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

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS

HOUSE OF REPRESENTATIVES

ONE HUNDRED SIXTH CONGRESS

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

TUESDAY, MAY 25, 1999

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

The Subcommittee met, pursuant to notice, at 2:06 p.m., in room 1100, Longworth House Office Building, Hon. Amo Houghton (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
May 18, 1999
No. OV–7

CONTACT: (202) 225–7601

Houghton Announces Hearing on the Impact of Complexity in the Tax Code on Individual Taxpayers and Small Businesses

Congressman Amo Houghton (R–NY), 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, May 25, 1999, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 2 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 of the U.S. Department of the Treasury, the Office of the Taxpayer Advocate, tax professional organizations, and individual tax practitioners. 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 income tax system was established in 1913, the legislation was only 19 pages long. Today, the Internal Revenue Code covers 2,300 pages, not counting regulations. The resulting compliance burden for taxpayers is enormous, especially for lower- and middle-income taxpayers and small businesses.

Many studies have documented the impact of complexity. For example, one study showed that U.S. taxpayers spent more than five billion hours preparing tax returns with compliance costs of more than $200 billion in 1998. Two-thirds of compliance costs were borne by small businesses. Another study has shown that some small businesses pay more than seven dollars in compliance costs for every dollar they pay in taxes.

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

In announcing the hearing, Chairman Houghton stated: "Sixty-six percent of respondents in a recent Associated Press poll said that the Federal tax system is too complicated. The same poll showed that over half of those surveyed, 56 percent, pay someone else to complete their returns. When you consider that only 30 percent of taxpayers itemize, that is a good number of people who are paying someone else to fill out their income tax forms. Something is wrong when so many taxpayers with relatively straightforward returns lack confidence in their ability to fill them out."

FOCUS OF THE HEARING:

The Subcommittee will review current tax law to identify the impact of complexity, along with a number of proposals to simplify the tax code.

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*, Tuesday, June 8, 1999, 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, by close of business the day before the hearing.

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/'.

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 HOUGHTON [presiding]. Ladies and gentlemen, I think we will begin the hearing if we could.

Val, it is nice to have you here.

I would like to make a statement, and then I know Mr. Neal would like to make one and then Mr. Coyne would also.

Anyway, Mr. Albert Einstein once remarked, "the hardest thing in the world to understand is the income tax." And in trying to prepare his own return, he said, "This is too difficult for a mathematician. It takes a philosopher." So these troubling words were spoken long before the enactment of what is named the individual Alternative Minimum Tax. The AMT is computed on Form 6251. And it is a baffling calculation of adjustments and preferences.

They were also spoken long before the notorious Schedule D, which you have here. This schedule is used to calculate capital gains and losses, a form which is 2 pages and 54 lines long. According to the IRS, it takes an average of 6 hours and 41 minutes to fill out schedule D. It is required even if a taxpayer receives as little as $10 in capital gains income from a mutual fund.

The whole process began many years ago with a simple constitutional amendment. And it consisted of 32 words and here they are: "The Congress shall have the power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." Incidentally, the Revenue Act of 1913, which enacted the income tax, was 15 pages long.

Now, here is a copy of the Internal Revenue Code and it is printed on very, very thin paper. It covers over 2,300 pages and the regulations springing from this particular code fill, obviously, many volumes. The court cases—I am told—would fill a whole library.

As we all know, our tax system is unique. It relies on voluntary compliance with our tax laws. Now they must be intelligible. No one should have to skip a day of work to complete any tax form, nor should 56 percent of taxpayers have to pay someone else to complete their returns.

Two of my Subcommittee Colleagues, Mr. Coyne and Mr. Neal, have introduced bills to help simplify the Tax Code. Mr. Portman, sitting on my right, has introduced a bill to simplify the pension provisions of tax law. He also helped bring about enactment last year of key changes in the way we consider tax legislation in order to help reduce complexity. Today, I will be introducing a tax simplification bill as well.

Now, we have a great deal of talent and many good ideas springing from this Subcommittee and its staff. Today's witnesses have some important thoughts to share with us as well. But before calling on the first witness, I would like to yield to our Ranking Democrat, Mr. Neal, for his opening statement.

Mr. NEAL. Thank you, Mr. Chairman. I have a brief opening statement. I want to thank you for holding this hearing to address some of the complexities of the Federal Income Tax Code, especially for individual taxpayers. And I certainly want to compliment you on the bill you are introducing that contains a series of proposals to make life easier for average taxpayers. I also want to note the key role of Mr. Coyne, our Ranking Member, in efforts to change and to simplify the current method of taxing capital gains. His is a common sense approach that I hope we can all share in the appropriate moment.

As you know, my bill, H.R. 1420, eliminates about 200 lines from individual tax forms, work sheets, and schedules. It does this in essentially a revenue-neutral manner and without moving money between economic income groups. Other members have other ideas about simplification, such as Mr. Hulshof's SAVE Act. Mr. Chairman, this hearing can be an important step forward in the effort to reform the Federal income tax by raising simplicity to a competing value with all the other things we want to accomplish.

The income tax code will always be complex because we live in a complex society with a complex economy. To achieve fairness, our Tax Code must mirror that economic reality. But for those who do not engage in complex transactions, who have, indeed, a simple economic life, then the Tax Code should also mirror that reality.

In this instance, fairness means simplicity and, to that end, a taxpayer should not have to fill out dozens of lines simply because they received a small capital gains distribution. Nor should a taxpayer have to worry about alternative minimum tax because they want to take the child care credit or the education credits. Nor should those credits be cut back after we have promised them to the American people. Lifting at least these two burdens would go a long way toward helping taxpayers.

But that is just the least that we can do. We can also accomplish by direct means that which we are now accomplishing by indirect means. I think of the phaseouts of the personal exemption and itemized deductions as examples of needless paperwork. But how to jump start this process of simplification is a question that I am struggling with and certainly would welcome suggestions from other members of this panel. That is the critical role that we play today: how to jump start this process.

Simplification is like the weather, everybody talks about it, but nobody does anything. To put it in this context, simplification is an idea that everybody supports and, during normal times, is low enough on everyone's list so that it never quite gets done. I have concluded that it will be all but impossible to find the revenue by the means we normally apply to offset the cost of significant simplification. While the budget surplus is coming, it seems to have already been spent two or three times on ideas of differing merit, but which have significant political support behind them.

We could develop a series of small revenue raisers and dedicate the revenue to tax simplification. But the CQ Daily Monitor laid that notion to rest yesterday by pointing out that the tax and trade bills that are currently moving all use many of the same offsets to fund different bills. A simplification package is bound to lose out in such a game.

Again, I have concluded that the only realistic chance a major simplification bill has of being enacted is to be revenue-neutral as a free-standing proposal. That is why my bill is essentially revenue-neutral and, in fact, all three titles to the bill are revenue-neutral in and of themselves. I have also come to the conclusion that simplification cannot move money between economic income groups because that may be seen as a back-door way of advancing the agenda of one political party or the other. That is why my bill upholds the principle that those who benefit from simplification ought to pay for it to keep the focus purely on simplification.

I, for one, seriously doubt that a major tax cut is going to make it into law this year. But if it does, a major simplification title would fit nicely into that package. But if it doesn't, a major simplification package might be even more attractive because it would be a real accomplishment in an era of diminishing accomplishments for both parties.

In conclusion, Mr. Chairman, I hope this hearing will produce a number of technical suggestions to improve our efforts to date, but I also hope today is the first step toward bringing some well-deserved simplification to the American people. And I would close on a note that I offer in the middle of my statement, and that is I think the broader question for all of us today is how do we jump start this process.

Chairman HOUGHTON. Thanks very much, Mr. Neal. Mr. Coyne.

