3) treatment of deductions in lieu of depreciation for small businesses (section 179).

**DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:**

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit six (6) single-spaced copies of their statement, along with an IBM compatible 3.5-inch diskette in WordPerfect 5.1 format, with their name, address, and hearing date noted on a label, by the close of business, Monday, July 6, 1998, to A.L. Singleton, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Subcommittee on Oversight office, room 1136 Longworth House Office Building, at least one hour before the hearing begins.

**FORMATTING REQUIREMENTS:**

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be submitted on an IBM compatible 3.5-inch diskette in WordPerfect 5.1 format, typed in single space and may not exceed a total of 10 pages including attachments. Witnesses are advised that the Committee will rely on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.

4. A supplemental sheet must accompany each statement listing the name, company, address, telephone and fax numbers where the witness or the designated representative may be reached. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press, and the public during the course of a public hearing may be submitted in other forms.

Note: All Committee advisories and news releases are available on the World Wide Web at '[HTTP://WWW.HOUSE.GOV/WAYS MEANS/](http://WWW.HOUSE.GOV/WAYS_MEANS/)'.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202-225-1721 or 202-226-3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Chairman JOHNSON of Connecticut [presiding]. The hearing will come to order.

First, let me extend my apologies to those who are witnesses this afternoon. It's very unusual for us to have to delay a hearing, but three of the Members of this Subcommittee were also conferees in the IRS reform bill. My Ranking Member, Bill Coyne, who will be along any minute, and my second, Mr. Portman. So there wasn't any way to avoid delaying the hearing when the Senate offer didn't come over until so late in the day. So I apologize to you all. But I appreciate your input, and I'm particularly pleased to welcome here today some of my friends from Connecticut—Mr. Bafundo and my friends, Carl and Kathy Olandt, on whom I've relied for advice over many years. So I'm very glad to have you here today.

When the Federal income tax system was established in 1913, the legislation was only 15 pages long. Fifteen pages long, isn't that incredible? Today, the Internal Revenue Code is 2,300 pages long, and this number does not include the hundreds of thousands of pages of regulations, advisory opinions, and court opinions. It is no wonder that the Taxpayer Advocate reported to Congress last January that the number one concern of individuals and small businesses is the complexity of the IRS Code and the difficulty of preparing returns.

I conducted a survey in my home district this year, and the results parallel the Taxpayer Advocate's findings. The most common complaint was the complexity of the Code and the time spent preparing returns. More than 40 percent of my constituents said that they spent more than 10 hours preparing their taxes, and more than 50 percent said they had to hire a professional tax preparer. Nationally, the statistics are similar.

The compliance burden on taxpayers, because of the complexity of our Code, is truly staggering. Taxpayers spend more than 5 billion hours and \$225 billion annually just to prepare their returns.

What is even more troubling is a report that shows that small businesses spend more than \$700 in compliance costs for every \$100 of taxes paid. Indeed, doing one's taxes has become a tax in itself.

Simply put, the Tax Code has become an impediment, and I think that everyone in this room will agree that this is unacceptable. Middle-income tax payers are trying to save for their children's education and their retirement, but struggle to take advantage of tax laws meant to help them. Small businesses have propelled the U.S. economy forward in the nineties and are the primary allies of working Americans in providing retirement income to support Social Security, but they continue to worry whether they have complied with arcane provisions of the Tax Code and pension law. Think of where we would be today if the Tax Code were not so burdensome.

It is time that Congress tackle this issue head on. I propose that we start by clearing the underbrush. The Tax Code is flush with provisions that are obsolete. We should identify these provisions, with help from the private sector, and wipe them off the books for good. For instance, there are several provisions regarding the alter-

native minimum tax, or AMT as we call it, that are no longer needed because of changes in the regular tax. We should get rid of provisions like these and start cleaning up the Code.

Today, the Subcommittee will focus on some of the more complex provisions of the Code and explore ways to make them more taxpayer friendly, especially for middle-income tax payers and small business owners who are least able to afford expensive professional help.

On the individual side, we will discuss AMT and the so-called marriage penalty. On the small business side, we will discuss expensing and increasing the amount that small businesses can deduct rather than depreciate.

I am sure that the panelists have identified other provisions in their written statements that we will not be able to explore in depth today. Indeed, we have had some come to us since we prepared this hearing. But today's hearing is an important first step toward beginning to identify the underbrush, the deadbeat provisions in the Tax Code, and the ways in which we could truly move to simplify the Code for small business and for individual taxpayers in our country.

I'd like to yield to Mr. Coyne, but before I do that, I want to thank the Joint Committee on Taxation, specifically Lindy Paull and Mary Schmitt, for their work in identifying some of the provisions that the Subcommittee will discuss today, and for their continuing work to develop ideas for us as we move into taking on the challenge of simplifying the Tax Code and eliminating obsolete sections.

I'd like now to yield to my colleague, Mr. Coyne.

Mr. COYNE. Well thank you, Madam Chairman. And I want to thank you for holding today's hearing on a topic that is a source of concern to millions of Americans, and for your constant effort to assist and protect America's taxpayers as they comply with our Nation's tax laws.

This hearing, which will highlight challenges that individuals and small businesses have in complying with the Tax Code, is being held as we are about to complete historic legislation to restructure and reform the Internal Revenue Service. While most of the IRS reform debate has focused on the agency's administrative problems, we have devoted too little attention to the principal reason for the difficulties that the IRS confronts, namely the complex law that the IRS administers. As we consider today's testimony on simplifying the Tax Code, we must remember that our efforts in streamlining and improving the IRS will be much more successful if we move swiftly to reduce complexity of tax law.

As we prepare for the next Congress, we must confront the role that the Code plays in causing compliance headaches for many individual taxpayers and small businesses. As nearly 2,300 pages make up the Tax Code, with hundreds of forms and publications, most Americans are intimidated by the Tax Code, and they fear the consequences of making a mistake. Another unfortunate result of this complexity is that many Americans do not take advantage of tax benefits because they either are not aware of them or do not understand the complicated forms and instructions.

The debate on fundamental tax reform will continue well into the next Congress. However, unless and until we agree upon a replacement, we must fix tax problems with the current Tax Code by developing simplification measures that are fair and fiscally responsible. We should consider these alternatives as soon as possible so that we can provide relief sooner rather than later for individuals and small businesses.

My colleagues and I on the Ways and Means Committee have offered measures to reduce complexity and improve tax benefits for millions of individual taxpayers. Congressman Neal has introduced a bill, H.R. 4053, that would repeal the overall limitation on a taxpayer's itemized deductions and phase out the personal exemption and in doing so, would eliminate two complex worksheets. Mrs. Kennelly has introduced H.R. 2524, which would allow the standard deduction and personal exemptions under the alternative minimum tax as well as permit nonrefundable credits such as the family tax credit to offset the minimum tax. The proposal that I introduced would provide taxpayers with a simple 38-percent exclusion of their capital gains from taxation, thereby eliminating 35 lines on Schedule D. I am including for the record a copy of Schedule D, as well as a description of the several Ways and Means Committee Members' proposals regarding tax simplification.

[The information is being retained in the Committee files.]

Madam Chairman, while we consider the fundamental direction of our tax systems over the next several years, we must move forward on specific measures to simplify the Tax Code. Working together in a bipartisan basis, this is real relief that our Committee can provide now for individuals and small businesses.

Thank you.

Chairman JOHNSON of Connecticut. Thank you, very much, Mr. Coyne, and I do appreciate the proposals of the Members of the Ways and Means Committee. And we will be looking at every one of them in depth. It is really a pleasure to welcome now as our first—those first to testify. Steve and Anthony Bafundo, partners in A.J. Bafundo and Co., LLC, in Newington, Connecticut.

Thank you for being with us.

**STATEMENT OF STEVE BAFUNDO, PARTNER, A.J. BAFUNDO  
AND CO., LLC, NEWINGTON, CONNECTICUT**

Mr. STEVE BAFUNDO. Thank you, Chairman Johnson.

Members of the Subcommittee, my name is Steve Bafundo. I am a certified public accountant and partner in the Newington, Connecticut firm of A.J. Bafundo and Co., LLC. Joining me today is our firm's managing partner, Anthony J. Bafundo.

Our small, local firm consisting of three partners and four hard-working support staff prepares approximately 800 Federal tax returns a year and serves well over 200 small businesses and non-profit organizations, ranging in annual receipts from a few thousand dollars to \$15 million.

One of my primary responsibilities is to prepare and review the preparation of our form 1040s. The vast majority of our individual income tax clients would be described as middle- to upper-middle-income tax payers, with an average household adjusted gross income of approximately \$60,000.

In my opinion, the most distressing characteristic of our current Internal Revenue Code is the complexity of tax laws as they relate to the average American. It is unfortunate that many common circumstances that relate to the middle-class taxpayer trigger complex laws that leave the taxpayers confused and frustrated.

Examples of these are as follows: Taxpayers who rent part of their homes. These individuals have to deal with depreciation laws, potential passive activity loss limitations, and upon sale of the property, complex calculations for determining gains or losses.

Taxpayers who are sole proprietors. While we do prepare Schedule Cs for law practices and doctors' offices, the vast majority of our Schedule Cs are prepared to report income for more modest ventures that include office cleaning, snow plowing, home daycare providers, bulk newspaper delivery, handymen, and other small businesses—many of them second jobs the individuals perform to make ends meet. These taxpayers must comply with complicated depreciation calculations, vehicle usage rules, home office usage rules, self-employment taxes deductions, and estimated tax calculations, just to name a few.

Retired pensioners who receive Social Security. The computation of Social Security benefits is an 18-line computation that is tricky and very difficult to explain.

Taxpayers who invest in mutual funds. For the year ended December 31, 1997, taxpayers who received even small amounts of capital gains from their mutual funds were asked to compute a Schedule D that resulted in a record number of new clients seeking our assistance.

Other potential complicated tax scenarios challenging the average American taxpayer include alternative minimum tax, IRA and other retirement benefits, laws and regulations, and earned income credit.

[The prepared statement follows:]

**Statement of Steve Bafundo, Partner, A.J. Bafundo and Co., LLC,  
Newington, Connecticut**

Chairman Johnson, Members of the Committee

My name is Steve Bafundo, I am a Certified Public Accountant and partner in the Newington, Connecticut Public Accounting Firm of A.J. Bafundo & Company, LLC. Joining me today is our firm's Managing Partner, Anthony J. Bafundo. Our small local firm consisting of 3 partners and 4 hardworking support staff prepares approximately 800 Federal tax returns a year and serves well over 200 small businesses and non-profit organizations ranging in annual receipts from a few thousand to 15 million dollars.

One of my primary responsibilities is to prepare and review the preparation of our Form 1040's. The vast majority of our individual income tax clients would be described as middle to upper-middle income taxpayers with an average household adjusted gross income of approximately \$60,000.00. In my opinion, the most distressing characteristic of our current Internal Revenue Code is the complexity of laws as they relate to the average American.

It is unfortunate that many common circumstances that relate to the middle class taxpayer trigger complex laws that leave the taxpayer confused and frustrated, examples of these are as follows:

1. Taxpayers who rent part of their homes.—These individuals have to deal with depreciation laws, potential passive activity loss limitations and upon sale of the property, complex calculations for determining gains or losses.

2. Taxpayers who are sole proprietors—while we do prepare Schedule C's for law practices and doctors' offices, the vast majority of our Schedule C's are prepared to report income from more modest ventures that include office cleaning, snow plowing, home daycare providers, bulk newspaper delivery, handyman and many other small businesses, many of them second jobs, that individuals perform to make ends

meet. These taxpayers must comply with complicated depreciation calculations, vehicle usage rules, home office usage rules, self-employment taxes, deductions and estimated tax calculations just to name a few.

3. Retired pensioners who receive Social Security.—The computation of taxable Social Security benefits is a 18-line computation that is tricky and very difficult to explain.

4. Taxpayers who invest in mutual funds—For the year ended December 31, 1997, taxpayers who received even small amounts of capital gains from their mutual funds were asked to compute a Schedule D that resulted in a record number of new clients seeking our assistance.

Other potential complicated tax scenarios challenging the average American Taxpayer include Alternative Minimum Tax, IRA and other retirement benefits, laws and regulations and Earned Income Credit.

**STATEMENT OF ANTHONY J. BAFUNDO, PARTNER, A.J.  
BAFUNDO AND CO., LLC, NEWINGTON, CONNECTICUT**

Mr. ANTHONY BAFUNDO. I am responsible for the presentation of small business owner's taxes.

A small business owner does not just face Federal taxes. He has the following taxes necessary to start and run a small business: Payroll taxes, including withholding for Federal and State; sales taxes in Connecticut and most States; Federal and State corporation income taxes; licensing requirements in most professions and businesses; and labor law requirements.

From a Federal income tax perspective, the areas where the small business owner suffer from the complication of the Internal Revenue Code are: Alternative minimum tax; and depreciation.

Most small business owners are completely unaware of the alternative minimum tax.

Tax preferences are the adjustment of the deductions allowed on the regular tax versus the alternative minimum tax. The most onerous preference is depreciation. If businessowners have to prepare financial statements according to generally accepted accounting principles, GAAP, they must use one method of depreciation. Then, on their tax returns, they use MACRS, Modified Accelerated Cost Recovery System, depreciation. And for the alternative minimum tax, ADR, asset depreciation range, depreciation. Therefore, for one asset, they must use three different methods and keep separate schedules for each.

Upon sale or disposition of the asset, they'd have three different gains or losses.

Small business corporations must also contend with other types of preferences. With the ACE, adjusted current earnings, preference, they must add to their alternative minimum taxable income the difference between the taxable income on their tax returns versus their financial statements if the financial statement income is greater than the tax return income. For example, if John Jones elects to prepare his tax return on a cash basis, and his financial statement on the accrual basis, he will more than likely have higher financial statement income than tax return income because of the accounts receivable due from his customers. The ACE adjustment was originally passed because of large corporations having huge profit but no taxable income.

Small business owners are required not only to have comprehensive knowledge about their profession or business, but are also required to be aware of a complicated and cumbersome tax structure.

Since they do not have the resources of the large companies, they are at a disadvantage and in most cases cannot afford the professional advice to prepare their returns correctly.

In summary, we recognize that many of these tax laws are created with the best intentions of the American public. Political compromises often contribute to a complicated and frustrating Tax Code. It is our belief that it is time to simplify the way the American public is taxed.

[The prepared statement follows:]

**Statement of Anthony J. Bafundo, Partner, A.J. Bafundo and Co., LLC,  
Newington, Connecticut**

I am responsible for the presentation of small business owner's taxes.

SMALL BUSINESS OWNER'S TAXES

1. Taxes necessary to start and run a small business:
    - a. Payroll taxes—including withholding for Federal and State.
    - b. Sales taxes in Connecticut and most states.
    - c. Federal and State Corporation Income Taxes
    - d. Licensing requirements in most professions and businesses.
    - e. Labor law requirements.
  2. From a Federal Income Tax Prospective the areas where the small business owners suffer from the complication of the Internal Revenue Code are:
    - a. Alternative Minimum tax, and
    - b. Depreciation
- Most small business owners are completely unaware of the Alternative Minimum Tax.

Tax preferences which are the adjustment of the deductions allowed on the regular tax vs the alternative minimum tax. The most onerous preference is depreciation. If a business owner has to prepare a financial statement according to Generally Accepted Accounting Principles (GAAP) he must use 1 method of depreciation. Then on his tax return he uses MACRS depreciation and for the Alternative Minimum Tax ADR depreciation. Therefore, for one asset you must use three different methods and keep separate schedules for each.

Upon sale or disposition of the asset, you have three different gains or losses.

Small business corporation must also contend with other types of preferences. With the ACE preference they must add to their alternative minimum income the difference between the taxable income on their tax returns vs their financial statements, if the financial statement income is greater than the tax return income. For example, if John Jones elects to prepare his tax return on a cash basis and his financial statement on the accrual basis he will more than likely have higher financial statement income than tax return income, because of the accounts receivable due from his clients. The ACE adjustment was originally passed because of your large corporations having huge profits but no taxable income.

The small business owner is required not only to have comprehensive knowledge about his profession or business but is also required to be aware of a complicated and cumbersome tax structure.

Since he does not have the resources of the large companies, he is at a disadvantage and in most cases can not afford the professional advice to prepare his returns correctly.

SUMMARY

While we recognize that many of these tax laws are created with the best intentions for the American public. Political compromises often contribute to a complicated and frustrating tax code. It is our belief that it is time to simplify the way the American public is taxed.

Chairman JOHNSON of Connecticut. Thank you very much, both of you. I'm very impressed with the number of issues that you brought up and the complexity of them. And now I'd like to turn to Carl Olandt, who is a CPA and runs his own small business, and his wife, Kathy.

**STATEMENT OF CARL R. OLANDT, NEW BRITAIN,  
CONNECTICUT**

Mr. OLANDT. Thank you very much, Madam Chairperson.

I'm testifying as a small business owner, an individual taxpayer, and a professional accountant. For over 25 years, I've prepared individual and small business tax returns, and I would like to thank this Subcommittee for allowing me the opportunity to voice not only my concerns but the concerns of the taxpayers for whom I prepare income tax returns.

My comments are short, direct, and simple, as I believe the Tax Code should be. The alternative minimum tax should be abolished. It is unfair. The current laws enable some taxpayers with substantial economic income to significantly reduce their regular tax. The purpose of the AMT is to ensure that these taxpayers pay a minimum amount of tax on their economic income. For the good of the Nation and the economy, the government should continue to encourage individuals and businesses to make economic investments. This encouragement should be enhanced by the special tax treatment that has already been established. The government should not be setting up the special tax treatment and then come by the way of the back door of the AMT to recapture taxes.

The worst part of the AMT is that the average taxpayer doesn't even realize when they may be subject to the tax. The instructions are 8 pages long and are extremely complex. According to the Internal Revenue Service, the average time for recordkeeping, learning about the AMT law or form, and preparing the form requires 5 hours and 56 minutes. And this estimated time only applies to the individual who can understand both the complexity and the language of the form. The instructions refer to certain home mortgage interest, refund of taxes, investment interest, depreciation, adjusted gains and losses, and numerous other items. How many people today understand exactly what this means unless they're a professional accountant? For example, a person who bought property or invested throughout the years and now sells this property or investments at a profit in a year with very low other income may become subject to the AMT without even realizing it, when there is no regular tax due.

Most professional and tax accountants, as myself, struggle with the preparation of the form and we usually rely on our professional computer tax package to alert us to when the form is required and for help with its preparation. Think about the individual who must complete this form without the aid of an accountant or a computer income tax package. This creates confusion and a genuine hardship on individuals.

I would like to make some comments on depreciation, which includes computer software.

The depreciation tables should be reviewed to reduce the depreciable time the Internal Revenue Service has set up to a more realistic time schedule. Computer software should be considered a consumable product and be allowed to be expensed at the time of purchase. This puts into effect the true expense paid out against income in the appropriate tax year.

Most small businesses purchase software programs tailored to their business as part of a computer package. This requires the business to depreciate the computer and software over a 5-year period. If software is purchased separately, it is required to be depreciated over a 3-year period. One major problem is that many businesses cannot keep a computer 5 years and remain current. Both the computer and the software must be continually upgraded to meet the ever-changing business needs. Most software programs do not even operate 3 years without requiring frequent upgrades. A specific example is my own tax program, which must be upgraded or replaced every year to keep current with the ever-changing Internal Revenue Service tax laws. By forcing businesses to depreciate software over a 3-year period, a negative effect is created in the year of the software purchase because business now must pay money—must pay tax on money they have already expended.

Both my clients and I believe the Internal Revenue Service should get the appropriate taxes due. But the tax law should encourage business to expand and improve, and should not make operating a business a tax hardship. There needs to be better coordination of business needs and taxes.

In closing, it is my belief that the Tax Codes do not need to be thrown out. A whole new tax system does not need to be developed. A flat tax system is definitely unfair to the majority of taxpayers. The income tax laws as presently written do contain many inequities, as so stated by Madam Chair and her esteemed colleague, Congressman Coyne. By reviewing the Tax Codes and incorporating common sense and simplicity, we can achieve a system that is acceptable for individuals and business alike.

Thank you.

[The prepared statement follows:]

**Statement of Carl R. Olandt, New Britain, Connecticut**

Honorable Congressional Committee Members.

I am testifying as a small business owner, an individual taxpayer, and a professional accountant. For over twenty-five years I have prepared individual and small business tax returns. I would like to thank the Committee for allowing me the opportunity to voice not only my concerns but also the concerns of the taxpayers for whom I prepare income tax returns. My comments are short, direct and simple as the tax code should be.

**1. THE ALTERNATIVE MINIMUM TAX—INDIVIDUALS. FORM 6251**

The alternative minimum tax should be abolished because it is unfair. The current laws enable some taxpayers with substantial economic income to significantly reduce their regular tax. The purpose of the AMT is to ensure that these taxpayers pay a minimum amount of tax on their economic income. For the good of the Nation and the economy the government should continue to encourage individuals and businesses to make economic investments. This encouragement should be enhanced by the special tax treatment that has already been established. The government should not be setting up the special tax treatment and then come in the back door, by way of AMT, to recapture taxes.

The worst part of the AMT is that the average taxpayer doesn't even realize when they may be subject to this tax. The instructions are eight pages long and are ex-

tremely complex. According to the Internal Revenue Service, the average time for record keeping, learning about the AMT law or form and preparing the form requires five hours and fifty-six minutes. This estimated time applies only to the individual who can understand both the complexity and the language of the form. The instructions refer to certain home mortgage interest, refund of taxes, investment interest, depreciation, adjusted gain or loss, incentive stock options, passive activities and tax exempt interest. How many people understand this? For example, a person who bought property or invested throughout the years and now sells this property or investments at a profit in a year with very low other income may become subject to the AMT without even realizing it, when there would be no regular income tax due.

Most professional accountants and tax consultants, as I myself, struggle with the preparation of this form and usually rely on their professional computer tax package to alert them to when the form is required and for help with its preparation. Think about the individual who must complete the form without the aid of an accountant or a computer income tax package. This creates confusion and a genuine hardship on individuals.

## 2. SMALL BUSINESS EXPENSING. DEPRECIATION WHICH INCLUDES COMPUTER SOFTWARE.

The depreciation tables should be reviewed to reduce the depreciable time the Internal Revenue Service has set up to a more realistic time schedule. Computer software should be considered a consumable product and be allowed to be expensed at the time of purchase. This puts into effect the true expense paid out against income in the appropriate tax year.

Most small businesses purchase software programs tailored to their business as part of a computer package. This requires the business to depreciate the computer and software over a five year period. If software is purchased separately it is required to be depreciated over a three year period. One major problem is that many businesses cannot keep a computer five years and remain current. Both the computer and software must be continually upgraded to meet ever changing business software programs do not even operate three years without requiring frequent upgrades. A specific example, is my own tax program which must be upgraded or replaced every year to keep current with the ever changing Internal Revenue Service tax laws. By forcing business to depreciate software over a three year period a negative effect is created in the year of the software purchase, because business now has to pay tax on money they have already expended.

As previously stated the depreciation tables are not realistic. For example, a new roof on residential rental property as required by the Internal Revenue Service law must be depreciated over 27.5 years. There are not many roofs built today that can last that long. Most roofs are only guaranteed from 5 to 15 years. The depreciation tables by not being realistic discourages many businesses from investing in equipment as often as they would normally do.

## 3. SECTION 179, FIRST YEAR EXPENSING FOR SMALL BUSINESS.

The section 179 deduction should be increased substantially. Due to the high cost of purchasing most equipment, the current allowable deduction of \$18,000.00 is not sufficient. By increasing the allowable amount of deduction business will be encouraged to expand and upgrade their equipment more frequently.

Many new businesses are not aware that they will not get full credit for the money they have expended for new equipment or starting a business. This places a major strain on business to pay out money for new equipment and still be able to cover required taxes. At tax year end, business now owes taxes on money they have used to purchase new equipment. This situation has caused many businesses to owe substantial tax money to Internal Revenue Service. In many cases business is forced to buy on the installment basis so they can maintain sufficient money to cover the taxes, ultimately the end result is business pays more money in interest and fee charges.

Both my clients and I believe the Internal Revenue Service should get the appropriate taxes due, but the tax laws should encourage business to expand and improve and should not make operating a business a tax hardship. There needs to be better coordination of business needs and taxes.

In closing it is my belief that the tax codes do not need to be thrown out. A whole new tax system does not need to be developed. A flat tax system is definitely unfair to the majority of taxpayers. The income tax laws as presently written do contain many inequities. By reviewing the tax codes and incorporating common sense and

simplicity, we can achieve a system that is acceptable for both individuals and business alike.

Chairman JOHNSON of Connecticut. Thank you very much, Carl. Mr. Evanich.

Mr. EVANICH. Evanich.

Chairman JOHNSON of Connecticut [continuing]. Member of the Board of Governors and member of the Federal Tax Division, Connecticut Society of Certified Public Accountants.

**STATEMENT OF JOHN L. EVANICH, JR., CERTIFIED PUBLIC ACCOUNTANT, MEMBER, BOARD OF GOVERNORS, AND MEMBER, FEDERAL TAX DIVISION, CONNECTICUT SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS, WALLINGFORD, CONNECTICUT**

Mr. EVANICH. Good afternoon, Madam Chairman, and Members of this distinguished Subcommittee. We, the Connecticut Society of CPAs, appreciate this opportunity to testify today on the individual alternative minimum tax, the marriage penalty, and the section 179 expensing deduction. My name is John Evanich, and I'm a certified public accountant from Connecticut. I'm a member of the Board of Governors of the Connecticut Society of CPAs and a member of their Federal Tax Division. I'm also a member of the American Institute of CPAs and their tax division.

The Connecticut Society of CPAs currently has over 6,600 members, many of whom are in public practice or otherwise prepare tax returns for many thousands of individual taxpayers and small businesses. Accordingly, we see firsthand many horror stories of taxpayers caught in the tangled web of tax law complexities and the unexpected traps of certain provisions of the tax laws. These complexities and traps cause taxpayers to lose faith in the tax system in general and in their ability to understand the tax consequences of otherwise straightforward transactions.

The three issues that I will be addressing involve concerns of complexity in the Tax Code, but they also involve concerns of fairness in our tax laws. As we all know, there are often unexpected consequences of well-intentioned tax provisions. These need to be continually sought out and corrected, particularly in light of continuing complexity of these same tax provisions.

As I said, I will briefly discuss three tax issues affecting middle-income individuals and small businesses, all of which are a concern to the Connecticut Society of CPAs. Namely, I would like to explain our concerns with the AMT, the marriage penalty, and the section 179 expensing deduction.

The alternative minimum tax, first. As you know, our tax laws contain many provisions allowing special treatment for certain types of income and gains, and special deductions for expenses and losses if certain rules are met. In the past, these tax laws allowed some taxpayers to pay little or no income tax, even though they may have received substantial economic income. Through passage and subsequent expansion of the alternative minimum tax, many more of these taxpayers now pay at least a minimum of tax on their economic income.

Unfortunately, in order to accomplish this goal, the AMT rules have become increasingly complex. In fact, the AMT is one of the most complex provisions in the tax system. The many items of preference and adjustment, which must be calculated in order to determine the taxpayers' AMT liability, are extremely complex, and many require a taxpayer to keep detailed and time-consuming records of assets and transactions. In effect, taxpayers must keep two complete sets of books, one for regular tax purposes and another for AMT purposes.

Furthermore, many of the provisions of the Taxpayer Relief Act of 1997, while each accomplishing its intended benefit, also cause some unexpected results.

First, many of the technical AMT tax provisions were actually made more complex. And second, many more individual taxpayers will now be subject to the AMT. In fact, many taxpayers who will not actually pay the AMT, must still keep these detailed records just to correctly determine which tax they are to pay—the regular income tax or the AMT tax.

Further complicating this situation is the increasingly complex nature of these provisions, as already mentioned. With a significant increase in the number of taxpayers subject to or potentially subject to the AMT, there will now be many less sophisticated taxpayers expected to be aware of and understand these provisions. Since an increasing number of these middle-class taxpayers, who will now be subject to the AMT, may currently prepare their own tax returns, either manually or using consumer type tax preparation software, and since in many cases the AMT cannot correctly be calculated from information directly used in preparing these returns, there's a significantly increased chance that taxpayers subject to the AMT will not correctly calculate and pay this tax. Needless to say, this will add significant further enforcement efforts to the responsibilities of an already overburdened Internal Revenue Service.

The Connecticut Society of CPAs strongly recommends that consideration be given to simplifying the AMT provisions as they're now written so that an average taxpayer would have at least a fair chance of understanding this tax and correctly preparing their own tax return each year.

Furthermore, we suggest these rules be modified to provide an exemption from the AMT for certain taxpayers with income below certain thresholds and with only certain specific preferences or adjustments.

If it's OK, I'm going to skip some of the details since I'm out of time. I would like to mention, if I could take another minute, the marriage penalty provisions.

Those are a significant concern. In effect, what they do is, the tax laws are causing people to either postpone getting married or actually consider divorce simply for purposes of tax saving.

In addition, the last item I have, the section 179 expensing deduction, while the expense allowance is being increased each year, from currently \$18,500 to eventually \$25,000, there's a reduction limitation if a taxpayer spends over \$200,000 a year in total equipment costs. That \$200,000 limitation hasn't been increased at all since it was first enacted in 1986. And again, the Connecticut Soci-

ety of CPAs recommends that that be increased or eliminated entirely.

The Connecticut Society of CPAs is honored to be invited to appear before this Subcommittee to present our views on certain tax provisions needing modification in the interest of simplification and fairness. We thank you for this opportunity and stand ready to work with you on these or any other tax provisions under consideration.

Thank you.

[The prepared statement follows:]

**Statement of John L. Evanich, Jr., Certified Public Accountant, Member, Board of Governors, and Member, Federal Tax Division, Connecticut Society of Certified Public Accountants, Wallingford, Connecticut**

#### INTRODUCTION

Good afternoon, Madam Chair, and members of this distinguished Subcommittee. We appreciate this opportunity to testify today on the individual alternative minimum tax (AMT), the "marriage penalty," and the "Section 179 Expensing deduction." My name is John Evanich, and I am a Certified Public Accountant from Connecticut. I am a member of the Board of Governors of the Connecticut Society of CPAs, and a member of their Federal Tax Division. I am also a member of the American Institute of CPAs and their Tax Division.

The Connecticut Society of CPAs currently has over 6,600 members, many of whom are in public practice or otherwise prepare tax returns for many thousands of individual taxpayers and small businesses. Accordingly, we see first-hand many horror stories, of taxpayers caught in the tangled web of tax law complexities and the unexpected traps of certain provisions of the tax laws. These complexities and traps cause taxpayers to lose faith in the tax system in general, and in their ability to understand the tax consequences of otherwise straightforward transactions.

The three issues that I will be addressing involve concerns of complexity in the tax code, but they also involve concerns of fairness in our tax laws. As we all know, there are often unexpected consequences of well-intentioned tax provisions, these need to be continually sought out and corrected, particularly in light of continuing complexity of these same tax provisions.

As I said, I will briefly discuss three tax issues affecting middle-income taxpayers and small businesses, all of which are of concern to the Connecticut Society of CPAs. Namely, I would like to explain our concerns with the Alternative Minimum Tax, the "marriage penalty," and the "Section 179 Expensing Deduction."

#### ALTERNATIVE MINIMUM TAX

As you know, our tax laws contain many provisions allowing special treatment for certain types of income and gains, and special deductions for expenses and losses if certain rules are met. In the past, these tax laws allowed some taxpayers to pay little or no income tax, even though they may have received substantial economic income. Through passage and subsequent expansion of the alternative minimum tax (AMT), many more of these taxpayers now pay at least a minimum amount of tax on their economic income.

Unfortunately, in order to accomplish this goal, the AMT rules have become increasingly complex. In fact, the AMT is one of the most complex provisions in the tax system. The many items of "preference" and "adjustment" which must be calculated in order to determine a taxpayer's AMT liability are extremely complex, and many require a taxpayer to keep detailed and time consuming records of assets and transactions. In effect, taxpayers must keep two complete sets of records—one for "regular" tax purposes and another for "AMT" tax purposes.

Furthermore, many of the provisions of the Taxpayer Relief Act of 1997, while each accomplishing its intended benefit, also cause some unintended results—first, many of the technical "AMT" tax provisions were actually made more complex, and second, many more individual taxpayers will now be subject to the AMT. In fact, many taxpayers who will not actually pay the AMT, must still keep these detailed records, just to correctly determine which tax they are to pay—the "regular" income tax or the "AMT" tax.

Further complicating this situation is the extremely complex nature of these provisions, as already mentioned. With a significant increase in the number of tax-

payers subject to (or potentially subject to) the AMT, there will now be many less-sophisticated taxpayers expected to be aware of and understand these provisions. Since an increasing number of these middle-class taxpayers who will now be subject to the AMT may currently prepare their own tax returns (either manually or using consumer-type tax preparation software), and since in many cases the AMT cannot correctly be calculated from information directly used in preparing these returns, there is a significantly increased chance that taxpayers subject to the AMT will not correctly calculate and pay this tax. Needless to say, this will add significant further enforcement efforts to the responsibilities of an already overburdened Internal Revenue Service.

The Connecticut Society of CPAs strongly recommends that consideration be given to simplifying the AMT provisions as they are now written, so that an “average” taxpayer would have at least a fair chance of understanding this tax, and correctly preparing their own tax return each year.

Furthermore, we suggest that these rules be modified to provide an exemption from the AMT for certain taxpayers, with income below certain thresholds or with only certain specific “preferences” or “adjustments.” For example, taxpayers with only itemized deductions and personal exemptions shouldn’t be paying the AMT at all. Likewise, taxpayers who qualify for either the new “Child Tax Credit” or “Education Tax Credits” shouldn’t find themselves giving this tax break back, in the form of an AMT.

There are many other ways that the AMT provisions can be modified to be more “user-friendly” for middle-class taxpayers, so that only those taxpayers originally intended to be subject to the AMT—those with large economic income and little or no regular income tax—will again be subject to both the tax itself and the burdensome recordkeeping requirements of these provisions.

#### MARRIAGE PENALTY

Under the current tax system, both a “marriage penalty” and a “marriage bonus” exist. A “marriage penalty” occurs when two married individuals have a greater tax liability when compared to two similarly situated single individuals. A “marriage bonus” occurs when the opposite result ensues. Two married individuals paying a lower tax liability than two similarly situated single taxpayers. In nearly all cases, current tax laws result in a “marriage penalty,” meaning that spouses with separate incomes usually will pay a higher tax than they would pay if they were allowed to file as single taxpayers. It has been estimated that about two-thirds of all married couples pay more income taxes than they would if they divorced!

Furthermore, tax complexity has again created an unbearable situation for many taxpayers. There are at least 63 provisions in the Internal Revenue Code where tax liability depends on whether a taxpayer is married or single. Many of these differences were originally created to be fair, to target benefits to specific taxpayers, or to prevent abuses of specific provisions. The Taxpayer Relief Act of 1997 added even more complexity in this area, specifically in the provisions regarding the Child Tax Credit, Education Tax Credits and other tax incentives for education, and even Roth Individual Retirement Accounts to name just a few!

Furthermore, there is now an ever-increasing list of tax provisions tied to some level of Adjusted Gross Income (AGI) or Modified AGI. Since nearly all of these AGI-controlled provisions impose a further “marriage penalty” on married taxpayers, the “penalty” continues to grow.

The Connecticut Society of CPAs strongly recommends that consideration be given to eliminating the “marriage penalty.” This would result in a more fair and equitable tax system, one in which marital status would not affect the amount of taxes paid by two similarly situated individuals. In addition, elimination of the “marriage penalty” would result in simplifying the tax laws, meaning that an “average” taxpayer would again have at least a fair chance of understanding their income tax, and correctly preparing their own tax return each year. Finally, the government would no longer be viewed as discouraging taxpayers from remaining married, or from getting married in the first place!

Also, consideration should be given to simplifying the calculation of a couple’s income tax liability, by eliminating many of the AGI-controlled limitations and phase-outs. In this way, taxpayers will feel two immediate benefits. First, simplified tax laws that they have a greater chance of understanding, and increased faith in the fairness of our overall tax system.

#### SECTION 179 EXPENSING DEDUCTION

Since 1982, small businesses have been allowed to elect to deduct currently, instead of depreciating over several years, the cost of certain qualifying property pur-

chased for use in their business. Although originally limited to \$5,000 of cost per year of such property, this annual limit has been increased several times over the past 16 years. The Section 179 limitation (\$18,500 for 1998) is currently in the midst of scheduled increases, and will eventually reach a maximum annual deduction of \$25,000 by year 2003.

However, since 1986, this tax benefit also has a specific limitation imposed on it. In order to qualify for the maximum deduction under this provision, a taxpayer cannot have purchased more than \$200,000 of total qualifying property during the tax year. For each dollar of property purchased in excess of this \$200,000, the Section 179 deduction is reduced by one dollar.