Mr. COYNE. Thank you, Mr. Chairman. I apologize for being late. I knew, however, that the minority party's position was going to be strongly upheld by the very distinguished gentleman from Massachusetts. So, with that, I would like to just submit my statement for the record.

[The prepared statement follows:]

Statement of Hon. William J. Coyne, a Representative in Congress from the State of Pennsylvania

Mr. Chairman, I want to thank you for holding today's hearing on a topic that is a source of concern for millions of Americans—simplification of our tax laws.

At nearly 2300 pages, with hundreds of forms and publications, the Federal Tax Code confuses and intimidates most Americans. They fear the consequences of making a mistake and dread the prospect of spending hours or days preparing their returns.

The debate on fundamental tax reform appears to be one which will continue indefinitely. Therefore, we must proceed to simplify the Tax Code wherever and whenever we can. We should start with the provisions which affect the greatest number of individual taxpayers and which are unnecessarily complex.

There are several proposals that the Subcommittee will hear about today. These are proposals that have bi-partisan support in the Congress and great appeal to the taxpaying public.

I have introduced H.R. 1407, the Capital Gains Tax Simplification Act of 1999. This bill would simplify capital gains calculations for all taxpayers and provide a modest capital gains tax reduction for most. I have attached for the record a copy of my recent "Dear Colleague" on H.R. 1407, as well as a copy of the current Schedule D, a tax form which millions of taxpayers would no longer need to fill out under my bill.

Importantly, H.R. 1407 would be revenue neutral. Simplification proposals which cost millions or billions in lost revenues are politically attractive. However, given the fiscal constraints facing this Congress, it is doubly important that simplification proposals have small—or even better—positive fiscal impacts.

I also support Congressman Neal's simplification bill, H.R. 1420, the Individual Tax Simplification Act of 1999. This bill incorporates capital gains simplification and significant alternative minimum tax relief, along with other reforms.

I understand that you, Mr. Chairman, are introducing tax simplification legislation, and I look forward to working with you and the other Members of the Subcommittee to make tax simplification a reality.

Today's hearing will provide an excellent forum for discussing individual and small business tax simplification proposals. I thank each of the witnesses for participating in this hearing.

CONGRESS OF THE UNITED STATES
Washington, DC, April 15, 1999.

Re: Capital Gains Tax Simplification

Dear Colleague:

As you know, the 1997 Taxpayer Relief Act has resulted in a significant increase in complexity for ordinary taxpayers with capital gains. We urge you to become a cosponsor of H.R. 1407, the Capital Gains Tax Simplification Act of 1999, which would simplify the calculation of the individual capital gains tax.

The current capital gains tax schedule and the underlying rules for taxation of capital gains are unnecessarily complex, as illustrated by the attached 1998 Schedule D, Capital Gains and Losses. The IRS estimates that these provisions will force taxpayers (with more than four sales) to spend, on average, more than 6 hours and 41 minutes filling out these forms (over 3 hours more than in 1994). Unfortunately, the problem will only get worse in the coming years as two additional tax rate categories established by the Taxpayer Relief Act of 1997 take effect in tax years 2001 and 2006. In addition, increasingly large numbers of taxpayers will have to fill out this complex schedule twice—once for the regular tax and once for the alternative minimum tax.

The complexity of the current law may fall hardest on mutual fund investors, many of whom are low- and middle-income taxpayers, because they now are required in all cases to fill out Schedule D to report capital gain distributions from their mutual fund. It has been estimated that nearly half of all U.S. households now own mutual funds. Under H.R. 1407, taxpayers whose only capital gains come from mutual funds would not have to fill out even a simplified capital gains schedule. They would simply total up their capital gains distributions, figure out what 62 percent of that total would be, and then write that amount on the appropriate line of their tax return form.

Some have also asserted that the current law's complexity was due to the previous 18-month holding period requirement (repealed by the IRS Restructuring and Reform Act). That is not correct. The repeal of the 18-month holding period requirement did not eliminate one line of Schedule D since the various capital gains tax rates will remain.

The bill that we have introduced would substitute a simple 38-percent capital gains exclusion for the confusing array of five capital gains tax rates provided in the 1997 Act. It also would permit individuals selling real estate to receive the full benefit of the capital gains tax reduction. We have not received a revenue estimate for H.R. 1407 yet, but the Joint Committee on Taxation determined that an identical bill last year would have raised $600 million over a 10-year period.

H.R. 1407 would simplify the computation of capital gains taxes for all individual taxpayers. In addition, more than 98 percent of individual taxpayers would be eligible for modest capital gains tax reductions. Many of the remaining 2 percent of taxpayers could also receive modest tax reductions under this bill. The following chart shows the impact of this legislation on capital gains tax rates.

	Rate Under Current Law			Rate Under Proposed Legislation
Rate Bracket (No. of Taxpayers in Bracket)	Assets Held More than 12 Months and Not Collectibles or Recapture Gain	Real Estate Depreciation Recapture Gain	Collectibles Held At Least 12 Months	All Capital Assets (Other Than Collectibles) Held More Than 12 Months
15 percent (61.58 million)	10	15	15	9.3
28 percent (24.0 million)	20	25	28	17.36
31 percent (2.3 million)	20	25	28	19.22
36 percent (1.0 million)	20	25	28	22.32
39.6 percent (0.5 million)	20	25	28	24.55

If you have any questions about this legislation or if you desire to be a cosponsor, please feel free to contact Matt Dinkel at extension 5–2301.

Sincerely,

ROBERT T. MATSUI
Member of Congress.

WILLIAM J. COYNE
Member of Congress.

SCHEDULE D (Form 1040)
Department of the Treasury
Internal Revenue Service (99)

Capital Gains and Losses

► Attach to Form 1040. ► See Instructions for Schedule D (Form 1040).
► Use Schedule D-1 for more space to list transactions for lines 1 and 8.

OMB No. 1545-0074
1998
Attachment Sequence No. 12

Name(s) shown on Form 1040 | Your social security number

Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-6)	(e) Cost or other basis (see page D-6)	(f) GAIN or (LOSS) Subtract (e) from (d)
1					
2 Enter your short-term totals, if any, from Schedule D-1, line 2		2			
3 **Total short-term sales price amounts.** Add column (d) of lines 1 and 2		3			
4 Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824				4	
5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1				5	
6 Short-term capital loss carryover. Enter the amount, if any, from line 8 of your 1997 Capital Loss Carryover Worksheet				6 ( )	
7 **Net short-term capital gain or (loss).** Combine lines 1 through 6 in column (f) ►				7	

Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-6)	(e) Cost or other basis (see page D-6)	(f) GAIN or (LOSS) Subtract (e) from (d)	(g) 28% RATE GAIN or (LOSS) * (see instr. below)
8						
9 Enter your long-term totals, if any, from Schedule D-1, line 9		9				
10 **Total long-term sales price amounts.** Add column (d) of lines 8 and 9		10				
11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824				11		
12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1				12		
13 Capital gain distributions. See page D-2				13		
14 Long-term capital loss carryover. Enter in both columns (f) and (g) the amount, if any, from line 13 of your 1997 Capital Loss Carryover Worksheet				14 ( )	( )	
15 Combine lines 8 through 14 in column (g)				15		
16 **Net long-term capital gain or (loss).** Combine lines 8 through 14 in column (f) ►				16		

Next: Go to Part III on the back.

* **28% Rate Gain or Loss** includes **all** "collectibles gains and losses" (as defined on page D-6) and up to 50% of the eligible gain on qualified small business stock (see page D-5).

Part III Summary of Parts I and II

17 Combine lines 7 and 16. If a loss, go to line 18. If a gain, enter the gain on Form 1040, line 13 — 17

Next: Complete Form 1040 through line 39. Then, go to **Part IV** to figure your tax if:
- Both lines 16 and 17 are gains, **and**
- Form 1040, line 39, is more than zero.