This reduction if property is acquired in excess of \$200,000 was added by the Tax Reform Act of 1986. Unfortunately, while the annual deduction under Section 179 has been increased several times since 1986, this "reduction limitation" has not increased at all during these past twelve years.

Since prices of equipment and other property have almost certainly increased since 1986, this limitation has actually discouraged certain taxpayers from purchasing new property if they are at or near this limitation. While other tax provisions are intended to encourage businesses to reinvest in new equipment and other property, this provision may often have the unintended result of actually discouraging such investment.

The Connecticut Society of CPAs strongly recommends that consideration be given to eliminating the "disincentive" that may result from this Section 179 "reduction limitation." In order to encourage all businesses to invest in qualifying property, and as a further step toward simplification, consideration should be given to the complete elimination of this "reduction limitation." Alternatively, consideration should at least be given to increasing the dollar threshold, over the same period as the current schedule of deduction increases, in order to at least not reduce or eliminate the potential benefits of this increase for many small businesses.

Furthermore, this would result in a more fair and equitable tax system, since all capital-intensive businesses would be able to take advantage of this deduction on an equal basis, regardless of the amount spent on qualifying property purchased in any one tax year. Finally, the elimination of this "reduction limitation" would also eliminate the necessity of small businesses postponing their purchase of necessary equipment, merely because they have maximized their qualifying purchases for the current year.

#### CONCLUSION

The Connecticut Society of CPAs is honored to be invited to appear before this Subcommittee, to present our views on certain tax provisions needing modification in the interest of simplification and fairness. Although we believe that there are many provisions of the tax law that can be improved, these three specific provisions are of particular concern for all middle-income individuals and small businesses.

We thank you for this opportunity, and stand ready to work with you on these or any other tax provisions under consideration. We believe that "Tax Simplification" and an improved level of "fairness" in our tax system is in the best interest of the entire country. Thank you for taking the time to hear our concerns.

Chairman JOHNSON of Connecticut. I thank you all for your input. I found it extremely interesting, and let me ask first, how do you as preparers keep up in the changes? What does it take to be out there as a CPA advising people on tax law in today's world?

Mr. OLANDT. Madam Chairperson, for myself, I subscribe to four professional tax accounting organizations and receive their monthly newsletters, and study them, scrutinize them every month for the changes and their explanation. And numerous times after IRS comes out with some policy direction even what our, such as the National Society of Accountants and other organizations have given their interpretation to it, it becomes—they rechange it when they send it to you to reexplain it to you so that it keeps us very much on our toes.

Chairman JOHNSON of Connecticut. Mr. Bafundo.

Mr. ANTHONY BAFUNDO. Well, we do it from three sources. First, we attend seminars given. Second, we have tax services that provide monthly updates. And third, we also have in-house seminars where we take a section of the Code and explain it to the rest of the staff. And we also send around certain changes that they have to read—we get a weekly change. And we make sure that every staff member signs off that they've read the changes for that particular week.

Chairman JOHNSON of Connecticut. You mentioned, Mr. Steve Bafundo, in your testimony the difficulty for taxpayers who rent part of their homes. I assume you're thinking about the residences that are common in Connecticut—two families, three families, situations like that. Is there—and this actually goes to a number of aspects of each of our testimony. As in other parts of the law, and in the individual Code, we recognize the need to exempt low-income filers from complexity. Is there a need to exempt, to make, to draw some different lines, on who is going to be affected by what? And if you were going to do that, for instance, at what income would you want to exclude people from the AMT—simplify the law in regard to rental—in an owner-occupied building?

Mr. STEVEN BAFUNDO. Well, first of all Congressman Johnson, you know that your own hometown of New Britain is filled with multifamily houses, and we do a heck of a lot of New Britain residents' tax returns. Most of these individuals don't make over \$50,000 a year. They're working-class families, and yet they are dealing with complex depreciation issues. In certain cases, the passive activity losses could come in if their income goes a little higher. But certainly they have to take a look at those forms.

And the only conclusion I draw is that when these laws were made up for rental properties, the assumption was that whoever wrote the laws figured that either everybody who had a rental property was going to a tax preparer, or they had access to a computer to be able to do those kind of computations. I think there should be some kind of differentiation as to whether you rent out a portion of your principal residence versus somebody that has a 10-unit apartment building. I think that you could clearly make things a lot easier for individuals to rent out the second floor, or maybe the second and third floors, and yet occupy that property. There's a lot of people that have to pay a fair sum of money to have their returns prepared solely because they rent out a portion of their house, something that's necessary for them to do to make ends meet.

Chairman JOHNSON of Connecticut. A similar issue that you raised in regard to sole proprietors, you know, people who have a part-time business or really are a small sole proprietor. When you enumerate the things that they have to take into account, would it be useful to consider an alternative single deduction that you could choose rather than enumerating all of these?

Mr. STEVE BAFUNDO. That would be great. I know a couple of years ago, there was an effort made to make it a little simpler, with the form C-EZ that was put in. But that doesn't really exempt them from the different considerations that they do have. For example, the vehicle usage, home office—if they have home office—and some of the other depreciation aspects. These—it would be

tough to come up with a standard deduction per se for a small business owner, but maybe that's something that you consider. The problem is that some of these small businesses—so many of them are so different—have different needs or different ways of doing business—that I don't know if you could come up with a standard. But it would be something to look at, because, once again, there's a lot of people that make very little money that need our services because they're up at 4 o'clock in the morning shoveling or plowing driveways, or they're delivering bulk newspapers. I'm giving you real-world examples. Or maybe they pick up a few thousand dollars during the year cleaning somebody's office at night. And yet these people have to pay hundreds of dollars to get their tax returns done, because they can't figure it out for themselves.

Mr. ANTHONY BAFUNDO. Well, there's also another consideration: Self-employment tax. Somebody who makes \$2,000, they may not pay any income tax, but they're subject to Social Security, so they have to file a tax return even though they don't owe Federal income tax.

And the second thing, sometimes we run across elderly people who own a house and rent a second floor, and they really—the only thing they have is the Social Security and the rent they get from the home. And when you figure out their tax, it's zero income tax. But they have to file a return because of taking taxable income into consideration when you file a return, you have to take gross income subject to taxation. So these people may have a rental property where they collect \$10,000 a year, and they're 70 years old, and they still have to file a tax return, even though they have no tax to pay. And most of these people are not in the best of financial shape.

Chairman JOHNSON of Connecticut. On the alternative minimum tax, let me just run down for you a couple of the suggestions that our tax staff has made and get your opinion as to whether this would be very—it would be helpful or not. Some of it may not pertain to the sizes of businesses that you deal with, but, for instance, we could repeal provisions that, in fact, are obsolete that relate to passive losses, R&D expenses, circulation expenses, farming losses, mining exploration, development expenses, long-term contracts, and pollution control facilities. Most of that wouldn't pertain to most of the small businesses you deal with, except the passive losses. Would that make any difference?

Mr. ANTHONY BAFUNDO. The——

Chairman JOHNSON of Connecticut. There are some others so you can——

Mr. ANTHONY BAFUNDO. We do quite a few contracting companies. Well, the long-term contract provisions where they have to—we use sometimes cash basis or percentage of completion.

Chairman JOHNSON of Connecticut. In other words, if we excluded that, that would be helpful?

Mr. ANTHONY BAFUNDO. Right, that would be helpful. Yes.

Chairman JOHNSON of Connecticut. What about coordinating certain provisions of the AMT with regard to regular tax, such as providing for the regular tax 7.5-percent AGI floor, rather than the alternative minimum tax 10-percent floor for medical expenses. You know, if we align to these things, would that make that easier?

Mr. ANTHONY BAFUNDO. Yes. Definitely. Especially medical. If somebody has medical expenses, normally they need the help. If they have to go over 7½ percent of their adjusted gross income, they probably have a similar amount of medical expenses and are in poor shape financially.

Chairman JOHNSON of Connecticut. And then, one of the things that we've discussed quite extensively is allowing deductions under the AMT for items not generally considered to be tax preferences, such as employee business expenses and investment expenses; that those would not be—they would not come under the AMT.

Mr. ANTHONY BAFUNDO. Yes, that makes sense.

Chairman JOHNSON of Connecticut. I am interested as you go home and sort of think about this, as you—you know, the more you can help us come up with specific ideas as to how to simplify and give us some ideas as to if we do this, how many does that help? Are you seeing a lot of individuals now coming into the alternative minimum tax system? Are you seeing more coming in now than you did 2 or 3 years ago?

Mr. Evanich.

Mr. EVANICH. Yes, Madam Chairman. Definitely more, and there will be significantly more as the provisions of the Taxpayer Relief Act of 1997 take effect. We're going to, for the first time, have taxpayers realizing that they're thinking they're getting an education tax credit or a child tax credit, but then finding out that they're giving it right back in the form of an AMT, and that's going to hit this year when they file their returns.

Chairman JOHNSON of Connecticut. This year?

Mr. EVANICH. Yes.

Chairman JOHNSON of Connecticut. I'd be interested in what you—what you—what change you think we need to make in the threshold to stave that off. We are looking at the possibility of excluding those expenses, allowing those preferences before the AMT hits. But it would be interesting to know what the—how you would have to lift the threshold in order to avoid denying people the benefits that we just gave them.

Mr. Coyne.

Mr. COYNE. Thank you, Madam Chairman. I would like to yield to Mrs. Thurman.

Mrs. THURMAN. I'd like to thank the gentleman.

I really want to focus on one issue because many of us have been doing some hearings for the last couple of weeks under guidance of the Chairman, Nancy Johnson, and the year 2000 issue. And I noticed in much of the testimony—or in some of the testimony today specifically you talked about some small business expensing and depreciation, including computer software. One of the things that we're concerned about is what are small businesses going to do out there while we're trying to worry about government, we're worried about how they're going to network and how they're going to interact without getting—because we need to get 2000 done.

Can you give us some ideas of some kinds of things that might promote to businesses or particularly to small businesses in the Tax Code that would maybe get them to kind of jump into this or at least see something in the Tax Codes that would help them get to this problem?

Mr. EVANICH. Congresswoman, I'd like to answer that. Yes, first of all in the section 179 expensing deduction area, elimination of the \$200,000 a year limitation, where you start to lose a dollar for every dollar that you spend over that, would allow all businesses to spend whatever they truly need to spend to purchase equipment without worrying about artificial limitations; so that we tax advisors don't sit with them in the 11th month, and say, no, don't buy any more equipment this year, wait until next year. They can truly buy what is right for their business. It's very easy to hit \$200,000 nowadays.

Mrs. THURMAN. Would it be, I mean could we do it in a way that we could just keep it for a short period of time because this is an immediate problem? And so, say, we said that if you do it in 1998, 1999, obviously, because we have to worry about how we would pay for all of this—I mean, I think, you know, we're trying to figure out the best way to do this. We've done some research and it says that, you know, I guess you could take some because of repair. Because there's a part of the Code that you could actually use this as a repair tax credit. I've tried to look at depreciation. I've tried to look at some other areas that I'm just trying to get these people motivated out there, because we are really concerned about what's going to happen when they don't have the equipment available. I mean is that—I mean, I know that kind of makes everything crazy in the Tax Code, but even if we limited it for a short period of time based on whatever money amount we needed. I mean, that's going to be our big issue.

Mr. EVANICH. Yes, unfortunately that is just bringing in one more element of complexity into—

Mrs. THURMAN. I know.

Mr. EVANICH [continuing]. What's already unbearable.

Mrs. THURMAN. And I really don't want to do that. That's a problem for me, but at the same time, I don't know how long you could continue that for a long period of time and what the cost of that would be. And, of course, we have to offset any expenditures that we have, and trying to find a replacement for that, depending on whatever—you know, it would be what the Tax Committee would come back with as the amount of dollars. And that could be huge, I suppose.

Mr. STEVE BAFUNDO. If I could address this for 1 second. The cost of computers these days, with the turnover in technology, is such that I believe if you did something maybe even permanently, but especially in light of the Y2K problem, I think it would be a tremendous savings to people if you could take electronic data processing type of equipment and maybe put on a special writeoff of some sort to encourage people to stay current. Without their computers, you know, one of the problems they have is they're not able to keep up with their accounting systems and with their tax preparation. So I think you would be helping people if you did something special with EDP type of deductions or writeoffs.

Mr. ANTHONY BAFUNDO. Right now, they're 5 years, so, you know, if you could have 3-year or a 2-year writeoff, or a complete writeoff, even though it is complicating the law.

Mr. OLANDT. It would definitely help if you gave special exemption to the data processing part of it because every business is

going to have to replace or readjust for the year 2K. And if you gave them just a flat exemption in that area, that would allow them to move into year 2K with their business and have everything correct to date. And for the amount that it would be based on the computer part or industry, I don't believe would cost the Federal Government that much money.

Mrs. THURMAN. OK. You want to add. You looked like you were ready to add something there?

Mr. ANTHONY BAFUNDO. Well, the computers, by their nature, do depreciate. Five years is practically infinity.

Ms. THURMAN. I did notice that in the testimony that there seems to be some consensus that this is an area. Quite frankly, in talking to my CPAs at home when I first ran for Congress, they told me the one thing you can do in business is to help them through some of their tax credits. That being one of them and, of course, we did some of that in 1993 where, I guess, we jumped up to about \$17,000 in equipment. They said the same thing that was the one thing you could do to keep them fueled and running. So it seems pretty consistent. I will say that I think all of us agree on the AMT. I hear it from everybody. That is just a nightmare out there.

There's another issue and I found this as an interesting one and I'm talking about because my Chairman is on the phone. But when I talked to my accountants this year, they told me on the capital gains issue—which seems to have gotten some attention—actually they have a different opinion. They said this first year was a nightmare because it was new and it was complicated and those kinds of things. But they kind of told me that after this year getting through this that it probably was not a big deal. I mean, you can agree or disagree.

Mr. OLANDT. Well, I tend to agree that for the accountant it's not a big deal and especially as we get more used to its items. But for the individual taxpayer, you've set up 10 percent—20 percent—25 and 28 percent, but the individual taxpayer really doesn't understand all this. For the majority—especially for about the 55 people that had capital gains—or 60 returns that I did, they in essence only saved somewhere around \$30, \$40. So we—but yet had to pay the accountant \$15, \$20, \$25 to prepare that 1-page return. In fact, many of us experienced the whole—a whole bunch of new clients strictly because of the capital gains. I mean, it did a lot to help us accountants but didn't do anything for the poor middle-class taxpayers.

Ms. THURMAN. But would that change even if we took it back to 12 months versus 18? Or is it just the whole issue of the rules and regulations that went with it?

Mr. OLANDT. It's the whole issue of the rules and regulations—

Ms. THURMAN. But not the month of the time period in which you hold it.

Mr. OLANDT. Right. That's part of the problem is they're—

Ms. THURMAN. OK.

Mr. OLANDT [continuing]. Keeping the complexity of paying attention to the direct buy and sell date which they have to do anyway. But the fact that it's so complicated and they have to take it off the regular tax and they have to compute at what level of tax

it is. For the savings at the end, they look at a lot of work for not a lot of that kind of money.

Mr. EVANICH. The Connecticut Society of CPAs, as a public service for our two largest newspapers in Connecticut, man the telephones during tax seasons for their readers to call in with questions.

Ms. THURMAN. Bless them. [Laughter.]

Mr. EVANICH. I think we did for 3 nights altogether—4 nights altogether. About 80 percent of the questions that we got revolved around capital gains and losses and sale of residence. Unfortunately with five different rates for capital gains and potentially five different AMT capital gains rates, the average taxpayer—especially trying to prepare their own returns—just doesn't have a chance of understanding.

Ms. THURMAN. OK. Well, thank you.

Chairman JOHNSON of Connecticut. Very sobering. I wanted to pursue this issue of expensing a little bit further. For years, the Committee has tried to increase the expensing threshold. How useful is that? At what level do you think expensing ought to be at? Software is becoming really, in a sense, a normal business expense now. Should that even be included in the expensing provisions or should it be limited to the hardware—to the computers and other equipment? So one is the level and second whether software should still be part of it.

Mr. OLANDT. Madam Chairman, I would say that the software itself should be just taken as a consumable product as I submitted in my written testimony.

Chairman JOHNSON of Connecticut. As a business expense?

Mr. OLANDT. As a business expense, yes. A lot of businesses, as I said, get tailored software to their businesses. If you're a contractor and you're trying to keep up with the materials, you're buying a package every year that gives roughly prices and they upgrade it semiannually usually. A lot of the contractors that I have, on their laptop computers, will upgrade their pricing so that when they go out and give a bid on producing a job, doing a home improvement, building an addition—they have some readily available information as to what the materials are going to cost them and have costed out what their time factor is going to cost them. Then continually having to rebuy either upgrades to it or new packages periodically all the time because of the ever-changing mode. What happens is—I mean—the one that they bought if they have to depreciate over 3 years is useless after less than 1 year, yet they're still expensing it out. It should be just made a consumable product the same as the way we go and buy paper—copy paper or—

Chairman JOHNSON of Connecticut. We do have proposals before the Ways and Means Committee to reduce the depreciation time for software. But what you're saying is that it should just be expensed as a business expense each year.

Mr. OLANDT. That's my opinion and most of my clients. Many of them probably—

Chairman JOHNSON of Connecticut. What about the expensing limit? What level do we need to—what level would be useful for most small businesses so that the Tax Code wouldn't drive the de-

cision as to whether to buy the equipment this year or a few months later?

Mr. OLANDT. Well, the \$18,500 that came into this year—I mean, it's just not sufficient. You take a person that buys a—I have a couple of clients that have a lawn mowing business. They are actually spending for a good high-powered seat big lawnmower that can cost him anywhere from close to \$30,000. So they're saving that money to put out and then they don't have a lot of money to cover the taxes on what they can't write off for that. It would also encourage a lot of other people that would go into business because they're saving to make this investment. But they have to be careful because if they spend everything into their business, they have no money at the end of the year. They actually get taxed on some of that money they've already spent. It's extremely hard for the small business and the person to make a go.

Mr. STEVE BAFUNDO. If I could, on the software issue. One of the requirements of our appearance before this Subcommittee is that we came up with software—or our testimony—written in WordPerfect 5.1. Well, we had a heck of a time finding WordPerfect 5.1. It's about three or four generations back. Thank God I have a neighbor that's a packrat that saved his old version of it. So if you want to see how quickly things are moving, you only have to look at this Committee itself and take a look at how quickly software becomes obsolete.

Chairman JOHNSON of Connecticut. That's very interesting because we reversed our order this year for this hearing and had the practitioners come before some of the organized groups. That really is wonderful—I mean, that's a perfect example of some—of just a small corner of the difficulties.