18 If line 17 is a loss, enter here and as a (loss) on Form 1040, line 13, the **smaller** of these losses:
- The loss on line 17; **or**
- ($3,000) or, if married filing separately, ($1,500) — 18 (

Next: Complete Form 1040 through line 37. Then, complete the **Capital Loss Carryover Worksheet** on page D-6 if:
- The loss on line 17 exceeds the loss on line 18, **or**
- Form 1040, line 37, is a loss.

Part IV Tax Computation Using Maximum Capital Gains Rates

19	Enter your taxable income from Form 1040, line 39			19
20	Enter the **smaller** of line 15 or line 17 of Schedule D	20		
21	If you are filing Form 4952, enter the amount from Form 4952, line 4e	21		
22	Subtract line 21 from line 20. If zero or less, enter -0-	22		
23	Combine lines 7 and 15. If zero or less, enter -0-	23		
24	Enter the **smaller** of line 15 or line 23, but not less than zero	24		
25	Enter your unrecaptured section 1250 gain, if any (see page D-7)	25		
26	Add lines 24 and 25	26		
27	Subtract line 26 from line 22. If zero or less, enter -0-			27
28	Subtract line 27 from line 19. If zero or less, enter -0-			28
29	Enter the **smaller** of: • The amount on line 19, **or** • $25,350 if single; $42,350 if married filing jointly or qualifying widow(er); $21,175 if married filing separately; or $33,950 if head of household			29
30	Enter the **smaller** of line 28 or line 29			30
31	Subtract line 22 from line 19. If zero or less, enter -0-			31
32	Enter the **larger** of line 30 or line 31			32
33	Figure the tax on the amount on line 32. Use the Tax Table or Tax Rate Schedules, whichever applies ▶			33
34	Enter the amount from line 29			34
35	Enter the amount from line 28			35
36	Subtract line 35 from line 34. If zero or less, enter -0-			36
37	Multiply line 36 by 10% (.10) ▶			37
38	Enter the **smaller** of line 19 or line 27			38
39	Enter the amount from line 36			39
40	Subtract line 39 from line 38			40
41	Multiply line 40 by 20% (.20) ▶			41
42	Enter the **smaller** of line 22 or line 25			42
43	Add lines 22 and 32	43		
44	Enter the amount from line 19	44		
45	Subtract line 44 from line 43. If zero or less, enter -0-			45
46	Subtract line 45 from line 42. If zero or less, enter -0-			46
47	Multiply line 46 by 25% (.25)			47
48	Enter the amount from line 19			48
49	Add lines 32, 36, 40, and 46			49
50	Subtract line 49 from line 48			50
51	Multiply line 50 by 28% (.28) ▶			51
52	Add lines 33, 37, 41, 47, and 51			52
53	Figure the tax on the amount on line 19. Use the Tax Table or Tax Rate Schedules, whichever applies			53
54	**Tax on taxable income (including capital gains).** Enter the **smaller** of line 52 or line 53 here and on Form 1040, line 40 ▶			54

Chairman HOUGHTON. Thank you very much. Mr. Portman.

Mr. PORTMAN. Mr. Chairman, I will be brief. I just want to congratulate you for shining the light on the issue of complexity. We have spent a year with the IRS Commission looking at the inner workings of the IRS and figuring out how to change the mission of the IRS, which was discussed at length by Commissioner Rossotti this morning. But at the end of the day, there was a consensus among all commissioners, and it was actually a consensus that was formulated in terms of specific recommendations, that we needed to simplify the Tax Code if the IRS is truly going to be the kind of taxpayer service organization that we all hoped for. So this does not just affect the taxpayer, Mr. Chairman, as you know, it affects the administration of taxes and I commend you for your proposal today and for holding a hearing today.

The pension reforms are also another example where we can move forward with regard to simplification and almost everyone on this Subcommittee is now working toward that goal on the legislation and I think this is, indeed, a good first step. Short of fundamental tax reform, we need to figure out ways to get under the hood as another great philosopher, not Einstein, said at one point. Get under the hood and figure out how to change aspects of our Tax Code to make it simpler for both the taxpayer and the tax administration. I commend you for having the hearing.

Chairman HOUGHTON. Who was that? Henry Ford.

Mr. PORTMAN. H. Ross Perot. [Laughter.]

Chairman HOUGHTON. Thanks, Mr. Portman. Mrs. Dunn.

Ms. DUNN. Mr. Chairman, thank you very much. I applaud you for holding this hearing. As I go home to my districts and speak to the people I represent in town hall meetings or in other meetings, they ask first and foremost that we do something to effectively simplify the Tax Code. Those of us who believe in tax relief would really like the first step of that to be tax simplification. And so I think the fact that you are holding this hearing today and that we are hearing from organizations that have to deal with the complicated Tax Code and also from our very able new taxpayer advocate, that speaks very well of your oversight capabilities and I think we are going to do a lot in this hearing. Thank you.

Chairman HOUGHTON. Thanks, Ms. Dunn. Mr. Watkins.

Mr. WATKINS. Thank you, Mr. Chairman, again, for your work and the Committee's work. And I still have got a couple of comments. One about the national taxpayer advocate. I utilized their assistance a couple of different times and they have been a great help in getting focused on a problem that was hard for our office to be able to get that done and that has been a great help.

Second, I guess about the overall tax, I think all of us would like to have, you know, tax simplification, but I have always felt like our national priority should dictate our tax policy. And, you know, is a domestic food basket important for this country? And, if we do, we have got to have the incentives to produce in this country a domestic food basket. Is a domestic oil supply important to the national security of this country? If it is, then we have got to have

the type of incentives that let us produce the energy and the oil production for this country in order to have that.

So as we look at trying to say how we simplify, there are certain things that we have got to have incentives to produce, so I am one who feels that very strongly that we have got to have those kind of economic impacts if we are going to have a future we want here in this country and, especially, in that global competitive world.

Chairman HOUGHTON. Thank you, Mr. Watkins.

Now, I would like to call our first witness, the Honorable W. Val Oveson, Taxpayer Advocate. Val, again, great to have you here.

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

Mr. OVESON. Thank you very much, Mr. Chairman and distinguished Members of the Subcommittee. I am pleased to be with you once again and very pleased to be addressing this very critical, important topic of simplification and, on the converse side, complexity of the Tax Code.

Complexity, in my opinion, is the No. 1 problem facing the American taxpayer and the tax administrators in the Government in general. It is not just one-sided. All of us are dealing with this complexity problem.

I use several factors as my basis for saying that it is the No. 1 problem—it popped up in my annual report this year, as I testified earlier this year to you and had done in that report for the 2 years running that had been presented to you. Analyzing the cases that come up from the field is one of the sources of identification that complexity is the No. 1 problem. Actually, the casework that we deal with, as well as surveys of taxpayers, tax practitioners, and small business groups that we conducted over the last year and a half, also tell us that it is a No. 1 problem. Surveys of our own taxpayer advocates in the field and their feelings of the work that they have conducted also identify it as the No. 1 problem.

As is written in my testimony, which I have submitted for the record, my opinion is that the following three issues are the most critical components of this complexity that, if you want to address, you need to solve. No. 1 is the frequency and the number of tax law changes. No. 2 is targeted tax relief for groups of taxpayers, including income phaseouts on deductions. And No. 3 is the alternative minimum tax.

Now let me go briefly into these areas. In the last 10 years, there have been 6,500 changes in the tax law in 61 bills. In the last 2 years alone, there have been approximately 1,260 changes of individual code sections. It is difficult for taxpayers to understand why the law changes so much and for them to assimilate it and to understand why; it is hard for them to deal with it.

Programming changes into the brittle computer system at the IRS is extremely expensive and fraught with risks in getting it right. The magnitude of the changes makes it hard to convey the changes to the taxpayer in forms and publications and the communications effort gets more and more difficult every day at the IRS. And it is difficult to train employees and the service level suffers. And I might add training the private sector, not only the taxpayers, but tax practitioners is also a major, major problem. For those rea-

sons, again, the frequency and number of tax law changes, I rate as No. 1.

Second is targeted relief for groups of taxpayers, including income phaseouts. These would be items such as the child care credit, the adoption credit, educational credits that are on top of other credits that are very similar. There are different qualifications for each of these credits. There are definitions that sound similar but they are really not and they are different among the credits, making it more complicated and difficult to sort through them. And then the income phaseouts are different and complicated in each of these areas.

I want you to know and understand that I am not commenting on the merits of the policy issues surrounding these issues. You need to sort through those policy issues. What I am telling you is that these are the areas that, in my opinion, are creating complication in the tax law.

Third is the alternative minimum tax. Again, you are well familiar with this issue of requiring taxpayers to actually compute their tax under two separate systems and to evaluate the two against each other. It is not indexed. AMT is affecting more and more people every day as more credits in the system come into play.

In conclusion, don't change the laws so much. If you are going to change the laws, make sure that they are actually less complex and not more complex. Thank you very much.

[The prepared statement follows:]

Statement of W. Val Oveson, National Taxpayer Advocate, Internal Revenue Service

Mr. Chairman and Distinguished Members of the Subcommittee: I am pleased to appear before this Subcommittee to address the subject of the complexity of the tax law. As you know, my role is to be the voice of the taxpayer and the advocate of a more equitable and balanced approach to tax administration. As my FY 1998 Annual Report to Congress describes, complexity of the tax laws is the number one problem facing taxpayers. This conclusion is supported by those groups directly impacted by such complexity—individual and small business taxpayers, tax practitioners and professional associations and IRS Field Taxpayer Advocates. I take great hope in the fact that Congress, by inviting the panelists you will have before you today for hearings like this, is acknowledging the problems complexity is causing and is prepared to help America's taxpayers. I am here today to lend my hand in easing that burden.

I. FREQUENCY AND NUMBER OF CHANGES TO TAX LAW

As I just suggested, I believe that Congress is serious about wanting to reduce the complexity of the tax laws. Section 4022 of RRA 98, which calls for complexity studies to be conducted by the IRS and the Joint Committee on Taxation, is a good place to start. As I mentioned last month before the Senate Finance Committee, I am confident that the two studies the law mandates will identify for the Congress and Federal tax administrators specific sources of complexity. The Commissioner's study will provide you empirical data on how existing law affects taxpayers and a window into how the tax laws you pass get translated into what the public experiences. I continue to be optimistic that you can use the information to reduce existing complexity. The study by the Joint Committee on Taxation will estimate the "complexity factor" of legislation and what that means to taxpayers. I hope that you can use that information to affect what I believe to be the single most complicating factor in tax administration—the frequency and number of changes to the tax laws.

In 1986, Congress drastically changed the tax laws by enacting the Tax Reform Act (TRA 86). The goal of TRA 86 was to create a simpler, fairer and more efficient tax system. In TRA 86, Congress made approximately 1850 separate amendments to the Internal Revenue Code. It reduced the number of tax brackets, modified the standard deduction and made many other changes that greatly reduced complexity.

Since TRA 86 and ending in 1998, Congress made approximately 6,500 changes to Title 26 in 61 different pieces of legislation. In fact, the Taxpayer Relief Act of 1997 and RRA 98 alone made 1,260 changes to the tax code. The magnitude of the changes made by those two pieces of legislation resulted in revisions of at least 100 separate IRS forms.

This translates into additional burden for taxpayers in several significant ways. First, it is difficult for taxpayers to understand why the law changes so much. As Ben Franklin said, "Nothing is certain but death and taxes." Taxpayers may not necessarily like the certainty of paying taxes, but certainty and familiarity at least lead to an understanding of expectations. An uncertain tax system leads to cynicism and unintentional noncompliance. Second, programming the changes into brittle computer systems is expensive and fraught with risks. Third, the magnitude of the changes, particularly recently, makes it hard for the IRS to convey those changes most effectively to taxpayers. The nature of changes can be difficult for the IRS to explain simply enough in forms, instructions and publications for taxpayers. The frequency of the changes means that IRS publishes guidance reacting largely to the most pressing issues, such as those for the next filing season, resulting in fewer resources to address longer standing questions. Finally, such frequent changes make it difficult for the IRS to adequately train its employees, which inhibits the service IRS employees can provide to taxpayers. Every taxpayer has a right to expect that, in every encounter with an IRS employee, whether it is a phone call asking a question about how to fill out a return or a meeting with a revenue agent in an audit, the employee understands the current tax laws and has the skills to apply the laws to the facts and circumstances of that taxpayer. When our employees do not understand the complex and frequent changes to the laws, we cannot explain the laws to the taxpayer. Failing to understand the law results in frustration on both ends.

For example, TRA 97 changed the law regarding capital gains. It lowered the rates, but it provided different brackets based on the type of property and the length of the holding period. There are 10 percent, 20 percent, 25 percent and 28 percent brackets. It resulted in the IRS completely overhauling Schedule D and in a marked increase in the amount of time and information required to complete that schedule. As a matter of fact, the burden estimate for the 1998 Schedule D is 6 hours and 41 minutes. These changes also resulted in a great deal of frustration for taxpayers who had difficulty calculating their capital gains and could not get through when calling the IRS for help. What could make things even more confusing is that this will become even more complicated in the relatively near future. A new 8 percent rate becomes effective in 2001 for capital gains on assets held longer than five years, that otherwise would have been subject to the 10 percent rate. Also in 2001, yet another rate—18 percent—will apply to capital gains otherwise subject to the current 20 percent rate with respect to assets held longer than five years.

Cumulatively, the changes over the last 13 years, but particularly TRA 97 and RRA 98, have greatly increased complexity. In conjunction with the complexity studies, I hope that you will simplify the tax code. If not, then I suggest that you can alleviate the burden of complexity on taxpayers, practitioners and tax administrators, as well as our tax system, by not changing the tax laws so frequently.

II. Targeted Relief for Groups of Taxpayers

Frequency and number of changes to the laws are obviously not the only causes of complexity in the tax code. I believe that targeted relief or incentives for groups of taxpayers significantly adds to the complexity of the tax law and the difficulty these taxpayers have in understanding and complying with the law. As I did before the Senate Finance Committee, I would like to take a moment to point out that I am not commenting on the merits of the policy reasons for targeted relief. Those in a position to make policy decisions may conclude that a certain subsidy is best or most simply delivered through the tax code. My goal here, like the RRA 98 studies, is to point out where the laws cause problems for taxpayers.

Recently, the Administration and Congress enacted into law many credits to help families, such as the child tax credit, the adoption credit and the education credits. These are in addition to the already-existing credits such as the child and dependent care credit, the credit for the elderly and the earned income tax credit. While these credits have resulted in lower taxes for taxpayers, they have also increased the complications these same taxpayers experience. Some of these credits sound like they involve similar concepts, but the tax law has defined them differently. For example, the definition of a "qualifying child" or "qualifying individual," used to determine eligibility to claim the child and dependent care tax credit, the child tax credit and the earned income tax credit, is different in each case. So, taxpayers who sit down to prepare their returns must fill out different worksheets or schedules and

look to different instructions each time they claim similar sounding credits to determine which definition applies and whether their circumstances meet the requirements in every situation.