Mr. ANTHONY BAFUNDO. One other thing they ought to eliminate is the—they have a lower alternative minimum tax threshold on the kiddie tax. I have one guy that has nine children under 14 and takes me about 6 or 7 hours to do those returns. The—

Chairman JOHNSON of Connecticut. Just for the kiddie tax portion?

Mr. ANTHONY BAFUNDO. No, there's a \$1,000—I think it's gone up to about 15 now—\$1,500.

Chairman JOHNSON of Connecticut. Yes.

Mr. ANTHONY BAFUNDO. It's gone up to \$1,500. There's only a \$1,500 limitation on alternative minimum tax for children under 14 years alone—14 years of age. This guy has nine children under 14 who have income. It takes me 5 or 6 hours to do that tax return. It's unbelievable. I don't understand why they did that. I guess they did that because the children are paying at the parent's rate on the regular tax. But when you get to the alternative minimum, they end up paying more tax on the alternative minimum tax than they would on the regular tax because the low—

Chairman JOHNSON of Connecticut. You mean the children do?

Mr. ANTHONY BAFUNDO. The children, yes.

Chairman JOHNSON of Connecticut. That's a very good point.

Mr. ANTHONY BAFUNDO. Because of the low—it's only a \$1,500 exemption as opposed to \$45,000 and so forth that you get on the regular AMT.

Chairman JOHNSON of Connecticut. What level of expensing would you recommend given your experience with small businesses?

Mr. ANTHONY BAFUNDO. Well they're taxing the child at the parent's rate anyway. So I would say—I would raise the limit to around \$5,000—the AMT.

Chairman JOHNSON of Connecticut. Under the AMT, the limit for child deductions to \$5,000?

Mr. ANTHONY BAFUNDO. Yes.

Chairman JOHNSON of Connecticut. And what about—

Mr. ANTHONY BAFUNDO. It's now \$1,500.

Chairman JOHNSON of Connecticut. What about expensing for small businesses? Would separate startup costs from annual expensing limits? If so, what would they be? Because we do also have proposals for a separate start-off—startup cost deductions. I'm reluctant to get into the complexity of differentiating between startup costs and—

Mr. ANTHONY BAFUNDO. Yes, right.

Chairman JOHNSON of Connecticut [continuing]. Other year costs. But, for instance, what is a usable level of expensing? What would be good to help small businesses grow in terms of expensing level?

Mr. ANTHONY BAFUNDO. Well, I would say that they—I would say 10,000 to 20,000—somewhere in that area would probably—for somebody to start up a business. I don't know what you're considering a startup cost. That's the other question—

Chairman JOHNSON of Connecticut. But what about on an annual—

Mr. ANTHONY BAFUNDO. You're talking about buying equipment—equipment, of course, you have the \$18,500 anyway.

Chairman JOHNSON of Connecticut. What about on an annual basis? What would be a good expensing level to allow?

Mr. ANTHONY BAFUNDO. For startup costs?

Chairman JOHNSON of Connecticut. No, just regular, every year—annual?

Mr. ANTHONY BAFUNDO. From the AMT?

Chairman JOHNSON of Connecticut. No, just regular tax expensing level.

Mr. ANTHONY BAFUNDO. Oh, you're talking about section 179?

Chairman JOHNSON of Connecticut. Yes.

Mr. ANTHONY BAFUNDO. I'm not quite sure what you're referring to.

Chairman JOHNSON of Connecticut. Yes, right, sorry. That's exactly—

Mr. ANTHONY BAFUNDO. Oh, OK. I would say \$30,000 would be.

Chairman JOHNSON of Connecticut. How about the rest of you?

Mr. EVANICH. I was going to say my suggestion would be first—get to the \$25,000 or \$30,000 as quickly as possible. Second, that \$200,000 limit is really a secondary problem. But in addition, if a person is involved in more than one business, not only does each business have that limitation—\$18,500 right now, but the individual also has an overall limitation. So if I own two businesses, those businesses in aggregate can only have \$18,500 of expenses. So I can't spend \$18,500 on each of those businesses.

Chairman JOHNSON of Connecticut. So it should be business specific, not tax specific?

Mr. ANTHONY BAFUNDO. For businesses it should be, rather than limited per individual.

Mr. OLANDT. Personally, I'd like to see it go a little higher, Madam Chairperson, to approximately about \$50,000. Equipment is so expensive today for the small business person. Again, like I said I have people that have—do lawn care and their lawnmowers, their tractors that they must use for the big jobs that they take on are not cheap. They're extremely expensive. It's not just them. A person that's doing snowplowing—that buys the truck and the plow and the attachments to it—\$25,000 may sound like a lot but when you talk—if you're just starting out and you have to put some office equipment, then office equipment I'm including copy machines, fax machines, and computer. Also, the regular equipment to run your business. That \$25,000 is eaten up quite quickly. I'd really like to see for the small business men it go a little higher.

Chairman JOHNSON of Connecticut. If there are no further questions, we'll move onto the other panel. I thank the witnesses very much for your input. We are going to have a vote fairly soon, so I want to move on to the other panel. But thank you very much. As you have other thoughts, please feel free to share them with us. I thank you for the specificity of your testimony—that was very helpful.

Robert McIntyre, director of Citizens for Tax Justice; Michael Mares, American Institute of Certified Public Accountants; and Robert Weinberger, vice president of H&R Block. Thank you very much for being with us this afternoon. We'll start right in so that we can at least get most of the testimony in before we have to vote.

Mr. McIntyre.

**STATEMENT OF ROBERT S. MCINTYRE, DIRECTOR, CITIZENS FOR TAX JUSTICE**

Mr. MCINTYRE. Thank you, Madam Chairman—or Chairman, or whatever we say these days. It's great to be after the Connecticut panel. My wife of 27 years was born in Connecticut, so it must be a great State—right?

It's also nice to hear you guys talking about tax simplification. We've been pushing the idea of a fairer and simpler tax system for years. Of course, given recent history, it's possible that you'll be striking fear into the hearts of most taxpayers just bringing up the word simplification, since it often means something rather different than that when the rubber hits the road.

If we were having a comprehensive hearing about dealing with complexity in the Tax Code, I'm sure we would be talking about the hundreds of billions of dollars of special provisions in the Code now that are largely responsible for why we have all this complexity. But I want to focus today—in my brief time—on one item that didn't sound complex when it was first proposed, but has become one of the most complicated provisions in the Tax Code for average taxpayers—and that's last year's enacted child credit.

You remember when things started, it was just going to be \$500 per kid for everybody. What could be simpler than that? But then some people said, Well, you know, we really shouldn't be giving

this to high-income people. They don't need the money. Some other people said Well, we probably shouldn't be giving this to low-income people because the Congress does need the money to do other things. Then other people said Well, if we're going to give this allowance as a tax credit, we want to make sure it doesn't reduce people's taxes down too low. After all, that's not a good idea—at least not for people with significant incomes. So, you ended up with a tax credit worksheet that I think is going to look a lot like what I've got up here in this poster.

You are going to spend the first third of the form—like you do with the dependent care credit now—finding out if these credits will take you down below what you'd owe under the alternative minimum tax. To figure that out, you'll have to compute the alternative minimum tax in many cases.

So we're going to have 27 to 28 million families faced with the possibility of filling out the minimum tax form just to determine whether they are allowed to take the new \$500 child credit. Not all of them will have to fill out the whole thing. Some will be able to stop after awhile, but they'll be facing one of the most complex forms in the Tax Code for the first time—thanks to the legislation adopted last year.

Now once you get by the minimum tax—and by the way that provision actually affects only about half a million out of the 28 million people who will get the child credit, but of those 28 million, many million will have to fill it out—

Chairman JOHNSON of Connecticut. Excuse me, you mean the refundable part of it only—

Mr. MCINTYRE. No, we haven't got to the refundable part yet—we're doing nonrefundable. We're working our way down this form to the refundable section. Part 1 deals with the nonrefundable part of the credit and that's where the alternative minimum tax comes into play. If the credit turns out to be refundable, which it is for larger families, then you don't have to worry as much about the alternative minimum tax, although there can be interactions where it will become part of your calculation.

Once you have determined the nonrefundable issues which involve the alternative minimum tax, then you have to write down all of your different tax credits separated out between nonrefundable, personal credits and the other kinds of credits that are nonrefundable, but aren't called nonrefundable for purposes of section 26 of the Tax Code and the alternative minimum tax. That's largely the foreign tax credit, which involves people who get a dividend from a foreign corporation or something like that, although there are certain business credits that fall into this category.

Having listed those credits in separate baskets, you then go on to start computing. Of course, it depends whether you have two kids or three which route you will take on the form. If you have three children or more, you may find the credit is refundable but you then need to calculate the sum of your income tax limit in the earlier section plus your FICA taxes minus the earned income tax credit, and other credits that you didn't deduct before in computing the other limit. If that turns out to be bigger than your limit under the first calculation, which is the nonrefundable limit, that portion

may be refundable to you. Therefore you can get your taxes down in some cases quite low.

On the other hand, at least as adopted in the 1997 bill, there's been some technical corrections proposed which have not yet been adopted which are different, if you would fall into the nonrefundable situation, but that limit, because of a foreign tax credit, is greater than your limit as computed under the refundability portion which normally would not apply to you as a family with only two children or less, you may find part of the credit to be refundable. At least that's the statute that was passed.

So I'm figuring that this probably—and I'll be filling out this credit form next year—is even more complicated than last year's new capital gains form. It's also going to be filled out by a lot more taxpayers.

Most of these complex things were enacted with good intentions—most of them, not all of them. I think the so-called supplemental credit was put in for some mean-spirited reasons. But most of it was done for ostensibly good reasons. Yet all this complexity turns out not to amount to much except as complexity, and probably could be dispensed with to a large degree—if you treated simplification as an important item on the agenda. I hope you do. I hope that as you move forward to deal with other tax legislation, that you also hire somebody on the Joint Tax Committee as the Tax Simplification Monitor and find out what these tax forms are going to look like before you pass another piece of legislation that turns out to be as monstrous as this one has turned out to be. Thank you.

[The prepared statement follows. The attachments are being retained in the Committee files.]

**Statement of Robert S. McIntyre, Director, Citizens for Tax Justice**

Today's topic before the Subcommittee is tax complexity. A comprehensive discussion of this issue would, by necessity, address the hundreds of billions of dollars worth of provisions that have been put into the tax code for reasons extraneous to fair and efficient tax collection—generally to encourage behavioral changes or simply to reward certain activities or taxpayers. As long-time advocates of a simpler, fairer tax system, we at Citizens for Tax Justice have written and testified extensively on this topic. See, for example, *The Hidden Entitlements* (1996), available from our office or at our web site, [www.ctj.org](http://www.ctj.org).

Today, however, I want to limit my remarks to a discussion of the rather extraordinary complexity introduced by one, seemingly innocuous new tax provision: the \$500 per child tax credit adopted in the 1997 Taxpayer Relief Act.

**THE \$500 CHILD CREDIT: A CASE STUDY IN COMPLEXITY**

The new child tax credit provision of the tax law had its genesis in the notion that every family in America should get a \$500 allowance for each of their children. But other considerations quickly emerged.

Some people didn't think that such an allowance made much sense for well-off families. Others argued that it shouldn't go to lower-income families either (in part based on cost considerations). And because the \$500 allowance was conceived from the beginning as a tax credit—apparently so it could be described as a (praiseworthy) tax cut rather than a (wicked) spending increase—many worried about excusing large families with significant incomes from paying any income tax at all.

As a result of all these conflicting goals, we now have a child tax credit that will require potentially qualifying taxpayers to fill out not only a new child-credit tax form, but also an extremely complicated new worksheet and in some cases the Alternative Minimum Tax form—a combination often even more complex than the much-bemoaned new capital gains tax calculation form also mandated by the 1997 tax act.

The new child credit form itself will probably not be hugely complex, and I will not dwell on it here. Essentially, the new form will require taxpayers to list and

count their children age 16 and under, multiply that amount by \$500 (\$400 for tax year 1998) and, if necessary, apply the income phase-out rules at higher income levels.

The real complexity of the new child credit arises when it comes to the “worksheet” that must be completed to calculate various other limits on the credit and to determine whether it is refundable or non-refundable. In broad strokes, this worksheet is designed (1) so that the credit cannot reduce tax liability below what would be owed under the Alternative Minimum Tax for families with one or two children, and (2) for larger families, so the credit cannot exceed combined income and FICA tax liability less the earned-income tax credit.

I have devised an example of a new child credit limit worksheet, based on the statutory goals it must accomplish. The new worksheet can be combined with the old 10-line credit-limit worksheet for the dependent care credit, with the addition of 18 new lines. I’ve attached a representation of such a new worksheet, along with several examples of filled-income worksheets by taxpayers in different situations.

Here is a brief line-by-line explanation of what taxpayers will face in completing the new child credit (and dependent care credit) limit worksheet:

Lines 1–11 of the new worksheet are based on the design of the current dependent care credit limit worksheet. The purpose is to limit certain non-refundable tax credits, mainly the dependent care credit and the new child credit, so that they do not reduce tax liability below what would be owed under the Alternative Minimum Tax (AMT). To calculate their credit limits, taxpayers claiming the dependent care credit and/or the \$500 child credit must fill out either the complex AMT form (a copy is attached) or in some cases a shortened version of the AMT computation provided on the credit limit worksheet itself.

Because of its fairly large exemption—\$45,000 for couples and \$33,750 for unmarrieds—the AMT doesn’t actually affect many child credit claimants (even if they do have to fill out the form). But some middle-income couples with lots of children may find that the AMT can limit the amount of dependent care credit and child credit they’re allowed to take—although generally only because their taxes are very, very low. The effects of this rule on the \$500 child credit, however, are substantially mitigated by the refundable rule for families with more than two children. See example 7.

Lines 12–14 of the new worksheet list other non-refundable credits that come into play in calculating the limits on the \$500 child credit. It should be noted that the foreign tax credit and certain business credits are treated differently than other non-refundable credits in calculating the limit on the \$500 child credit for families with one or two children. In effect, some families who have these kinds of credits may be eligible for a partially or fully refundable child credit, while families with similar amounts of other types of non-refundable credits would not be eligible for a refundable child credit. See example 6. One rationale for special treatment of the foreign tax credit may be the principle that we do not intend to tax foreign income twice.<sup>1</sup>

Oddly, for families with 3 or more children, it is sometimes advisable not to claim an otherwise claimable foreign tax credit or business credit, because these credits do affect refundability of the \$500 child credit under the alternative limit calculation (limit B). Not many taxpayers take the foreign tax credit, but for those who do, making this determination will probably require professional assistance. See example 4.

Lines 15–20 compute the \$500 child credit under limit B, which can generate a refundable credit. For families with three or more children, the portion of the credit that is refundable is equal to the excess of the sum of the regular non-refundable credit limit and FICA taxes, less the earned-income tax credit, over credit limit A (see below). Although generally, these calculations are applicable only to families with three or more children, they can also be necessary for taxpayers with one or two children who also have foreign tax credits or certain business credits.<sup>2</sup>

Line 21 calculates the \$500 child credit under limit A. Under this limit, the child credit cannot reduce taxes (after other non-refundable credits, such as the dependent care credit) below what would be owed under the Alternative Minimum Tax. The credit computed under limit A is generally a non-refundable credit, but if the limit calculated here is bigger than the amount computed under limit B, then the

<sup>1</sup>Different technical corrections included in the pending House and Senate IRS restructuring bills rewrite this refundability rule, and appear to make it inoperative for families with fewer than three children and largely meaningless, albeit still quite complicated, for larger families.

<sup>2</sup>See footnote 1.

excess will be refundable. Generally, this only affects taxpayers with foreign tax credits. See example 6.<sup>3</sup>

Lines 22–26 get to the final child tax credit, parsing it between non-refundable and refundable portions. This distinction does not always matter, but often will, especially for families with large numbers of children.

#### LESSONS FROM THE COMPLEXITY OF THE CHILD CREDIT

So there we have it. An apparently simple idea—to give every family \$500 for each child—has been transformed into one of the more complicated items in the tax code from the point of view of affected tax filers.

What can we learn from this? For one thing, it illustrates the danger, even folly, of trying to implement non-tax policies through the tax code. Our instinctive insistence that tax laws be fair makes it difficult to use the tax code for non-tax policy purposes without adding much more complexity than a direct spending program would typically entail. Similar criticisms, of course, can be leveled at many other tax-based spending programs, including many adopted in last year's tax act.

Of course, even a tax code that is limited as much as possible to the goal of collecting enough revenue to pay for government programs fairly and efficiently will have some complexity. Business taxation, in particular, will always be complicated, both because of the inherent complexity of business itself and because overly simple rules can often be gamed by aggressive taxpayers. Tax proposals that pretend otherwise, such as the flat tax, are frauds.

But we can and should make our tax laws much simpler than they are today for the vast majority of taxpayers. Indeed, the tax code after the Tax Reform Act of 1986 was far simpler for most people than it had been. It is only in recent years that a bipartisan coalition of tax complexifiers has moved us so far away from the principle of tax simplicity.

Tax simplification, does not, by the way, require compromising progressivity. On the contrary, those who promote radical tax redistribution proposals like the flat tax or a national sales tax get in the way of true simplification. It's not just that these half-baked proposals are actually far more complex than advertised. More important, middle-and low-income voters are not likely to tolerate paying a much larger share of the tax burden than they do now in the name of simplicity (as the single rate plans would necessarily require). The recent, widely criticized House vote to abolish the tax code without naming a replacement illustrates the widespread understanding by members of Congress of the politically disastrous nature of these flat-rate proposals.

Although recent history makes one wary, the right kind of comprehensive, progressive tax reform remains an excellent idea. Proposals like Representative Gephardt's plan show that it is at least theoretically possible. In the meantime, members of the tax-writing committees ought to focus more on using the tax code for its primary purpose of raising revenue fairly, rather than as a tool of economic and social policy. Or if that's a pipe dream in the short run, then what Congress wrought in enacting last year's child credit should at least encourage taxwriters to pay a lot more attention to complexity issues when they pass tax laws.

Chairman JOHNSON of Connecticut. Thank you, Mr. McIntyre. Just for the record, you probably are aware that in the IRS reform bill, we do include in the Conference Committee, as we write tax legislation a member of the IRS—a tax expert from the IRS—so that we can try to avoid this kind of problem in the future to a far greater extent than we have in the past. There's a famous story about 2 lines of pension law that result in 1,000 pages of regulations. So I am very interested to—I was not aware that the child credit had resulted in such extraordinary complexity. In the testimony of the earlier panel, it's very clear that reverberations on this are families through the alternative minimum tax mechanism. I'd like to recognize Michael Mares from the American Institute of Certified Public Accountants.

<sup>3</sup>See footnote 1.