Further, the interaction of these targeted provisions, with each other and with those currently existing, creates a great deal of complexity. The credits mentioned above must be claimed in a specific order. In addition, the child tax credit, adoption credit, the education credits and the earned income tax credit are each subject to different income phase outs. These phase outs are equivalent to marginal rate increases and require a taxpayer to perform additional calculations on a separate worksheet, rather than simply entering a standard credit amount on a tax form. The combination of these credits, along with exemptions and deductions, can also cause unintended consequences for taxpayers if they become subject to the Alternative Minimum Tax (AMT).

I am not suggesting that we should or should not employ targeted relief or incentives. Rather, I am advising you that certain legislation increases the complexity of the tax laws and the burden on taxpayers and the system. You must weigh the desire for simplicity against the policy reasons for the legislation. Going forward, you can help to reduce complexity by harmonizing the provisions to the extent possible. In this way, you can take steps to minimize the burden taxpayers experience in taking advantage of relief they expect from the laws that you passed.

III. OTHER ISSUES

I am certain that the other panels today will discuss some very specific areas in which you can reduce complexity and proposals to accomplish that result. I would like to take this opportunity to mention very briefly a couple of places in the tax code that could benefit from your attention.

Based on several articles this past filing season, I think the AMT is probably one of the most discussed and least understood areas in the tax code with good reason for both. Taxpayers that Congress never intended to subject to the AMT are and will increasingly be required to calculate the AMT. That means having to calculate taxes twice, once under the standard rules and once under the AMT rules, which requires taxpayers to understand the basics of the two regimes. Considering that taxpayers can be intimidated by preparing their returns under the one, more common, set of rules, I cannot imagine that subjecting more of them to the AMT will increase their comfort or compliance level.

I also believe that the penalty and interest regimes are unnecessarily complex and, as a result, misunderstood by taxpayers. With regard to the complexity of the regimes, I hope that the RRA 98 studies will provide you an important tool in improving interest and penalty administration. With regard to taxpayers' understanding of the interest provisions, I think the RRA 98 provision requiring the IRS, beginning in 2001, to provide taxpayers with interest computations and Internal Revenue Code citations imposing the interest will help taxpayers better comprehend their tax situations.

CONCLUSION

Mr. Chairman, it is important that we continue to discuss our tax laws and the effect of our laws on taxpayers. It is my hope that you will carry through the difficult task of reducing complexity. If not, I recommend that you not add to the complexity and slow down the frequency of change to the tax laws.

Chairman HOUGHTON. Thank you, Mr. Oveson. I would like to ask one question, and then I will turn it over to the rest of the members of the panel. You know, we constantly get tripped up on who does what. I have said this to Mr. Rosotti at times. Why don't you do this? Why don't you do that? And he said, "Well, that is a policy issue; it is not mine." I am trying to work out the mechanics and the structure of the IRS. But, I just wonder whether the Internal Revenue Service, just taking this meeting as a key, couldn't do an awful lot through the administrative function, rather than waiting for the change in the law.

Mr. OVESON. Well, first of all, there are many things that the IRS can do and many of those things are being addressed. But none of that can compensate for the tax law that you described, Mr. Chairman, in your opening remarks. It is essential if we are going to get simplification, that we get true simplification in the code.

But there are things that the IRS can do and let me mention a couple. Forms and publications. Again, we need to make those as simple and as clear in plain English as possible and a project has been underway for some time to do that. By the way, the issue popping up as about the third or fourth most serious problem is clarity of the forms and letters that go out to taxpayers. So there is a lot more that we can do with forms and letters and publications.

With customer service, there is a lot that we have done and, interestingly, have we gone too far with customer service? I think not, but there are those that would say that we have. But, certainly in the customer service area, there is more that we can do to help people, taxpayers, negotiate the tax system. So, yes, there is more that needs to be done, but we really need your help in simplifying the code to make that really meaningful.

Chairman HOUGHTON. I will ask you a question. You don't have to answer this if it is too sensitive for you, but I want to ask it anyway. Prior to the State of the Union, does the President ever ask the Internal Revenue Service to come in? When he talked about the 28 tax credits that he had, did he ever say to you, you know, I would like to do this and I think it is going to reduce—or is this something that is really handled at the Treasury level?

Mr. OVESON. I don't know. He didn't ever ask me and I have no knowledge of whether he asked the Commissioner or others at the IRS.

Chairman HOUGHTON. All right. Thanks. Mr. Coyne.

Mr. COYNE. Thank you, Mr. Chairman. Mr. Oveson, with the tax laws getting more complicated with each year that passes by, what comments do you have about the Taxpayer Relief Act of 1997 now that we have had a year or so of experience with it?

Mr. OVESON. Again, I have commented in my testimony and I would comment again that the targeted credits are a complicating factor in the code. Again, the policy decisions of why you do credits of that type versus something else is something you need to work out in the policy side of the business between you and the Treasury and the White House. But it complicates the code.

Mr. COYNE. Is that the only offering that you could give from that particular Act?

Mr. OVESON. I think that is pretty strong, actually. There were approximately 1,260 changes between the 2 years. There were just a lot of changes and a lot of complications and we hear that through the casework. We hear it through practitioners and then the other work that we do in the field.

Mr. COYNE. What complexity problems has the current tax return season yielded that you would be concerned about? The one that just has passed, for individual taxpayers?

Mr. OVESON. The biggest complication I see from this past tax season is the sheer size and momentum of the changes of the bill that passed last summer. Again, much of that bill—I would say

most of that bill—was taxpayer friendly and provided additional rights to taxpayers. Since you would have to say that was good, I would say it was good. I think it was a great piece of legislation. But you can't escape the fact that there was a lot of change and a lot to assimilate, certainly within the IRS. We are reeling and struggling to train employees, to change the systems, and to get all of the features that were in that bill implemented and get them working. And I think the same would be true from the outside.

Mr. COYNE. On the EITC issue, given the fact that both practitioners and taxpayers have had trouble calculating the earned income tax credit, do you have any recommendations in that area?

Mr. OVESON. Yes. The report to Congress that I presented in December has about four suggestions on the EITC. The top two: One is really a refund offset issue that the earned income tax credit should not be subject to offset by other debts. In a hardship kind of basis, we see that issue come up a lot. The other one that we see on EITC is the top wage-earner issue where only the top wage-earner in a household can be eligible for the credit. And we recommended that that be changed. And we have also recommended that you change the definition of qualifying individual and make that consistent with the exemption. That causes a lot of confusion as people are trying to claim the credit and comply with the law.

Mr. COYNE. Thank you.

Chairman HOUGHTON. Thanks, Mr. Coyne. Mr. Portman.

Mr. PORTMAN. Thanks, Mr. Chairman. Let me look back to the report language from the IRS Restructuring and Reform Act which just passed last summer, as you say. With regard to Mr. Houghton's earlier question to follow up on that, I think what Chairman Houghton was getting at is the sense that we want to have an independent view from the IRS on our process of developing tax legislation. And he took it a step further by saying, wouldn't it be great if the President actually consulted with his Internal Revenue Service before coming out with the Administration proposals, whether it was attractive new tax credits or other changes in the law that added complexity.

And I guess all I can say is that, under this law, we made two requirements. One was that there be a new complexity analysis done by the Joint Tax Committee as legislation is considered by this Committee or by the Finance Committee. We are waiting this year to see how that is going to work. I know Joint Tax is hard at work on it. And I would hope that the IRS, as intended in the law, would work with the Joint Tax Committee in providing input to the Joint Tax Committee as to the burden on the system. But that is new and that is a complexity analysis that will bear fruit even next month and the month after as we get into tax writing with this Committee. There you have a role to play because you, I hope, will be givin input to the IRS, as taxpayer advocate, which then will go into the process.