**STATEMENT OF MICHAEL MARES, CHAIR, TAX EXECUTIVE COMMITTEE, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS**

Mr. MARES. Thank you and good afternoon, Madam Chair and Members of this distinguished Subcommittee.

The AICPA has long been an advocate of tax simplification. Tax law complexity helps create perceptions of unfairness, difficulty of administering the laws, it increases compliance cost, and it interferes with economic transaction decisions. The end result of this is an erosion of voluntary compliance. To maintain a voluntary tax system that's viable, simplification must have a prominent position in the tax process. Although it should not necessarily take precedence over revenue and tax policy objectives. While a tax system that is simple for all taxpayers may never be designed, simplification must be an integral part of the system both from the legislative and regulatory process, as well as from the administrative process.

We believe at least four elements are necessary to create a simpler tax system—both through new legislative proposals and a review of existing law. First, there must be a visible constituency. That constituency must communicate the need for simplification to Congress and to the administration. Next, guiding principles for tax simplification must be identified followed by factors that contribute to complexity must also be identified. Finally, simplification must be considered at all stages of the process. I will spend the rest of my time discussing specific areas of complexity, particularly the alternative minimum tax, or AMT.

The AMT is one of the most complex parts of our tax system. Among its numerous complexities is the maintenance of a number of supplementary schedules for many years to allow the computation of future AMT items as the adjustments and preferences turn around. This complexity also calls into serious question the ability of the IRS to audit compliance with the AMT. Unfortunately several items enacted in the Taxpayer Relief Act of 1997 will have a dramatic impact on the number of individuals who will find themselves shifting to the alternative tax system. Many of these have been previously discussed in prior testimony. For many this will be a shock and in all likelihood will cause further problems for the IRS, which will have to dedicate significant resources to ensure compliance, educate taxpayers, and handle taxpayers' questions.

We wish we had the answer to the problem, but we recognize there is no simple solution given the likely revenue loss to the government. As a start, however, Congress should consider first, indexing the AMT brackets and exemption amounts. Then allowing some or all of an individual's itemized deductions and personal exemptions as adjustments to regular taxable income in arriving at AMT. Third, Congress could eliminate many of the AMT preferences by reducing for all taxpayers the regular tax benefits of some AMT preferences. For example, extending regular depreciable lives.

Next Congress should consider allowing certain regular tax credit against AMT such as the child credit, or the education credit as had been mentioned earlier. Providing an exemption for AMT for low- and middle-income tax payers with regular, taxable adjusted

gross income of less than \$100,000 would go a long way toward alleviating many of the problems discussed. Finally, and perhaps most importantly, Congress should consider the impact of alternative minimum tax on all future tax legislation.

Due to the increasing complexity, compliance problems and a perceived lack of fairness toward the intended target, an additional alternative Congress might also want to consider is repealing the individual AMT altogether. Hidden tax breaks are another result of the complexity added to our tax laws over the past decade. The phaseouts of itemized deductions, personal exemptions, IRA deductions are examples of provisions which increase the effective tax rate individuals pay. Since married filing separate taxpayers are denied many deductions outright, their effective tax rate is even higher. Instead of a straightforward tax rate increase, Congress has used back-door approaches such as phaseouts and limitations to raise the effective tax rate on high-income individuals.

Under section 179, taxpayers may elect to treat the cost of certain qualified property as an expense rather than a capital asset. For each dollar of section 179 expense—in excess of the \$200,000 cap—the maximum amount of deduction will be reduced by each dollar. Since the maximum deductible amount is being increased from \$17,525, we believe the \$200,000 cap should also be raised incrementally to be consistent. It also is equitable. It would also assist small businesses to take advantage of this particular election.

In today's world, one piece of machinery or even several pieces of machinery can easily exceed this limit. We would be happy to work with you on any specific proposals as this Congress moves forward in this complex area that deserves careful analysis and consideration. We thank you for this opportunity to present our comments and suggestions on simplifying the tax law. I will be happy to answer any questions you may have.

[The prepared statement and attachment follow. Additional attachments are being retained in the Committee files.]

**Statement of Michael Mares, Chair, Tax Executive Committee, American Institute of Certified Public Accountants**

INTRODUCTION

Good morning, Madam Chair, and members of this distinguished Subcommittee. We appreciate this opportunity to testify today on simplification, individual alternative minimum tax (AMT), tax rates and phase-outs. I am Michael Mares, Chair of the Tax Executive Committee of the American Institute of Certified Public Accountants (AICPA). The AICPA is the national professional organization of CPAs, with more than 331,000 members. Many of our members are tax practitioners who, collectively, prepare income tax returns for millions of Americans.

SIMPLIFICATION

The AICPA has long been an advocate of simplification of the tax system. The complexity of our tax law has reached the point where many taxpayers and practitioners believe that it is undermining voluntary compliance. Frequent change, the lack of deliberation in the legislative process, and the increasing magnitude and complexity of the Internal Revenue Code are our principal concerns. The following significant problems result from existing tax complexity:

- *Perceptions of unfairness.* The tax law is perceived by many as unfair.
- *Difficulty of administration.* It is difficult for the Internal Revenue Service to administer the tax law.
- *Compliance costs.* The cost of compliance for all taxpayers is increased. Of particular concern are the many taxpayers, especially those with unsophisticated financial affairs who are forced to seek professional tax return-preparation assistance.

- *Interference with economic transactions.* Complexity interferes with economic decision making.

The end result is erosion of voluntary compliance. Taxpayers and tax practitioners simply find it harder to understand and comply with the tax law.

To maintain a viable voluntary tax system, simplification must have a prominent position in the tax process, although it should not take precedence over revenue and tax policy objectives. While a tax system that is simple for all taxpayers may never be designed, simplification must be an integral part of the tax legislative, regulatory, and administrative process.

#### *What is Needed*

At least four elements are necessary to create a simpler tax system, both through new legislative proposals and a review of existing tax law:

- A visible constituency must communicate the need for simplification to Congress and the Administration.
- Guiding principles for tax simplification must be identified.
- Factors that contribute to complexity must be identified. This will lead to development of a framework for analyzing the balance among equity, policy, revenue, and simplification objectives.
- Simplification must be considered at all stages of the legislative process. The process itself must provide thorough consideration of tax proposals, including simplification issues.

#### *Guiding Principles and Factors that Result in Complexity*

We believe the guiding principles in pursuing a simpler tax law are:

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

We also must recognize that the following factors create complexity:

- The effects of change;
- Subjectivity;
- Lack of consistent concepts;
- Structural complexity;
- The effect on taxpayers not targeted by a particular provision;
- Forms;
- Administrative issues;
- Transactional application and business dynamics;
- Diffusion of responsibility;
- Inconsistent application of rules; and
- The legislative process.

One approach to evaluating these factors is the use of the attached complexity index. Assistance in evaluating a proposal's contribution to simplification or complexity is needed. There must be a framework for considering tax legislative proposals. It is not sufficient to merely develop tools for measuring a proposal's effect on the complexity of the law. Procedures should be adopted to ensure that the tools are used and that the information obtained is formally considered in the process.

The AICPA has drafted and proposed many simplification proposals targeting specific areas of the tax law, including AMT, phase-outs, and rates, which are covered in our testimony. In addition, we have drafted individual tax simplification proposals for: the earned income tax credit, capital gains tax, estimated tax safe harbor, kiddie tax, education IRAs, underpayments, charitable contributions, mileage allowance, domestic relations, and interest expense; as well as various small business tax simplification proposals for: section 179 expensing, self-employed health insurance premium deduction, employee versus independent contractor, and the half-year requirements. We have included these proposals at the end of our testimony. Please feel free to review the attached proposals for further details on these issues.

## BACKGROUND ON AMT

Our tax laws give special treatment to certain types of income and allow special deductions for certain expenses. These laws enable some taxpayers with substantial economic income to significantly reduce or eliminate their regular tax. The purpose of the AMT is to ensure that these taxpayers pay a minimum amount of tax on their economic income.

## COMPLEXITY OF AMT

The AMT is one of the most complex parts of the tax system. Each of the adjustments of Internal Revenue Code (IRC) section 56, and preferences of IRC section 57, requires computation of the income or expense item under the separate AMT system. The supplementary schedules used to compute many of the necessary adjustments and preferences must be maintained for many years to allow the computation of future AMT as items “turn around.”

Generally, the fact that AMT cannot always be calculated directly from information on the tax return makes the computation extremely difficult for taxpayers preparing their own returns. This complexity also calls into question the ability of the Internal Revenue Service (IRS) to audit compliance with the AMT. The inclusion of adjustments and preferences from “pass through” entities also contributes to the complexity of the AMT system.

## EFFECTS OF THE TAXPAYER RELIEF ACT OF 1997 AND AMT ON INDIVIDUAL TAXPAYERS

Several items enacted in the Taxpayer Relief Act of 1997 will have a dramatic impact on the number of individuals who will find themselves shifting to the alternative minimum tax (AMT) system in addition to being subject to tax under the regular tax system. For many, this will come as a real surprise and, in all likelihood, will cause substantial problems for the IRS, which will have to redirect significant resources to this area in the future to ensure compliance, educate taxpayers, and handle taxpayer questions.

In fact, John Scholz, Deputy Assistant Secretary in the Treasury Tax Policy Analysis Office, has stated that the number of taxpayers subject to the AMT (which is currently less than one percent) is expected to escalate 30 percent a year for at least ten years. He noted that the trend will mean eight percent of United States taxpayers, or 11 million individuals, will be subject to AMT by 2007. One point to keep in mind—11 million individuals will actually have to pay the AMT, how many million more will have to fill out the complex Form 6251 to show they do *not* owe it?

Most sophisticated taxpayers understand that there is an alternative tax system, and that they may sometimes wind up in its clutches; unsophisticated taxpayers may never have even heard of the AMT, certainly do not understand it, and do not expect to ever have to worry about it. Unfortunately, that is changing—and fairly rapidly—since a number of the more popular items, such as the education and child credits that were recently enacted, offset only regular tax and not AMT. Due to these changes, we believe it is most important that Congress obtain information (from Treasury, the Joint Committee on Taxation staff, or OMB) not only as to the revenue impact of the interaction of all these recent tax changes with the AMT, but also of the likely number of families or individuals that will be paying AMT as a result of 1997's tax legislation.

Specifically, taxpayers' situations will be exacerbated by the following.

1. The child tax credit is not available against the AMT. Thus, middle-income taxpayers will see their regular tax go down by \$500 or more (depending upon the number of dependent children), but their AMT potential liability will not be reduced at all.

2. Under the Hope tuition tax credit, middle-income families receive up to a \$1,500 credit, per eligible student, for regular tax purposes, though none of the credit is available against AMT. The same is true of the Lifetime Learning Credit, with a maximum \$1,000 credit through 2002, and \$2,000 credit thereafter. These credits alone will generate a substantial number of new AMT filers. With one or more children in college and others at home under 17 years of age, the result is a large group of taxpayers who would, under no circumstances, be considered rich, but who will now be paying the alternative minimum tax.

For example, a couple with a teenage child (\$400 child care credit), a child in the first year of college (\$1,500 Hope Scholarship Credit), and a child in the last year of college (\$1,000 Lifetime Learning Credit), with total earnings of \$65,000; \$3,000 of interest and dividends; \$500 each IRA deductions; a standard deduction of \$7,100 and \$13,500 of personal exemptions would have a net regular tax liability of \$4,587

(\$7,487 tax, less \$2,900 credits), but because of AMT would lose the benefit of \$1,133 of those credits. (See the attached Appendix E for further details.)

Another example (also in Appendix E) is a head of household taxpayer, earning \$45,000; with \$500 interest and dividends; a \$750 IRA deduction; \$6,250 of standard deduction, and \$8,100 of personal exemptions for herself, one child with a \$1,500 Hope Scholarship Credit and one child with a \$1,000 Lifetime Learning Credit. This taxpayer loses \$800 of credits due to the AMT.

#### INDEXING THE AMT BRACKETS AND EXEMPTION

While the AICPA has not undertaken detailed studies, anecdotal examples (such as those in our attached Appendix E) indicate the likelihood that taxpayers with adjusted gross incomes in the \$60,000-\$70,000 range (or below) will be subject to AMT. Aside from the fairness issues involved—this is not the group that the AMT has ever been targeted to hit—we see some potentially serious problems of compliance and administration. Many of these taxpayers have no idea that they may be subject to the AMT (if, indeed, they are even aware that there *is* an AMT). Thus, we anticipate large numbers of taxpayers not filling out a Form 6251 or paying the AMT who may be required to do so, thus requiring extra enforcement efforts on the part of the IRS to make these individuals (most of whom will be filing in absolute good faith) aware of their added tax obligations. Further, IRS notices to these taxpayers assessing the proper AMT may well be perceived as unfair, subjecting the IRS to unfair criticism that should be directed elsewhere.

#### INDIVIDUAL AMT RECOMMENDATIONS

We wish we had “the” answer to the problem, but recognize there is no simple solution given the likely revenue loss to the government. As a start, however, Congress should consider:

- Indexing the AMT brackets and exemption amounts.
- Eliminating itemized deductions and personal exemptions as adjustments to regular taxable income in arriving at alternative minimum taxable income (AMTI) (e.g., all—or possibly a percentage of—itemized deductions would be deductible for AMTI purposes).
- Eliminating many of the AMT preferences by reducing for all taxpayers the regular tax benefits of AMT preferences (e.g., require longer lives for regular tax depreciation).
- Allowing certain regular tax credits against AMT (e.g., low-income tax credit, tuition tax credits).
- Providing an exemption from AMT for low and middle-income taxpayers with regular tax AGI of less than \$100,000.
- Considering AMT impact in all future tax legislation.

Due to the increasing complexity, compliance problems, and a perceived lack of fairness towards the intended target, an additional alternative Congress might also want to consider is eliminating the individual AMT altogether.

#### CONTRIBUTION TO SIMPLIFICATION OF AMT

The goal of fairness that is the basis for AMT has created hardship and complexity for many taxpayers who have not used preferences to lower their taxes but have been caught up in AMT’s attempt to bring fairness. Many of these individuals are not aware of these rules and complete their return themselves, causing confusion and errors. The 1997 law and the impact of inflation on indexed tax brackets and the AMT exemption are causing more lower income taxpayers to be inadvertently subject to AMT. Recommendation 1 of indexing the AMT brackets and exemption would solve this problem.

Under recommendation 2, those individuals who are affected only by itemized deductions and personal exemption adjustments would no longer have to compute the AMT. Itemized deductions are already reduced by the 3 percent AGI adjustment, 2 percent AGI miscellaneous itemized deduction disallowance, 7.5 percent AGI medical expense disallowance, \$100 and 10 percent AGI casualty loss disallowance, and the 50 percent disallowance for meals and entertainment. Similarly, the phase out of exemptions already affects high income taxpayers. It is also worth noting that because state income taxes vary, taxpayers in high income tax states may incur AMT solely based on the state in which they live, while other taxpayers with the same adjusted gross income (AGI), but who live in states with lower or no state income taxes, would not pay AMT.

In addition, under recommendation 3, many of the AMT preferences could be eliminated by reducing for all taxpayers the regular tax benefits of present law AMT

preferences (e.g., require longer lives for regular tax depreciation). This would add substantial simplification to the Code, recordkeeping and tax returns. Under recommendation 4, those who are allowed regular tax credits, such as the low income or tuition tax credits, would be allowed to decrease their AMT liability by the credits. This would increase simplicity and create fairness. Compliance would be improved.

Under recommendation 5, fewer taxpayers will be subject to AMT and the associated problems. By increasing the AMT exemption to exclude low and middle income taxpayers, the AMT will again be aimed at its original target—the high-income taxpayer.

By eliminating AMT altogether, all the individual AMT problems would be solved.

#### CONCLUSION ON AMT

In conclusion, we see AMT as becoming more prevalent and causing considerable disillusion to many taxpayers who do not see themselves as wealthy and who will believe they are being “punished” unfairly. AMT will apply to many taxpayers it was not originally intended to affect. We believe our proposals offer a wide range of ways to help reduce this problem.

#### HIDDEN TAX RATES

Hidden tax rates are a result of the complexity added to our tax laws over the last decade. The phase-outs of itemized deductions, personal exemptions, and IRA deductions are examples of hidden rates which add to the effective tax rate individuals pay. In addition, the limitation on deductions, such as 7.5 percent of AGI for medical expenses, 2 percent of AGI for miscellaneous itemized deductions, and 10 percent of AGI for casualty losses increases the effective tax rate for many individuals. Since married filing separate taxpayers are denied many deductions, their effective tax rate is even higher. There has been a reluctance by Congress to raise tax rates to achieve progressivity. Instead of a straight forward rate increase, Congress has used backdoor approaches, such as, phase-outs and limitations to raise the effective tax rate on high-income individuals. A chart detailing many of the phase-outs in current law is attached.

For example, under current law, if an individual’s adjusted gross income exceeds a certain level, otherwise allowable itemized deductions are reduced. Likewise, the personal exemption amount for a taxpayer whose adjusted gross income exceeds a specified threshold is reduced. The goal of these measures is to increase the progressivity of the tax system by having high income taxpayers pay a greater tax burden. However, the same results could be achieved through adjusting the top tax rate. It is our understanding that H.R. 4053, recently introduced by Representatives Rangel and Neal, would simplify and repeal the phase-outs on itemized deductions and personal exemptions, and would replace them with a straight forward rate increase. We support such an approach.

The impact of new or complex tax laws and complicated phase-outs must be considered when tax legislation is enacted. Congress should actively strive for simplification and stability. Tax law complexity originates with the statutes. Higher than advertised effective tax rates result from limiting provisions throughout the Code to certain taxpayers, instead of simply increasing tax rates. Tax law complexity is the result. The phase-outs are the clearest example of hidden tax rates, so we have concentrated the remainder of our testimony on them.

#### BACKGROUND ON PHASE-OUTS BASED ON INCOME LEVEL

Numerous sections in the tax law provide for the phase-out of benefits from certain deductions or credits over various ranges of income based on various measures of the taxpayer’s income. There is currently no consistency among these phase-outs in either the measure of income, the range of income over which the phase-outs apply, or the method of applying the phase-outs. Furthermore, the ranges for a particular phase-out often differ depending on filing status, but even these differences are not consistent. For example, the traditional IRA deduction phases out over a different range of income for single filers than it does for married-joint filers; whereas the \$25,000 allowance for passive losses from rental activities for active participants phases out over the same range of income for both single and married-joint filers. Consequently, these phase-outs cause inordinate complexity, particularly for taxpayers attempting to prepare their tax returns manually; and the instructions for applying the phase-outs are of relatively little help. See the attached Appendices A and B for a listing of most current phase-outs, including their respective income measurements, phase-out ranges (for 1998) and phase-out methods.

Currently, many of the phase-out ranges for married-filing-separate (MFS) taxpayers are 50 percent of the range for married-filing-joint (MFJ), while many of the phase-out ranges for single and head of household (HOH) taxpayers are 75 percent of married-joint. That increases the marriage penalty as the spouses' incomes become equal.

#### RECOMMENDED CHANGE TO THE PHASE-OUTS

Simplicity can be achieved by eliminating phase-outs altogether. However, if that is considered either inequitable (simplicity is often at odds with equity) or bad tax policy, significant simplification can be achieved by providing consistency in the measure of income, the range of phase-out (including as between filing statuses) and the method of phase-out.

Instead of the 20 or so different phase-out ranges (shown in attached Appendix C), there should only be three phase-out ranges for low, middle, and high income taxpayers.

If there are revenue concerns, the ranges and percentages could be adjusted, so long as the phase-outs for each income level group (i.e., low, middle, high income) remained consistent for all relevant provisions. In addition, the "marriage penalty" impact should be considered in adjusting phase-out ranges for revenue needs.

We have proposed that, to eliminate the marriage penalty and simplify the Code, all phase-out ranges for married-filing-separate (MFS) taxpayers would be the same as those for single and head of household (HOH) taxpayers, which would be 50 percent of the range for married-filing-joint (MFJ) range.

The benefits that are specifically targeted to low-income taxpayers, such as the earned income credit, elderly credit, and dependent care credit, would phase-out under the low-income taxpayer phase-out range. The benefits that are targeted not to exceed middle income levels, such as the traditional IRA deduction and education loan interest expense deduction, would phase-out under the middle-income taxpayer phase-out range. Likewise, those benefits that are targeted not to exceed high income levels, such as the new child credit, new education credits and IRA, and the new Roth IRA, as well as the existing law AMT exemption, itemized deductions, personal exemptions, adoption credit and exclusion, series EE bond exclusion, and section 469 \$25,000 rental exclusion and credit, would phase-out under the high-income taxpayer phase-out range. See the chart below.

Additionally, instead of the differing methods of phase-outs (shown in attached Appendix D), the phase-out methodology for all phase-outs would be the same, such that the benefit phases out evenly over the phase-out range. Every phase-out should be based on adjusted gross income (AGI).

Proposed Income Level Range for Beginning to End of Phase-Out for Each Filing Status

Category of Taxpayer	Married Filing Joint	Single & HOH & MFS
LOW-INCOME .....	\$15,000–\$37,500	\$7,500–\$18,750
MIDDLE-INCOME .....	\$60,000–\$75,000	\$30,000–\$37,500
HIGH-INCOME .....	\$225,000–\$450,000	\$112,500–\$225,000

#### CONTRIBUTION TO SIMPLIFICATION OF PHASE-OUTS

The current law phase-outs complicate tax returns immensely and impose marriage penalties. The instructions are difficult to understand and the computations often are difficult to do manually. The differences among the various phase-out income levels are significant. True simplicity could easily be accomplished by eliminating phase-outs altogether. However, if that is not feasible, for whatever reason, significant simplification can be achieved by creating consistency in the measure of income, the phase-out range (including as between filing statuses) and the phase-out methodology. The phase-outs should be eliminated by adjusting rates, or by applying the phase-outs to consistent ranges, using a consistent methodology. This would ease the compliance burden on many individuals. If there were only three ranges to remember and only one methodology, it would be a lot simpler and easier to recognize when and how a phase-out applies. Many portions of numerous Internal Revenue Code sections could be eliminated. By making the MFJ phaseout ranges double the ranges applicable to single individuals and making the MFS ranges the same as single individuals, the marriage penalty attributable to phase-out ranges would be eliminated.

## EXPENSING DEDUCTION

Under section 179, taxpayers may elect to treat the cost of qualifying property as an expense rather than a capital asset. Section 179 will be gradually increased to \$25,000 by year 2003. This section restricts the amount of the election in circumstances where the taxpayer places into service qualifying property in excess of \$200,000. For each dollar of section 179 property in excess of \$200,000, the maximum credit (\$18,000 for 1997) will be reduced by one dollar. We suggest the maximum deductible amount is being increased from \$17,500 to \$25,000. The \$200,000 limit should also be raised in increments to stay even. It would be equitable. Plus, it assists small businesses to be able to take advantage of this election. In today's world, one piece of machinery or several pieces of equipment can easily exceed this limit.

## CONCLUSION

We would be happy to work with you on specific proposals as this Congress moves forward in this complex area that deserves careful analysis and consideration. The AICPA again thanks you for this opportunity to present our comments and suggestions on simplifying AMT, tax rates and phase-outs.

Chairman JOHNSON of Connecticut. Thank you very much. You should know that actually the accountants, 2 years ago, developed some simplification proposals and brought them around to their members. That really is the ground of which this hearing grew. I appreciate your input very much, and particularly the detail in your testimony.

Mr. Weinberger.

**STATEMENT OF ROBERT A. WEINBERGER, VICE PRESIDENT,  
GOVERNMENT RELATIONS, H&R BLOCK; ACCOMPANIED BY  
ANITA EDWARDS, TAX PREPARER, H&R BLOCK**

Mr. WEINBERGER. Thank you, Madam Chair, and Members of the Subcommittee. I'm Bob Weinberger, vice president for government relations at H&R Block. I'm part of the team that prepared the 10 simplification suggestions we submitted in 1997 and 1998. With me this afternoon is Anita Edwards, from Olney, Maryland, who's been an H&R Block tax preparer for the past 22 years and who can join me in responding to your questions.

Just a brief word about H&R Block. We're the Nation's largest tax preparation company. At our 8,800 offices throughout the country, we handle 15.6 million individual returns—which is about 1 out of every 7 received by the IRS. That works out to about 36,000 per congressional district. We also do over half the electronic returns that practitioners filed with the IRS and produce tax software in the form of Kiplinger's TaxCut.

I have four points that I want to stress today before addressing particular changes.

The first is that simplicity is often offset by other important objectives for a tax system such as fairness, enforceability, economic efficiency and incentives for saving and economic growth.

One brief example is the adoption credit. It is thought widely to be good public policy but it adds complexity to the Code. It trades off simplicity for a valuable social policy goal.

Second, preparing tax returns is relatively simple for most Americans, although recent laws are making returns more complex. Complexity is concentrated on high-income and business taxpayers.

This is a point which I think is important to make to give the discussion about complex provisions some context.

Millions of Americans are below the filing threshold. Of the 124 million who do file, about 52 million or 42 percent either file a 1040-EZ or a 1040-A form, both of which are relatively simple. Twenty-six million of them are able to file by a telephone through the IRS TeleFile Program. Over 70 percent of taxpayers take the standard deduction and do not itemize. For these taxpayers, the tax system is still relatively simple.

The burden of complexity focuses on business filers, especially on small businesses, on those who are self-employed, and on high-income individuals who itemize and have income from passive activities or in the form of capital gains, dividends, rents, and pension and annuity disbursements.

While over one-half of taxpayers do use a tax preparer, and complexity is certainly one reason, many taxpayers do so primarily to expedite their refund, which 70 percent receive, or to free more time for family or other pursuits. Many of us are capable of changing the oil in our car but find that paying someone to do it allows better use of our time.

That picture may be changing. The Taxpayer Relief Act of 1997 is a major culprit with complex capital gains and IRA changes and new credits with multiple phaseouts, although it does simplify taxes on home sales.

Similarly, the alternative minimum tax, forms now filled out by fewer than 1 percent of taxpayers, will be required of 6 to 8 percent in a decade. Many taxpayers who don't consider themselves wealthy but use credits for education, children or dependent care may be surprised to find themselves subject to the AMT.

But while these provisions are genuinely complex, they still affect a minority of taxpayers, albeit an increasingly significant and understandably vocal minority.

Third, the main reasons for complexity have little to do with progressive tax brackets. But they arise from defining income, rewarding congressionally favored activities, and meeting budget needs. A multirate structure may invite complicated tax minimization strategies and activities, but it is not a cause of complexity by itself. Most taxpayers simply look up their tax in a table or apply a formula.

There are other reasons for complexity which are in the province of the Committee. They involve tailoring or personalizing the tax system to individual circumstances. For example, the earned income tax credit would be less complex if it were less finely tuned to family circumstances. The simplest of taxes, a poll tax, which is one-size-fits-all is very unfair. So complexity may be a byproduct of achieving other goals like personalization that achieves fairness.

Also, Congress and the administration, for example, have increasingly turned to targeted tax cuts, credits and deductions as more attractive vehicles for programs than traditional spending through government agencies—which again adds complexity to the Tax Code.

Finally, much can be done to simplify the Code now even as we continue to debate and discuss wholesale reform or replacement.

We've submitted 10 suggestions to the Committee and 2 have been selected for today's discussion. I think they've received a fairly adequate discussion so far. I'll be happy to respond to questions on them. The points that we were asked to discuss are in the supplemental material which I submit for the record. They involve expensing computer software and the alternative minimum tax.

We look forward to working with the Subcommittee in making the tax system a simpler one and welcome your questions.

[The prepared statement and attachment follow. Additional attachments are being retained in the Committee files.]

**Statement of Robert A. Weinberger, Vice President, Government Relations,  
H&R Block**

Madam Chair and Members of the Subcommittee:

Thank you for the opportunity to discuss tax code simplification. I'm Robert Weinberger. I was part of the H&R Block team which prepared the ten simplification suggestions sent to the Ways & Means Committee and the Treasury Department in 1997 and 1998. With me is Anita Edwards from Olney, Maryland who has been an H&R Block tax preparer for the past 22 years and who can join me in responding to your questions.

ABOUT H&R BLOCK

H&R Block, founded in 1955 and headquartered in Kansas City, is the nation's largest tax return preparation company. Our 8,800 company-owned and franchised offices are located in every state. In 1998, we handled 15.6 million individual returns, which is about 36,000 per Congressional district and one in seven received by IRS. We originate over half the electronically-filed returns that the IRS receives from practitioners. Over 120,000 individuals take our tax training courses annually. Block Financial Corp. develops and markets Kiplinger TaxCut tax preparation software with over 1.5 million users. Other subsidiaries offer financial products and services including mortgage loans.

KEY POINTS

Before addressing the specific proposals, I'd like to make four points to put complexity in context:

- First, simplicity is often offset by other important objectives, like fairness;
- Second, while preparing tax returns is relatively simple for most Americans, recent laws are making returns more complex; complexity is concentrated on high-income and business taxpayers;
- Third, the main reasons for complexity have little to do with progressive tax brackets; they arise from defining income, rewarding favored activities, and meeting budget needs; and
- Fourth, much can be done to simplify the existing code even as we debate wholesale reform or replacement.

First, simplicity is only one of several goals for a good tax system and it is often balanced against other objectives such as fairness and progressivity, enforceability, economic efficiency, and incentives for savings and economic growth. For example, the adoption credit complicates the code but its supporters believe it represents the overriding objective of good social policy. Similarly, indexing capital gains for inflation, which has been proposed but not adopted and which Assistant Treasury Secretary Lubick calls "the mother of all complexity," has support from many advocates of simplicity because they believe not doing so is profoundly unfair. Simplicity gets traded off for other goals. What constituency there may be for simplification usually melts when revenue is needed or attractive changes are offered, however complex.<sup>1</sup>

<sup>1</sup>Simplicity in tax law is hard to achieve. As Judge Learned Hand wrote over a half century ago, "In my own case, the words of such an act as the Income Tax . . . merely dance before my eyes in a meaningless procession . . . cross-reference to cross-reference, exception upon exception—couched in abstract terms that offer no handle to seize hold of—[and] leave in my mind only a confused sense of some vitally important, but successfully concealed, purport, which it is my duty to extract, but which is in my power, if at all, only after the most inordinate expenditure of time." Cited in Panel Discussions on Tax Reform, House Committee on Ways & Means, 94th Congress, 1st Session (1975), p. 138.

Second, preparing tax returns is relatively simple for a majority of Americans. Without minimizing complexity, it should be kept in perspective. Millions of low-income Americans are below the filing threshold. Of 124 million taxpayers who do file, about 52 million, or 42%, are able to use simple Forms 1040EZ—including 26 million eligible to file by telephone—and 1040A. Only 29% of filers itemize deductions. One survey found that 45% of all taxpayers spend less than 10 hours per year on their taxes.<sup>2</sup> About 80% of income tax filers pay at or below the 15% marginal rate on taxable income; and two thirds pay less than a 10% effective rate on their AGI.

The burden of complexity is focused on businesses, especially small business (although some accounting and bookkeeping would be done anyway), and on high-income individuals, especially the self-employed, who itemize and have diverse sources of income in the form of capital gains, dividends, rent, and pension or annuity disbursements. While over half of taxpayers receive professional help—and complexity is one reason, many taxpayers do so primarily to expedite their refund—which 70% receive—or to free more time for family or other pursuits. Many of us are capable of changing the oil in our car, but find that paying someone to do it allows better use of our time.

That picture may be changing. The Taxpayer Relief Act of 1997 is a major culprit—with complex capital gains and IRA changes and new credits with multiple phaseouts, although it does simplify taxes on home sales. Similarly, the Alternative Minimum Tax forms now filed by fewer than 1% of taxpayers will be required of 6–8% in a decade.<sup>3</sup> Taxpayers who don't consider themselves wealthy but take large deductions for employee business expenses or use tax credits for education, children, or dependent care may be surprised to find themselves subject to the AMT. But while these provisions are complex, they still affect a minority of taxpayers, albeit an increasing, significant and understandably vocal minority.

Third, the main reasons for complexity are defining and measuring income, subsidizing Congressionally-favored activities, and squeezing or stretching tax provisions to fit budget needs. A multi-rate structure may invite complicated tax minimization strategies, but it is not a cause of complexity by itself since most taxpayers simply look up their tax in a table.<sup>4</sup> Complexity can arise from personalizing and tailoring tax laws to individual circumstances instead of one-size-fits-all—a poll tax, for example, is simple but unfair. The Earned Income Tax Credit could be less complex, but more unfair, if it were less finely tuned to family circumstances. Complexity can also arise from defining income. Taxing capital gains and wage income identically would simplify taxes, but it would also trade off other objectives such as creating incentives to invest.

Some complexity may be needed to maintain progressivity. And some may be needed to favor activity that Congress feels is in the public interest—such as child care, education, retirement savings, home ownership, charity, or business R&D.<sup>5</sup>

<sup>2</sup>Cited in Joel Slemrod and Jon Bakija, *Taxing Ourselves* (1996), p. 2. These comments rely on Professor Slemrod's July 12, 1995 testimony before the National Commission on Economic Growth and Tax Reform. "For the majority of Americans with an uncomplicated financial situation, the tax system is not all that burdensome . . . [M]ost of the cost of compliance of the individual income tax is borne by a fairly small fraction of taxpayers." Testimony, p. 8. See also Slemrod's chapter on simplification in Henry J. Aron and William G. Gale, eds., *Economic Effects of Fundamental Tax Reform* (1996), ch. 10, and David Bradford and Joel Slemrod, *Making Tax Choices* (1996), p. 16–17.

<sup>3</sup>See Joint Committee on Taxation, *Present Law and Issues Relating to the Individual Alternative Minimum Tax ("AMT")* (JCX-3-98), February 2, 1998, and *Description of Possible Proposals Relating to the Individual Alternative Minimum Tax ("AMT")* (JCX-48-98), June 22, 1998. The Taxpayer Relief Act of 1997 contained 36 retroactive changes, 114 changes effective August 8, 1997, 69 changes effective January 1, 1998, and 5 thereafter, 285 new sections and 824 amendments to the Code. It followed legislation in 1996 that made 600 other changes to the code. On average, since the enactment of the Internal Revenue Code, major tax legislation has been adopted every 18 months.

<sup>4</sup>Slemrod 1995 testimony, p. 11: "An oft-cited cause of tax complexity is the number of tax brackets. But here one must be careful. The number of tax brackets *per se* does not cause substantial complexity. One of the great red herrings during the debate over the Tax Reform Act of 1986 was that collapsing 14 tax brackets (15, for single filers) to three was an important simplification. This is nonsense, because once taxable income is computed, calculating tax liability from the tax tables is a trivial operation that is not perceptibly simplified by having fewer brackets [although a single bracket would simplify tax administration and withholding]." See also Aron and Gale, eds., *Economic Effects of Fundamental Tax Reform* (1996), p. 6.

<sup>5</sup>See Slemrod 1995 testimony, p. 2. Another reason deserves mention: the legislative process involves compromise, splitting the difference rather than choosing between competing versions, and pressured drafting that often adds complexity. This may explain the convoluted calculations that will be needed to take the child credit, especially for low-income families with 3 or more

Continued

Budget needs can also influence complexity—phaseouts and limits on eligibility are sometimes needed to fit the cost of tax provisions into funds available. Finally, Congress and the Administration have increasingly found “targeted” tax cuts, credits and deductions more attractive vehicles for programs than traditional spending through government agencies—which adds complexity, sometimes for good reasons.

Fourth, much can be done to simplify the current code now. We shouldn’t let the debate over more wholesale reform or replacement of the tax code detract from that important effort. That is why H&R Block forwarded ten modest suggestions for simplifying tax provisions that affect average taxpayers in 1997 and 1998.<sup>6</sup> We’re eager to cooperate in improving the existing code even as we participate in the longer-range dialogue about broader reforms.

Much can be done administratively. The IRS presently has a major effort underway to simplify forms and reduce the number of notices sent, an effort in which we have assisted. The Service deserves credit for its efforts to reduce the time and expense burdens of paperwork for tax compliance.

You’ve asked us specifically about two of our suggestions—permitting deductions of non-customized software in the year of purchase, and modifying or eliminating the individual AMT. Attached to my testimony are our 1998 Simplification Suggestions and expanded comments on the software and AMT proposals. With your permission, I’d like to submit them for the record along with more detailed examples of the effect of these laws that were developed by our Tax Training Department for hypothetical taxpayers.

#### SIMPLIFY DEDUCTIONS FOR BUSINESS SOFTWARE

We propose simplifying the purchase of non-customized software, up to a specified dollar limit, such as \$1,000, by allowing a full deduction in the year of purchase. This is a good example of a small change that will help millions of small business owners *and* the IRS. Current law dictates that most software of this type be amortized over 36 months. Common software for word processing, communications, and tax preparation is usually updated within that recovery period. This causes additional complexity in recordkeeping and tax preparation when the deduction, which is usually small, is claimed over several years. Many taxpayers are unaware of these rules and fail to comply. The revenue impact would be small since the costs are eventually written off anyway.