Second is that there is a new requirement, as you know, that the IRS send us, in addition to your report, an IRS report every year. And that report is regarding sources of complexity in the administration and the Federal tax laws. And then we would list all the factors and take them into account, including many of the things you take into account: frequently asked questions and so on. And

there, again, I hope that you will provide input that you are getting.

My point is that this new law we passed last summer is intended to reduce complexity prospectively. And it comes out of the commission's work of over a year's worth of effort looking at this and deciding that, if you are really going to have the tax laws work, you have got to reduce the complexity.

There is also in the report language, though, this Sense of Congress that the IRS should provide the Congress—and I am reading the report language here—"with an independent view of tax administration." And I guess part of what my frustration has been in my short time here in the last 6 years is that we often get an administration position and we don't get an IRS position on tax complexity.

And I would just pose the question to you, do you feel as though your input going into the system, whether it is to the IRS and then to the Joint Tax Committee or directly from the IRS to the Congress in terms of these two reports or in your report to us, do you feel as though you are able to give us an independent, unvarnished, apolitical, non-tax ideology or tax policy view as to administration? Do you feel comfortable giving us that input and do you feel as though you are giving adequate input?

Mr. OVESON. To answer your question directly, yes I do. And the fact that I would be here today talking about the alternative minimum tax as directly as I am is, I think, a testament to that independence and to that directness.

Mr. PORTMAN. And talking about the EITC takes some courage also.

Mr. OVESON. Yes.

Mr. PORTMAN. Although some of your suggestions would broaden the EITC in an area where we have already got a tremendous amount of mispayment and some would say fraud.

Mr. OVESON. Thank you. One of my concerns with the EITC is that it is there. It is in the law. And we see taxpayers that would qualify that are being excluded from it. And that our position, as you have put into the statute, is to look at the taxpayers point of view with EITC and not, necessarily, from the compliance point of view.

On the other issues, we do have the study internally within the IRS, on complexity and I will be a player. I will be on the Committee. I will be working with them and advising the group that is working on complexity within the IRS. I will be a contributor to it.

With regard to the Joint Committee work, I look forward to the outcome of that work and, hopefully, it will be extremely valuable to you as you evaluate proposals against that complexity analysis. And I would be happy to help any way you or the Joint Committee would like.

Mr. PORTMAN. Thank you. Thank you, Val.

Chairman HOUGHTON. Thank you, Mr. Portman. Mr. Neal.

Mr. NEAL. Thank you, Mr. Chairman. In your written statement, you raised the question of AMT and you suggest that you can't imagine subjecting more and more taxpayers to the AMT will increase "their comfort or compliance level." The most immediate problem is the nonrefundable credits and the AMT. Would you be willing to give us a better idea about your thoughts of what will

happen to compliance and taxpayer frustration in general if we don't fix the problem with AMT and nonrefunable credits?

Mr. OVESON. That is a bit speculative. The question asks for a speculative answer. My personal opinion is that, as the law gets more complex, people choose to drop out of the system, to not comply, because it is so complex, out of frustration or out of other kinds of feelings. And that it is not conducive to good tax compliance to have the law get more and more complex. And this alternative minimum tax, as you suggest, is an area that kind of creeps up and grabs people by the back of the neck and creates a lot of anger.

Mr. NEAL. Well, as you know, my legislation would collapse the three phaseout ranges for the adoption, education, and child credits into one phaseout range. Do you think that is a useful suggestion?

Mr. OVESON. I have read your proposals and your bill, and, in general, the simplification that it would create, I think, would be great.

Mr. NEAL. Thank you. Thanks, Mr. Chairman.

Chairman HOUGHTON. Thanks, Mr. Neal. Mr. Watkins.

Mr. WATKINS. Thank you. The third line on your testimony, you basically said, you know, you see yourself as your role would be to be the voice of the taxpayer and the advocate of more equitable and balanced approach to tax administration. Do you see that more in policy or do you see that more dealing with the compliances that the taxpayers run into?

Mr. OVESON. I see it more with the administration of the tax law and the day-to-day field work that we have got taxpayers out there working in every area of the country and every State——

Mr. WATKINS. I am glad to hear you say that because I think that is where many of us need help out there. As I said in my opening statement, I have turned to the taxpayer advocacy group a couple of times and they have been able to be on the ground and been able to intercede in working with giving some confidence in working with the IRS with some of the problems that they have had and I have felt like it was really a plus in that area. And I know we have a lot of changes, you know, as we go about looking at the tax policy and I know the great one we would like to have would be sort of simplified that one could probably do their own taxes. And I don't know that if we will ever see that.

But, again, I have stated, you know, as I have tried to analyze it and reflect on it, I think our national priorities shouldn't dictate our tax priorities. And I don't know how we maintain certain positions economically around the world, especially in this competitive global economy we are in unless we have certain incentives in place.

And that is like a national food basket for this country. Food is important and we need to have the kind of tax policies that make it feasible to do so. In the same way as we look at the national security and the need of energy, we have got to have tax incentives to produce the type of oil production that quantity and all that we need to have, especially when you see, if we analyze our national policy as we deal with Kosovo and all concerning oil embargoes and the other things that has turned against us, we are going to find that we are in a world of hurt, literally.

So I think we have to look at our priorities and say, what are our incentives? What is necessary for us to have that national security and what do we have to have in the way of trying to secure the future for our children and our grandchildren? So I appreciate your being on the ground and your groups trying to help many of the families out there and individuals and small businesses that are running into complication. I think it is a great assistance. Thank you.

Chairman HOUGHTON. Thanks very much. Mr. Weller.

Mr. WELLER. Thank you, Mr. Chairman. And, Mr. Oveson, thank you for your testimony. And I am glad to see you here today. I represent the southside of Chicago and the south suburbs and whether I am at a union hall or the VFW or the local coffee shop or a grain elevator in some of the rural areas I represent, everyone complains about their taxes are too high, but they also complain about how they are too complicated, too unfair, they are frustrated that over half of them tell me they have to hire someone else to do their taxes. They are afraid of being audited if someone else doesn't fill out their tax forms.

But they really focus on the unfairness of the Tax Code and the complexity of the Tax Code is part of the unfairness. But they are frustrated that the Tax Code unfairly treats married working couples. They are frustrated that the Tax Code unfairly treats family farms and family businesses because of the estate tax. They are frustrated that the alternative minimum tax is now goring middle-class working families. They are frustrated that senior citizens who want to work longer after the age of 65 are stuck with the work penalty, the earnings limit, which confiscates much of their social security benefits. And the self-employed are also frustrated that the big corporations can deduct 100 percent of their health insurance premiums, but the little guys and the little gals that are self-employed can't.

And Jennifer Dunn and I have put together a package of what we call tax simplification that addresses the unfairness in these areas as a solution, not only of lowering the tax burden, but also to address the complexity of the code by simplifying the unfair aspects of the code. And I would like to focus on a couple of these just to ask your perspective. Particularly the marrieds tax penalty which I consider to be the most unfair complication in the Tax Code which affects 21 million married working couples who pay an average of $1,400 more in higher taxes just because they are married.

Do you consider, you know, the consequences of our Tax Code where our joint filers pay higher taxes, joint filers with an identical income pay higher taxes than two single filers, perhaps living together, with identical incomes—that married couple pays $1,400 more—do you consider that fair?

Mr. OVESON. Boy, you put it to me so directly. The fairness issue of the marriage penalty, I think, cuts both ways and certainly there are some that get caught one way and some that get caught the other way and I think that is a policy issue that you need to grapple with. There are certainly some complexity issues related to the marriage penalty, but I don't think it is a clear-cut complexity issue.

Mr. WELLER. So you really feel that, for 21 million couples that pay $1,400 more, it is not really unfair that they do? Now, as a taxpayer advocate, I would think that you would want them treated more fairly.

Mr. OVESON. If you fixed it in that direction, you are going to have a whole group of other taxpayers that are going to go the other direction, depending on how you fix that issue.

Mr. WELLER. Well, if you have a man and woman with identical incomes who are living together, have the same household income as a married couple, should the married couple pay more in taxes just because they are married?

Mr. OVESON. And that is a policy issue that I am not going to comment on.

Mr. WELLER. All righty. Well, I certainly believe it is unfair and I know 21 million couples, 42 million people, who do and certainly feel our Tax Code should be marriage neutral so that you should not pay more just because you are married, under our Tax Code. And, you know, the CPAs were before us a year ago and we were talking about the marriage tax penalty in testimony and they pointed out that, you know, once you get beyond the marriage tax penalty, the big one that exists for joint filers, that there are 63 other marriage tax penalties. And most of them are the result of the so-called targeted tax cuts.

Mr. OVESON. Yes.

Mr. WELLER. You know, where there is various means testing and so forth and the means testing is never double for joint filers what it is for single filers. Do you feel that it would help simplify the code if we eliminated those 63 different marriage penalties——

Mr. OVESON. Yes.

Mr. WELLER [continuing]. So that joint filers would be able to earn twice as much as single filers?

Mr. OVESON. Definitely.

Mr. WELLER. Well, how about for the larger marriage tax penalty for joint filers? Do you feel it would simplify the code if joint filers would be able to earn twice as much as a single filer with the same burden as two single filers?

Mr. OVESON. Again, my concern with your question is that there are some tax policy elements to your question and to the issue. There are some simplification issues. And it is hard to separate those out. And, certainly, the deal with the phaseouts and the credits and the others would be extremely helpful in solving the complexity issue. Again, there are some tax policy questions implicit in all that I would prefer not to get into.

Mr. WELLER. Well, I would like to work with you. I think it is really wrong that under our Tax Code our society's most basic institution is punished by our Tax Code and I believe one of the best ways we can help families is to simplify the code by eliminating that unfair aspect called the marriage tax penalty. Thank you, Mr. Chairman.

Chairman HOUGHTON. Thank you very much. I would like to just ask a final question, unless other people have continued questions. These are not up-to-date figures, but a few years ago, we had a regional meeting of the Oversight Committee, when Mr. Pickle was chairman of it, and I think we figured at that time that it cost

something like $400 billion for people to make out their taxes. I mean, it was that expensive.

So, I look at your testimony here and you talk about the frequency and the number of the changes to the tax laws. Suppose we froze that for 1 year—had no changes. The same thing as far target relief for groups of taxpayers. There would be no credits, no exemptions, and no deduction changes at all. We would do the same thing as far as the alternative minimum tax is concerned. What sort of impact would this have on the country?

I mean, you obviously wrote this thing and you have a sort of a composite view. Tell me how you feel about it.

Mr. OVESON. I think in a large view of the situation, that it would be helpful to have a multi-year commitment not to change the Tax Code. You would have to forego some solutions: the marriage-tax penalty, the alternative minimum tax, other kinds of issues that you feel would help simplify the code. You would have to forego those. But the impact that that would have on the taxpayers themselves, certainly the impact that it would have within the IRS, particularly during these times when we are rebuilding and redoing the computer systems and having to, as Commissioner Rosotti explained earlier today and has said many times, redesign and rebuild the home while you are living in it; it is even worse when you talk about redesigning an airplane while you are flying it. While you are making these changes, it is extremely difficult and fraught with risk.

So my suggestion, No. 1, less changes, less frequent changes to the Tax Code, was implying just what you suggested here, that there would be some tremendous benefits in freezing that for a period of time.

Chairman HOUGHTON. Well, I think that there are two categories—the internal and the external. Internal, obviously it helps the IRS, you know, in terms of the transition in using your new computer system and trying to get more electronic filing and things like that. But what does it do for the ordinary American? Suppose you did this, which you suggest, what would it do, in a year, if that happened?

Mr. OVESON. I think the longer you do it, the more benefits there are. In a year, certainly all of the tax software vendors won't have to scramble to do that, although they may lose some market in terms of making the changes and selling them. But, from what I hear from practitioners and having been one in the past, there is just a lot of things you don't catch as you go through and it is difficult and you have got to go really scramble to learn the changes that go on. And there would be a benefit throughout the economy, throughout the taxpaying world to not having the level of changes that we have had recently.

Chairman HOUGHTON. OK. Mr. Coyne, have you got any questions?

Mr. COYNE. No, Mr. Chairman.

Chairman HOUGHTON. And, Mr. Weller, have you got any other?

Mr. WELLER. No.

Chairman HOUGHTON. Well, Val, let me ask if you have some thoughts on this as a followup to your statement; you might want to send them along to us. You talk about this multi-year program.

Some of the impacts it would have inside, specifically stating those things which you do for the ordinary taxpayer. I think it would be an interesting followup to this meeting if you could do that. And thank you. Thank you very much.

Mr. OVESON. Thank you.

Chairman HOUGHTON. We certainly appreciate your not only being here, but also the wonderful work you are doing.

All right. Now we have the tax practitioner panel. Mr. Gerard Sokolski, who is a CPA partner in a firm in the great city of Rochester, New York, and Stephen B. Smith, who is a general partner in a CPA firm in Columbia, Missouri. Would you please come to the stand. OK, good. Thank you.

Gentlemen, how are you? Good to have you here.

Mr. Sokolski, would you like to start with your testimony?

STATEMENT OF P. GERARD SOKOLSKI, CPA, TAX PARTNER, MENGEL, METZGER, BARR & CO., LLP, ROCHESTER, NY; ON BEHALF OF NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. SOKOLSKI. Certainly. Thank you. Good afternoon, Mr. Chairman, and Members of the Oversight Subcommittee. I am Gerry Sokolski, CPA, a tax partner with the regional upstate New York firm of Mengel, Metzger, Barr, and Company and, as of June 1, I will be president-elect of the New York State Society of CPAs. I am honored to testify before you today on tax simplification. My written testimony contains several points which I will not be able to address in the time allotted. I therefore respectfully request that my written testimony be admitted to the record.

Let me first offer my opinion as to the chief causes of unnecessary complexity. If we face those causes, stare at them eyeball-to-eyeball, perhaps we can take some steps to eliminate unnecessary complexity in the future.

Ladies and gentlemen, in the words of Pogo, "I have met the enemy and they is us." By they, I mean taxpayers and tax advisers who obtain special provisions for their clients. They include legislative staff, many of whom are fresh out of school and have never worked out there in the real world. And, with utmost respect, they also means you. I know that you all have very busy schedules, but sometimes the tax laws look as though you haven't thought them through sufficiently. Perhaps it is unreasonable to expect legislators to understand their legislation in this complex society. Still a key element of tax law draftsmanship, going back to Adam Smith, is that tax law should be understandable.

Now on to specifics. Recent changes to the IRA rules have made this area extremely complicated. The complexity results from many different phaseouts applicable to the IRAs. Not just IRA phaseouts need reform. In 1998, child credits, tuition tax credits, and education loan interest deductions dramatically highlighted the problem with the so-called middle income phaseouts. Who would have thought that a young married couple just out of school and making $37,500 each would not be able to deduct student loan interest because their combined income was too high? I suggest that you use a uniform phaseout schedule that kicks in at a higher income level

if phaseout is necessary at all. This would make the tax system simpler, if not more palatable.

Also needing reform are the minimum distribution rules from qualified retirement plans. The current rules were designed in the early 1960's. In the 1990's, they are hurting the working elderly and also widows. They feel they may need more money in their accounts later in their lives. Also the unisex tables used to compute minimum distributions discriminate against women because of their higher life expectancy.