#### SIMPLIFY OR ELIMINATE THE AMT

We also propose eliminating the complex AMT for individuals or minimizing its impact by increasing the exemption and simplifying rules relating to depreciation and dependents. The existence of a second, parallel tax system to guarantee that no one escapes taxation completely because of tax preferences adds complexity and has the perverse effect of Congress giving benefits with one hand and taking them away with the other.

In general, AMT income is calculated by adding certain adjustment and preference items to regular taxable income. One unnecessarily complicated preference item is the difference between AMT depreciation and regular depreciation. AMT depreciation for nonresidential real property is based on a 40-year life and regular depreciation is based on a 39-year life. The difference is minuscule but must be calculated by the taxpayer with non-residential rental property.

I’ve submitted an example of the AMT effect on heads of households claiming the child credit, where someone earning \$75,000 may receive more benefit from the child credit than a similar taxpayer with earnings of \$60,000, and several examples showing the computations and paperwork involved. I’ve also submitted several AMT simplification alternatives.

We welcome the opportunity to work with your Subcommittee to improve the tax system.

children. For earlier examples from the Tax Reform Act of 1986, see Jeffrey H. Birnbaum and Alan S. Murray, *Showdown at Gucci Gulch* (1987).

<sup>6</sup>Our 1998 suggestions were prepared by a team in H&R Block’s Tax Training Department led by Rusty Wallower, our late Director of Tax Research and Information Delivery, and sent to members of the House Ways & Means and Senate Finance Committees on February 9, 1998. We sent follow-up correspondence March 13, 1998 and June 2, 1998 about the opportunity to amend the IRS Restructuring Bill (H.R. 2676) to permit use of a table in place of complex calculations required by the child credit provisions of the TRA. The additional information on software and AMT was prepared by a team in our Education Department led by Karen Yeager.

## Proposals for Eliminating Certain Tax Complexities

### SIMPLIFY DEDUCTIONS FOR BUSINESS SOFTWARE

#### *Proposal:*

Allow a direct deduction in the year of purchase of non-customized software up to a specified dollar limit (such as \$1,000).

#### *Reason:*

- *Often the costs of the software are relatively small.*

The requirement under section 167(f)(1) that software be depreciated over a 36 month period using a straight-line method can create a very small deduction. Proposed § 1.167(a)-14 states that the deduction is determined by amortizing the adjusted basis of the computer software using the straight line method described in § 1.167(b)-1 (except that its salvage value is treated as zero) and an amortization period of 36 months beginning with the month that the computer software is placed in service.

For instance, a \$99 software package would result in a \$33 deduction if placed in service in January.

- *Improve Compliance*

Many taxpayers are unaware of the requirement to amortize and out of ignorance fail to comply with the law.

#### *Benefits:*

- *Help small businesses*

Small businesses rely on purchased software to meet their business needs. Under § 167(f)(1) an expense for purchased software must be deducted over 36 months. If the software should meet the definition of section 197 property, the expense would have to be amortized over 15 years. The tax compliance costs and recordkeeping cost are additional burdens for the small business owner.

- *Reduces recordkeeping*

If the taxpayer can expense the item in the year of purchase, there is no need for maintaining records over three years.

- *Less paperwork*

Tax compliance adds additional forms and statements to the return such as Form 4562, Form 4797, and attachments.

- *Saves administration costs for the IRS*

Allowing an expense for business software in the year of purchase would save the IRS by reducing costs of input, handling, storage, and paperwork.

- *Increase Fairness*

Taxpayers who pay to have their tax returns prepared by a tax professional bear the additional burdens of compliance. The paid tax preparer will treat the expense properly while the taxpayer who prepares his or her own return may not understand these complicated rules and may deduct the entire cost in the year of purchase.

- *Simplicity*

Deducting software costs below a certain limit will make tax compliance simpler and easier.

#### EXAMPLE:

John Smith owns a small accounting business. In 1998, he purchased a tax software package for \$600 on January 2. He bought a word processing program for \$360 in March and a utility software package for \$99 in February.

In 1997, John purchased tax software for \$600.

#### *Effect on Tax Compliance:*

John must keep records on each of these purchases.

John would amortize the \$600 tax software package over 36 months. Under current law, he would be allowed a deduction of \$200 on his 1998 tax return. John records the amortized deduction on Form 4562 which he attaches to his tax return along with a required statement explaining the amortization. He must keep a worksheet for this asset to record what has been deducted and what is available for deduction in future years.

The word processing program (costing \$360) must be amortized over 36 months. In 1998, John would be allowed a deduction of \$100. Once again, John must keep records of his purchase and the deductions claimed. An entry would be made on Form 4562 to report and deduct the allowed expense and a statement would be attached to the return.

The utility software package (cost \$99) must be amortized over 36 months. John would be allowed a deduction of \$30 on his 1998 return, \$33 on the 1999 return, \$33 on the 2000 return, and \$3 on the 2001 tax return.

On the 1998 tax return, John may be allowed to deduct the unrecovered cost of the tax software he purchased in 1997 if he can prove that it is obsolete. He must file Form 4797 to deduct the unrecovered cost.

*Additional Forms and Paperwork for Tax Compliance:*

Form 4562  
Form 4797  
Amortization Worksheet

SIMPLIFY OR ELIMINATE THE INDIVIDUAL ALTERNATIVE MINIMUM TAX

*Proposal:*

Eliminate the Alternative Minimum Tax (AMT) for individuals entirely. Or minimize the impact by increasing the exemption and simplifying the rules.

*Reasons:*

• *Complexity*

AMT is a big part of what is wrong with the tax code. IRC § 56 provides numerous complex adjustments that can eliminate a tax benefit claimed for regular tax purposes. The rationale of AMT is to prevent high income taxpayers from paying little or no income tax due to their ability to utilize tax preferences. The reality is that many middle income taxpayers can find their much needed credits or deductions reduced or eliminated. The law gives a benefit for regular income tax purposes but takes it away through the complex rules of AMT.

• *Schedule A Deductions Can Subject a Taxpayer to AMT*

Large itemized deductions on Schedule A can subject a taxpayer to AMT.

Employee business expenses can subject a taxpayer to AMT. Employee business expenses can put an employee at a disadvantage. Many employees who are not reimbursed for their business expenses can only deduct these on Schedule A. Often, these amounts are substantial and the employee loses the benefit of the deduction because of AMT.

• *Credits*

The Dependent Care Credit can be substantially reduced by AMT. See the Wayne and Gloria Ambrose Example.

The Child Tax Credit is eliminated for many middle class taxpayers by AMT limitations. See the Table in Example 1.

The Foreign Tax Credit's interaction with AMT can become so complex that many tax practitioners (and the IRS) can't calculate it correctly. Many taxpayers pay substantially more tax than they owe because they do not understand the AMT Foreign Tax Credit so they don't claim it on Form 6251. The taxpayer ends up losing the credit for regular tax purposes.

*Benefits:*

• *Simplicity*

AMT is a parallel tax system with complicated rules. Individuals who have taken advantage of certain incentives to reduce their tax find the complicated rules of AMT can substantially reduce or eliminate the benefits.

A better way of limiting these benefits may be through expanded use of the AGI phaseouts available through the regular tax system. A phaseout can be an effective and simpler method of limiting benefits to higher income taxpayers rather than the complicated calculations related to AMT.

• *Fairness*

Many taxpayers do not understand the complexities of AMT. Many taxpayers who prepare their own returns may ignore the complex AMT adjustments.

Taxpayers are often surprised when a certain tax benefit is eliminated by AMT.

It is not just high income taxpayers who are affected by AMT. Moderate income taxpayers with credits such as the dependent care credit and the child tax credit can find these credits reduced by AMT. A review of the table contained in Example 1 makes clear that a head of household taxpayer earning \$75,000 may well see more benefit from the child tax credit than a similar taxpayer with earnings of \$60,000.

- *Reduce Recordkeeping*

AMT requires parallel recordkeeping for many of the credits, deductions, and expenses. Taxpayers must maintain the records even though he or she may not be subject to AMT in the current tax year.

- *Reduce Paperwork*

Additional Forms, worksheets, and records are required to comply with the complex AMT rules.

- *Enhance Compliance*

Self-preparers who are unaware of the complex AMT rules may, through ignorance, avoid providing the IRS with information needed to correctly calculate their AMT.

- *Reduce IRS costs*

It is difficult to figure out who might be subject to AMT without auditing a return. Certain AMT adjustments are not readily apparent from the tax returns. IRS is able to determine at least partial AMT liability from the tax return and must design and maintain systems to identify under-calculation of AMT. If a under-calculation is found, IRS must then notify taxpayers of their additional AMT liabilities. Many IRS notices are sent to taxpayers requesting that they complete a Form 6251 only to find that the taxpayer doesn't owe AMT.

- *Decrease Dissatisfaction with Tax Code*

Congress intended AMT to instill confidence in the tax system by preventing higher income taxpayers from paying little or no tax. However, the complexity of section 56 increases frustration with the code.

#### EXAMPLES:

Five examples are provided that demonstrate the current complexities of AMT. These examples illustrate the following:

- Impact of AMT on heads of households claiming a child tax credit
- The volume of forms and paperwork necessary to comply
- The volume of paperwork necessary to calculate the proper capital gains rate for AMT
- The impact of AMT on the calculation of the dependent care credit.

*Example 1—Child Tax Credit Table*

Demonstrates the impact of AMT on head of household taxpayers.

*Example 2—Martha Matthews Return*

The Martha Matthews return includes six pages of forms that are required only in order to calculate the foreign tax credit allowed for AMT purposes. The end result of these calculations is a \$0 AMT tax.

*Example 3—Single Taxpayer Return*

The Single Taxpayer return includes six pages of forms required only in order to calculate the correct capital gains tax for AMT purposes.

*Example 4—Nicky Beverly Return*

The Nicky Beverly return includes six pages of forms and worksheets required only in order to calculate the correct AMT tax. This return also indicates where additional recordkeeping is required to track:

- AMT differences for depreciation and property basis
- AMT credit carryforward.
- AMT allowed losses for passive activities.

*Example 5—Wayne and Gloria Ambrose illustration*

The Wayne and Gloria Ambrose example demonstrates how a \$480 dependent care credit is reduced because of AMT to \$23. The Ambroses itemize their deductions and, for AMT, must add back part of their medical expense deduction, all of their state taxes paid and deducted, all of their miscellaneous itemized deduction amount, and the reduction in cost of stock purchased through and incentive stock option.

*Additional Forms and Paperwork for Tax Compliance:*

- Form 6251
- Form 8801
- Multiple Worksheets

Chairman JOHNSON of Connecticut. Thank you very much for your testimony, Mr. Weinberger. Thank you all.

I'm sorry that because of the series of votes we're going to have, we aren't going to be able to get into questions. But I do appreciate the detail of your testimony and the effort that you've helped us get started here today. It is a very big job.

But I think we need to understand what the challenge is of simplification—both in terms of how to effect it, you know, how to make it happen and what the revenue costs would be. Because a lot of the complexity is due to the effort to reduce the revenue loss of tax benefits or to target those tax benefits at certain groups of individuals or businesses, so complexity is the result of policy objectives, but nonetheless at a certain point that complexity in and of itself becomes a policy issue. It's perfectly clear from this hearing today that we are absolutely at that point and we are beginning to compound our problems through further use of the Tax Code as we did in the last tax bill. So I do consider this a very important project even though today's hearing got kind of jammed in between things. We do appreciate the depth of your testimony and we invite you to think about what are the next things we ought to be thinking about.

I do see this as kind of a two-prong operation and one that will take—will be ongoing. One is clearing the deadwood—removing obsolete provisions and the other is simplifying key provisions. Some of the bigger ones are going to take us a long time, but in the immediate future, we must deal with some of the problems in the AMT and certainly we do intend to make change in the marriage penalty.

So thank you very much for your written testimony, thank you for being with us today. My colleague has no questions and thank you very much.

[Whereupon, at 4:27 p.m., the hearing was adjourned subject to the call of the Chair.]

[Submissions for the record follow:]

**Statement of Hon. Barbara B. Kennelly, a Representative in Congress from the State of Connecticut**

Thank you, Madame Chair, for allowing me to appear before the Subcommittee today on behalf of two pieces of legislation I have introduced which are designed to lessen the impact of the individual alternative minimum tax on the average family. The individual AMT was designed to prevent high rollers with sophisticated tax planners from paying no tax. The problem is that it has become much more than that. Both of these bills were made necessary by inattention to detail and a conscious disregard for fulfilling promises made in the enactment of last year's tax bill. These problems must be addressed.

**FAMILY INFLATION TAX**

First, my legislation, H.R. 3965, would repeal the family inflation tax. While the \$500 per child credit enacted in last year's Taxpayer Relief Act will provide vital tax relief to millions of American families, it will result in a tax increase for other families.

Did you know that some families, after receiving the initial benefit, will actually have their taxes increased in the future because of complicated efforts to reduce the benefits of the \$500 child credit? Yes, that is correct. Over time, a number of families will see future tax increases even if their income does not change!

This happens because of the interaction of three provisions, the partially refundable family credit, the reduction of the partially refundable family credit by minimum tax liability and the inflation adjustments to the regular tax. For some families paying the minimum tax, the inflation adjustments cause tax increases by increasing minimum tax liability and thereby reducing partially refundable credits. Each year, the inflation adjustment of the standard deduction and personal exemptions—a provision that results in tax savings for the majority of taxpayers—actually results in a tax increase for these families. We should not allow this to happen. That is why I introduced H.R. 3965. Because tax year 1998 is the first year for the \$500 per child credit, it is vital that we fix this problem before returns have to be filed.

On a related note, there is a tremendous amount of bipartisan support for fixing the marriage penalty. One of the most popular proposals would increase the standard deduction for married couples, a proposal that would actually make this problem with the alternative minimum tax worse. I have been talking about the need to fix the marriage penalty for years. We should fix it but we should also include this fix so we don't increase taxes on families in the name of eliminating a penalty.

H.R. 2545—TO MAKE NONREFUNDABLE PERSONAL CREDITS, THE STANDARD DEDUCTION AND PERSONAL EXEMPTIONS CREDITABLE AGAINST THE INDIVIDUAL ALTERNATIVE MINIMUM TAX

Second, my legislation, H.R. 2545, would make good on a promise we made the American people. The Taxpayer Relief Act of 1997 promised American families both an education and a family credit. Unfortunately for many American families these credits will turn out to be phantom credits.

Many average families will be thrown into the alternative minimum tax (AMT) simply because they take advantage of the new child and education credits. This happens because individuals pay the greater of regular tax reduced by nonrefundable credits or the AMT not reduced by nonrefundable credits. And because both the family and the education credit are added back for purposes of the AMT, families with children are more likely to be thrown into the AMT simply by using these credits. In the case of families with 3 or more children young enough to be eligible for the family credit, the bill permits the family credit against the employee share of FICA so that the minimum tax is no longer a problem for those families. However, it will be unpleasant surprise for many others.

In 2008, 8 million families will lose the child credit because of AMT and 3 million families will lose the HOPE credit because of AMT. For example:

- a single mother with 2 children in day care with \$51,400 in gross income would lose all of her child credit plus \$141 of her dependent care credit in the year 2000 because she gets thrown into the AMT.
- a two-parent family with 3 children including one college freshman and \$67,000 in gross income would lose \$1,477 of their \$2500 combined family and HOPE Scholarship credit because they get thrown into the AMT.
- a two-parent family with 2 children in college and \$64,100 in income would lose \$723 of their Hope scholarship credit because they get thrown into the AMT.

This simply makes no sense! The AMT was meant to assure that sophisticated taxpayers couldn't zero out their taxes. It was never intended that your children would throw you into the AMT.

As some on the Subcommittee may recall, I offered an amendment during markup of the Taxpayer Relief Act of 1997 which would have made the new child and education credits creditable against the AMT. While this amendment failed, it was included in the Democratic alternative. While the Joint Committee on Taxation has determined that without a change in the law, the number of individual returns affected would grow from 605,000 in 1997 to 8.4 million in 2007, this dramatic growth is not merely the result of inflation, but rather deliberate policy choices. Simply adjusting the exemption for inflation would not address the child or education credit problem.

Therefore, I have introduced H.R. 2524 which would make nonrefundable personal credits creditable against the individual AMT and the personal exemption and standard deduction deductible for purposes of the individual AMT. I would hope that we could resolve this problem this year before taxpayers file their first returns claiming these new credits. And I would hope that we could work to find common ground on this very serious issue. Thank you.

### Statement of National Federation of Independent Business

Madame Chair, the National Federation of Independent Business (NFIB) is pleased to have the opportunity to submit the views of its constituents before the Ways and Means Subcommittee on Oversight.

NFIB is the nation's largest small business advocacy organization, representing 600,000 members in all fifty states and the District of Columbia. The typical NFIB member has five employees and grosses \$350,000 in annual sales. Our membership reflects perfectly the nation's commercial economy—we have the same representation of retail, service, manufacturing and construction that makes up the nation's business community. NFIB sets its legislative positions and priorities based upon regular surveys of its membership.

#### TAX SIMPLIFICATION

It is NFIB's position that the only real solution for a fairer, simpler tax code for all Americans is to scrap the current code and replace it with one that promotes investment and savings. We need a tax code that rewards hard work and that all Americans can understand. For that reason, NFIB applauds the House of Representatives for voting last week to adopt the "Tax Code Termination Act" and looks forward to seeing this legislation move through the Senate and to the President's desk.

In the short term, however, there are specific tax provisions that are particularly onerous to small business. If Congress has a 1998 tax cut bill, we hope these issues will be addressed. They are payroll tax reform, death taxes, health care deductibility for the self-employed, independent contractor clarification, increased small business expensing, capital gains simplification, and abolishing the Alternative Minimum Tax.

#### REFORM PAYROLL TAXES

First, Congress must reform payroll taxes. One of the biggest disincentives to job creation for small businesses is the burden of payroll taxes on both employers and employees. Of five major tax burdens, payroll taxes were listed as the most costly tax in the NFIB tax survey, just ahead of personal income taxes. And 53 percent said payroll taxes are less fair or much less fair than business income taxes.

One payroll tax is especially burdensome—the Federal Unemployment Tax, or FUTA tax. Unlike the workers compensation system, the federal government plays a very significant and intrusive role in the administration of state unemployment compensation programs. Washington imposes a payroll tax and requires enormous paperwork burdens on state governments. Much of the money that Washington collects from this tax goes to finance the deficit, not to run the program.

We need to eliminate the FUTA tax and let the states run the unemployment compensation system. The states have done an excellent job in taking over control of the old welfare system (or AFDC), and it certainly makes sense to give them control over the unemployment system as well.

The effect on small business from eliminating this tax could help create new jobs by reducing the cost of hiring new employees. It would also send a strong signal to small business that Washington understands that payroll taxes are too high and that strong action is needed.

At the very minimum, Congress should repeal the .2 percent FUTA surtax that was extended as part of year's tax bill. The "temporary" FUTA surtax was enacted in 1976 in order to repay borrowing of the federal unemployment trust fund from the Treasury. These debts have been repaid since 1987, yet the FUTA surtax continues to be collected solely as a means of reducing the federal deficit NFIB supports full and immediate repeal of the FUTA surtax.

#### ELIMINATE THE DEATH TAX

Although last year's tax bill provided targeted relief, the death tax continues to be one of the most oppressive taxes on small businesses and family farms. NFIB considers death tax reform to be crucial to the continued survival of the small American family business. Current death tax rates cripple a small business passed on to heirs, and can force them to liquidate the very enterprise they have worked in their whole lives. The death tax may provide government revenue in the short run, but the long-run costs—a thriving business extinguished, productive jobs lost, the American dream diminished—far outweigh the gains.

Small businesses are also particularly vulnerable to the intricacies of death tax law. Some owners with mobile assets can ensure a successful transfer to heirs by purchasing life insurance and through other methods, but many small business men and women cannot afford this kind of planning. They neither have the time nor the liquid assets to properly structure their estate. Unfortunately, unlike a publicly traded corporation, which continues operation regardless of how shareholders plan for their death, a closely held business, unless there has been careful and costly planning, is usually devastated by the death of an owner.

Furthermore, because all assets are included in calculating the estate—such as the decedent's home and other personal assets—many businesses worth far less than the exemption level become victims of the death tax. Because so many small businesses operate on cash flow, often with extremely small or negative profit margins, current law allowing small businesses to spread their tax liability over fourteen years does not provide adequate relief.

The 1995 White House Conference on Small Business voted death taxes as the fourth greatest problem to small business needing reform. Eliminating the death tax for family businesses would remove one of the greatest government burdens imposed upon small family businesses, setting national priorities where they should be: encouraging the continued operation and expansion of family business through generations. This issue will continue to be a priority on NFIB's agenda until it is eliminated.

#### 100% DEDUCTIBILITY FOR SELF-EMPLOYED HEALTH CARE COSTS

Another area where Congress could build on last year's tax bill would be to increase health care deductibility for the self-employed. While the number of uninsured continues to rise, one way Congress can help ease this is to move more quickly to 100-percent deductibility for the self-employed. Current law phases the deduction up to 45 percent this year and next.

Unfortunately, full deduction will not be realized by the self-employed until the year 2007. Small business men and women cannot put off all their health care needs until the year 2007. They should not have to wait until then to completely deduct them either. Congress should be applauded for putting the deduction on a glide path to 100 percent, but any tax bill adopted this year should provide immediate 100-percent deductibility.

#### CLARIFY THE DEFINITION OF INDEPENDENT CONTRACTOR

The current 20 common law factor test for determining who is an employee versus an independent contractor has for too long handcuffed small businesses. These instructions are at best vague and unclear, making it difficult for small employers to honestly know whether they are complying with the rules.

At the 1995 White House Conference on Small Business the top recommendation of the delegates was clarifying the independent contractor definition. In addition, a recent NFIB Education Foundation Survey of small business owners found that the issue of determining an independent contractor was one of the biggest problems facing small business today.

NFIB supports legislation that would clarify the definition of an independent contractor.

#### SMALL BUSINESS EXPENSING

Another positive step taken last Congress was to increase the annual limit on businesses expensing to \$25,000 by the year 2003—less than what was called for in the Contract for America, but still an improvement.

Expensing is critically important because it: 1) allows small businesses to escape the complexity associated calculating depreciation schedules for different pieces of equipment; 2) reduces cash flow problems by allowing small businesses to deduct more up front—putting those dollars back in the hands of business faster; 3) helps the small businesses who need working capital as well as entrepreneurs looking to purchase an important piece of equipment; and 4) is good for the economy—if businesses are allowed to write-off investments in the year they are purchased, they are more likely to invest, thereby increasing growth and jobs.

NFIB believes that increasing expensing is the best tool the Congress has to encourage investment by small and medium size firms. NFIB supports an immediate increase in the expensing limit to \$35,000.

## CAPITAL GAINS

NFIB has long been an advocate for reducing the tax on capital gains to encourage investment and job creation. Last year's "Taxpayer Relief Act" reduced the top tax rate on capital gains, but only at the expense of simplicity.

The "Taxpayer Relief Act" reduced the long-term tax rate on capital gains from 28 to 20 percent, but it also increased the holding period necessary to claim a long-term gain from 12 months to 18 months, effectively creating three top tax rates for capital gains—40 percent for gains on assets held less than 12 months, 28 percent for assets held between 12 and 18 months, and 20 percent for those held more than 18 months. This longer holding period has added needless cost and complexity to the exchange of productive assets, as well as numerous additional lines to the tax form.

Even with the increased complexity of the three rate system, last year's capital gain tax cut has been wildly successful at stimulating economic activity. According to recent reports, the latest revenue figures show that instead of losing revenue, as was previously estimated, the tax cut will actually increase federal collections significantly.

NFIB supports a further reduction in the capital gains tax rate to 15 percent. In addition, NFIB supports returning the holding period for long-term capital gains to 12 months.

## ABOLISH THE ALTERNATIVE MINIMUM TAX FOR INDIVIDUALS

Finally, NFIB would like to raise a tax provision which, although not a burning issue today, is likely to become a major concern to many small business owners in the near future—the individual Alternative Minimum Tax.

According to the Joint Committee on Taxation, fewer than 1 in 150 taxpayers is subjected to the AMT today. By 2007, however, that number is expected to grow to 1 in 14, with the largest increase coming from taxpayers earning between \$50,000 and \$100,000. The individual AMT is a remarkably complex and obtuse provision in a tax code not known for its clarity. It literally requires taxpayers to calculate their taxes twice, and then pay the larger amount. While originally designed to ensure that wealthy Americans pay a reasonable level of their income in taxes, the AMT has the side effect of hitting taxpayers—increasingly middle-class taxpayers—when they can least afford the bill. The AMT literally kicks taxpayers "when they are down."

In 1993 and 1997, Congress made numerous reforms to the corporate AMT to reduce its complexity and cost to certain industries. But many small businesses file as individuals, not corporations. The NFIB supports abolishing the individual Alternative Minimum Tax. At the very least, the existing AMT exemption—currently just \$33,750 for single filers and \$45,000 for married couples—should be increased and indexed to shield middle-income taxpayers from this onerous tax.

## CONCLUSION

NFIB would like to thank the Madame Chair for this opportunity to testify before the Ways and Means Subcommittee on Oversight on the important issue of tax simplification. There is no greater burden placed on small businesses by government than that of the tax code, and we look forward to working with the members of this committee and all members of Congress to move towards a simpler, flatter tax code.

**Statement of Hon. Richard E. Neal, a Representative in Congress from the State of Massachusetts**

Madam Chairwoman, first of all I would like to thank you for holding this hearing which addresses complexity of the tax code for individual taxpayers and small businesses. I will focus my testimony on the complexity of our current tax system for individuals. Our tax code has become too complicated and I think it time that we review it and make concrete change to simplify it. This hearing is a good starting point.

Last year, Congress passed the Taxpayer Relief Act of 1997 which created a whole new host of complexities to the code. The Taxpayer Relief Act added about 320 pages to the tax code. The new provisions are complicated because of the different effective dates and eligibility requirements. The new tax bill will cause more individuals to be thrown in the alternative minimum tax (AMT) and this will result in many taxpayers not being able to take advantage of the newly passed credits.

Present law imposes a minimum tax known as the alternative minimum tax (AMT) on an individual taxpayer to the extent the taxpayer's minimum liability exceeds his regular tax liability. The AMT imposes a lower marginal rate of tax on broader base of income. Since 1969, some form of the AMT has been in place. The purpose of the AMT is to have individuals with some measure of economic income to pay at least a minimum amount of tax.

Under present law in 1998, 848,000 taxpayers will pay the AMT and this is 0.8 percent of taxpayers. In 2008, 8,822,000 taxpayers will pay the AMT or 7.2% of all taxpayers. A reason for this expected increase is personal exemptions, standard deduction, and tax brackets are indexed for inflation and the AMT is not indexed for inflation.

Last year's new bill created many new credits which benefited families, such as the child credit and the HOPE Scholarship credit. When calculating the AMT, the family credit and the education credit are added back. In the next few years, many families will not be able to receive benefits of the credits. The disallowance of credits can begin with income limits as low as \$42,350.

Rep. Kennelly and I have introduced legislation which would make nonrefundable personal credits (dependent care, child, and education credits) and the standard deduction and personal exemption deductible for AMT purposes. We have also sponsored legislation to repeal the family inflation tax. The \$500 per child credits enacted in last year's Taxpayer Relief Act will provide tax relief to millions of American families. However, some families will face a tax increase.

Due to the interaction of three provisions, for some families paying the minimum tax, the inflation adjustments cause tax increases by increasing minimum tax liability and thereby reducing partially refundable credits. The three provisions are the partially refundable family credit, the reduction of the partially refundable family credit by minimum tax liability and the inflation adjustments to the regular tax.

The two bills just described fix problems that were exacerbated by the Taxpayer Relief Act. I think this Committee should look at both of these proposals thoroughly. These two proposals would help working families take full advantage of the new tax credits.

Recently, I introduced H.R. 4053, legislation to simplify the computation of taxes for individuals. This legislation would replace two worksheet schedules with a total of 19 lines and replace them with one line.

This legislation simplifies the individual income tax by repealing the adjusted gross (AGI) limitation on itemized deductions and the personal exemption. Under current law, personal exemptions are reduced by 2% for each \$2,500 which the AGI of the taxpayer exceeds \$181,000 for joint filers and \$121,200 for single filers. If an individual's adjusted gross income exceeds \$121,200, certain otherwise allowable deductions are reduced by the lesser of 3% of the excess of adjusted gross income over the applicable amount, or 80% of the itemized deductions otherwise allowable for the tax year.

This legislation repeals the complicated provisions described above and replaces them with an additional income tax of 1.59%. The bill simplifies the calculation of current phaseouts and removes the marriage penalty of these provisions.

In order to remove the marriage penalty the new additional income tax will affect individuals with lower AGI. The additional income tax of 1.59% applies to individual taxpayers with adjusted gross income of \$75,000 for individuals and \$150,000 for joint filers. These thresholds are indexed for inflation. This additional tax does not apply to estates or trusts. This legislation is effective for taxable years beginning after December 31, 1998.

This legislation is revenue neutral. The purpose of this legislation is to make it easier for individuals to compute their taxes and to remove unfair marriage penalties included in phase-out provisions. This legislation is a start to simplifying the tax code. We should be reviewing the code and simplifying many proposals. This hearing should provide useful information to pursue this task.

**Statement of Hon. Jim Ramstad, a Representative in Congress from the State of Minnesota**

Madame Chairman, thank you for convening this important hearing on the tax code complexity affecting small businesses and middle-income taxpayers.

I don't need to recite the statistics that show how complex our tax code is. There is ample, painful evidence.

For small business entrepreneurs, who represent 99.7% of employers, employ 53% of the private work force, contribute 47% of all sales and 50% of private gross domestic product to our nation's economy, tax complexity is a special burden.

Small businesses have been crushed not only by high taxes, but also by mountains of tax paperwork. Small corporations spend over seven times what they actually pay in income taxes just trying to comply with our hopelessly complex tax code. This discourages investment, robbing small businesses of the opportunity to grow and create new jobs.

And middle-income taxpayers, who will increasingly be pulled into Alternative Minimum Tax calculations, will soon be facing the ultimate complexity nightmare.

Again, Madam Chairman, this is a critically important hearing. Thank you for your leadership in bringing attention to these issues.

### **Statement of White House Conference on Small Business**

The undersigned are the elected Regional Chairs of Taxation representing the 2000 delegates to the White House Conference on Small Business. We were delegated the responsibility of advancing implementation of the conference's recommendations with regard to the tax issues and reporting progress back to the delegates. As the Ways and Means Committee prepares to consider tax policy issues, the delegates to the White House Conference on Small Business want to remind you of the important tax issues for the growth and progress of small businesses in America.

#### **SIMPLICITY**

The single largest concern of the White House Conference on Small Business was dealing with the overall complexity of government and the complexity of the tax code in particular. Allocating and reporting income taxes and payroll taxes is the one common experience of every business and may be the only interaction which most businesses have with the federal government. Simplifying the tax process would, therefore, improve the situation for every small business. Studies have shown that it costs small businesses more to comply with the tax code, and considerably more in comparison to each dollar of sales, than it costs large businesses. Small businesses have fewer sales over which to spread the cost.

One of the major recommendations of the White House Conference was that Congress should concentrate on creating a simpler and fairer tax system. Within the context of the current tax code, four of the top White House Conference recommendations called for simplification of rules that are complex and frightening for small businesses:

- Clarification of the definition of an independent contractor. We will not expand on it today, except to say that it continues to be a source of concern for small businesses. Testimony was previously submitted on this subject.
- Immediate deduction of healthcare insurance premiums for the self employed.
- Repeal of the estate tax.
- An increased expensing allowance (in lieu of depreciation) under IRS 179 for equipment purchases for small businesses.

Each of these recommendations was born out of the frustration accompanying a tax code which is perceived as complex and unfair. Studies have shown that it costs many small businesses more money to comply with the tax record-keeping and reporting obligations than it costs to pay the taxes themselves.

#### **100% HEALTH CARE DEDUCTION FOR THE SELF-EMPLOYED**

We were pleased that Congress approved an eventual increase to 100% deductibility, but were disappointed that the increase will be phased out in over 10 years. This desire was in line with the White House Conference recommendation that the tax deductible amount be raised immediately to 100% and be deductible prior to the calculation of the self employment tax. Although there is some tax cost, the increase helps serve the policy goal of providing health insurance to as many people as possible. When there is little or no tax incentive for employers to buy health insurance for themselves and their families (note that 1.4 million children of self-employed individuals have no health coverage), they are likely to decide to forgo offering it to their employees as well. In other types of businesses, C-corporations for example, the health insurance premiums of the principals in the business are already fully deductible. We feel tax based decisions should not be substituted for sound business

judgment in the selection of business structure. If a tax bill is considered in 1998, we urge Congress to include this proposal as a matter of equity for all business people.

#### ESTATE TAX REFORM

One of the strongest recommendations of the White House Conference on Small Business was a call for the repeal of the estate and gift tax. The Taxpayer Relief Act of 1997 included a provision which provides some help for a qualifying small business (in cases where the value of the small business is over half of the gross estate.) While this is welcome relief, more needs to be done to protect businesses from being dismantled at the death of the principal. The passage of a small business from one generation to the next has a positive impact on the community, promoting stable employment, long-term community support of community groups, and an active interest in maintaining the quality of education and life in the "neighborhood."

If outright repeal is too costly under the budget requirements, we feel that proposals which provide for continued reduction of the tax and the administrative burden on small businesses would be helpful. By focusing the legislation, Congress can provide relief directly to farms and small family businesses while foregoing a relatively small amount of revenue. The Congress should adopt a tax policy that moves the country toward the positive goal of sustaining the economic vitality of a small business and away from a policy which requires expensive and complex estate plans and insurance. The reality today is that elaborate and costly estate plans often must be undertaken, which drains assets from productive business investment. Without such plans, there is no guarantee that the business will last to serve the next generation of owners or workers.

#### EXPENSING

The expensing limit of IRC § 179 will be gradually increased to \$25,000 (by the year 2003) from its current level by the Small Business Job Protection Act passed by Congress in 1996. We appreciate the attention Congress gave to this issue, but would urge greater increases and quicker implementation. Expensing is perhaps one of the most useful tax simplifiers for small business; however, its use still remains limited. In addition, Congress did not correspondingly raise the \$200,000 limit on purchases. These days, one piece of machinery (even for a very small business) can exceed this limit, effectively eliminating many small businesses from any benefits. Finally, a technical correction added to the bill changed the definition of small business property from IRC § 1245 property depreciable under IRC § 168 to add the requirement that the property qualifies under IRC § 38 *retroactively* to 12/31/90. This retroactive change imposes a burden on small businesses which had made investment decisions based on existing law.

#### SOFTWARE EXPENSING & THE YEAR 2000

One area where we, the Regional Chairs for Taxation of the White House Conference on Small Business, feel Congress could make a tremendous contribution is to allow expensing in the year a business purchases software obtained for business purposes. It is practically impossible to declare with certainty what the useful life of software is within a business. With the pace of technology, useful life gets shorter and shorter as better products which exploit hardware advances seem to hit the market continuously.

Particularly troublesome are the problems caused by the year 2000 (Y2K) which many small businesses do not fully understand. The cost to them to upgrade their software and hardware might be considerable. We believe it serves public policy to provide incentives to help small businesses assess their exposure to the problem and purchase new software as soon as possible. This will insure the continuity and free flow of business in 2000.

In 1996, the Gartner Group estimated that the year 2000 problem would cost \$600 billion to fix. Later estimates by Lloyds of London have been as high as \$1 trillion. Economist Ed Yardeni has estimated that there is a 35% chance of a global recession because some businesses will be unable to deal with their year 2000 problems. And, unlike most projects, the final due date can not be changed with the year 2000 problem—the year 2000 will arrive whether we are ready or not.

The Federal Reserve is currently predicting that 1% to 7% of US businesses will fail because of the year 2000 problem. The Board is encouraging all businesses to address the problem as early as possible. The Small Business Administration and the Department of Commerce are encouraging all small businesses to make plans to assess the situation now so that actions can be taken in a timely manner. Many

of the affected businesses will need new items of software and hardware, and we would urge that the materials immediately be deemed able to be expensed.

SUMMARY

In general, the White House Conference urged Congress to investigate a simpler, fairer tax system but purposely did not specify what changes should be made. The Conference also suggested a number of specific changes which we hope the Committee will continue to consider. We would like to recommend that any changes that are considered be analyzed for their impact on small businesses and that representatives of the small business community be included in future hearings on the subject.

We would like to work with you, your colleagues, and your staff to help you better understand the importance of these proposals to small businesses and the U.S. economy. Thank you for your time and attention to this matter.

Sincerely,

THE WHITE HOUSE CONFERENCE  
TAX CHAIRS

REGION 1 DEBBI JO HORTON,  
PROVIDENCE, RHODE ISLAND  
REGION 2 JOY TURNER, PISCATAWAY,  
NEW JERSEY  
REGION 3 JILL GANSLER, BALTIMORE,  
MARYLAND  
REGION 4 JACK OPPENHEIMER, ORLANDO,  
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