Capital gains rules are another area of unnecessary complexity. In 1996, the schedule D was a single page with 19 lines. Taxpayers whose only capital gains came from mutual fund dividends reported their gains on the first page of form 1040 and were excused from filing schedule D. No longer. After the 1997 Taxpayer Relief Act, schedule D ballooned to 54 lines on 2 pages.

Now on to the AMT. The AMT is now taxing taxpayers whom it was never intended to affect. One of my colleagues faxed me a startling example. It involves a divorced mother of two who received $102,000 of alimony and had AGI of $108,000. She paid nearly $7,800 of additional tax due to AMT because $14,000 of mostly real estate taxes and $10,000 of home mortgage interest was not deductible for AMT purposes.

This also highlights that AMT discriminates against taxpayers in high-tax States such as New York and California. Personally, I would like to see you repeal the AMT. But if you cannot, our written testimony suggests a number of reforms you should explore.

Another area of unnecessary and unexpected complexity is the so-called kiddie tax. Often kiddie tax situations require the running and rerunning of a family's tax returns to arrive at the correct tax.

I sincerely thank you for the opportunity to testify here today. It is an experience I will always cherish. Let me end by reminding you of one of Adam Smith's four maxims of taxation: Certainty. Specifically, Smith advised the tax which each individual is bound to pay ought to be certain and not arbitrary. The time of payment, the manner of payment, the quantity to be paid ought all to be clear and plain to the contributor and to every other person. If we regain that sense that taxes need to be clear and plain to every contributor, tax complexity will never be an issue. Thank you.

[The prepared statement follows:]

Statement of P. Gerard Sokolski, CPA, Tax Partner Mengel, Metzger, Barr & Co., LLP, Rochester, New York; on Behalf of New York State Society of Certified Public Accountants

Good afternoon, Mr. Chairman and distinguished members of the Oversight Subcommittee. I am P. Gerard Sokolski, CPA, a tax partner with the regional CPA firm of Mengel, Metzger, Barr & Co. LLP, which has four offices in upstate New York. Also, as of June 1, I will be the President-Elect of the New York State Society of Certified Public Accountants. The NYSSCPA represents more than 31,000 CPAs, who collectively serve literally millions of taxpayers, ranging from individuals and corner grocery stores to multinational megacorporations. My firm serves a variety of individual and small business clients in central and western New York State.

I am honored to testify before you today to give you a practitioner's views on the complexity of the Internal Revenue Code and the hardships it imposes on individual taxpayers and small businesses. Although many areas are too complex and require simplification, I will limit my comments today to six issues:

- Tax-advantaged savings accounts,
- Phase-outs,
- Retirement plan distribution reform,

- Capital gains and the Schedule D,
- Alternative minimum tax, and
- The "kiddie tax".

It is no wonder that Americans are burdened with an overly complex tax law. There have been significant tax-law changes in eight of the last 14 years—1986, 1987, 1988, 1989, 1990, 1993, 1996 and 1997. The 1997 Taxpayer Relief Act alone contains

- 36 retroactive changes,
- 114 changes effective August 5, 1997,
- 69 changes effective January 1, 1998, and five changes effective thereafter,
- 285 new Code sections, and
- 824 Internal Revenue Code amendments.

Because of the average taxpayer's inability to understand the requirements of the tax laws as interpreted in the tax forms, many are forced to pay a tax preparer to help them meet their tax obligations. This may be appropriate for wealthier taxpayers for whom tax advice is a necessary part of their financial planning, but I am hard-pressed to justify tax rules that also create a need for lower-income taxpayers to hire paid preparers.

Before turning to specific instances of tax complexity, let me offer my opinion as to the chief causes of unnecessary complexity. If we face those chief causes—stare at them eyeball to eyeball—perhaps we can take some steps to eliminate unnecessary complexity in the future.

Ladies and gentlemen, in the words of Pogo, "I have met the enemy and they is us!" By "they" I mean that the causes of complexity include taxpayers and tax advisors who obtain special provisions for their clients. "They" includes legislative staff, many of whom are fresh out of school or have never worked "out there" in the real world. Some staff members latch on to trendy economic theories and craft statutes that are simply impractical. And, with utmost respect, "they" also means you. I know that you all have very busy schedules, but sometimes the tax laws look as though you haven't thought them through sufficiently. Perhaps it is unreasonable to expect legislators to understand their legislation in this complex society.

Still, I submit to you that a key element to tax-law draftsmanship going back to the days of Adam Smith is that tax law should be understandable. If it is unreasonable to expect you to understand your own work product, how much more unreasonable is it to expect the average taxpayer to understand it?

Now to specifics.

TAX-ADVANTAGED SAVINGS ACCOUNTS

We are very supportive of tax-advantaged savings accounts. Nevertheless, recent changes to the IRA rules have made this area extremely complicated. In 1998, individual taxpayers could choose from among the

- Traditional IRA
- Spousal IRA
- Nondeductible IRA
- The Roth IRA
- The Education IRA (EDIRA)
- The SEP IRA, and
- The Simple IRA.

Availability of many of these phase out as incomes rise. But the phase-outs are not consistent. For instance, the income phase-out ranges from $30,000 to $40,000 for a single taxpayer in a traditional IRA to $150,000 to $160,000 for joint return filers for a spousal IRA where the spouse is not covered by a qualified plan. The nondeductible IRA has no income phase-out range at all. The phase-out range for the Roth IRA is between $95,000 and $110,000 for a single taxpayer and $150,000 and $160,000 for joint filers. The same phase-out rules apply for the Education IRA.

Perhaps a little uniformity is in order.

While discussing the area of retirement saving choices, I would be remiss if I did not mention the complexity of Keogh plans. These are the retirement plans for the self-employed. Because an algebraic formula must be used to calculate the maximum Keogh contribution, an individual owning an unincorporated business and filing a Schedule C is generally not capable of calculating his or her own self-employed contribution deduction. Thank goodness for computers!

With all of the current effort to save the Social Security program, it makes sense to encourage taxpayers to put more into retirement plans. In the case of the self-employed individual, the deduction should be a straight percentage of the individual's Schedule C income. An individual owner of a corporation merely has to mul-

tiply his or her salary by a maximum percentage to determine his or her annual deduction. Why not the self-employed?

You can also encourage additional contributions to IRAs if you eliminate or raise the income phase-out ranges. But please make them uniform throughout the various IRA vehicles.

PHASE-OUTS

It is not just IRA phase-outs that cry out for reform. This past year child credits, tuition tax credits and education loan interest deductions dramatically highlighted the problem with so-called middle-income phase-outs. Numerous middle class taxpayers who thought Congress had done something for them with the Taxpayer Relief Act of 1997 were disappointed, some even angry, to find out that the credits or deduction didn't apply to them. Who would have thought that a young married couple just out of school and making $37,500 each would not be able to deduct student loan interest because their combined income was too high? Presumably the intended effect was to show middle-income families that their member in Congress cared about them. The actual effect for many was disillusionment and even anger. My suggestion would be to use uniform phase-out schedules that kick in at a higher income level, if phase-out is necessary at all. This would make the tax system simpler if not palatable

RETIREMENT PLAN DISTRIBUTION REFORM

Another area that needs simplification and reform is Internal Revenue Code section 401(a)(9), which governs distributions from qualified retirement plans. Where do you come up with numbers like 59½ and 70½? These are the respective ages at which qualified plan distributions may begin and must begin.

I need to digress a moment and talk about half-years. I always assumed that ½-year increments are the result of congressional compromise. They also pop up, for instance, in the depreciation rules, where the cost of certain buildings must be recovered over 31½ years. Talk about unnecessary complexity! Ladies and gentlemen, please stay away from 6-month increments in your compromise discussions.

The current qualified plan distribution rules were first designed in the early 1960s. In the 1990s they are hurting the elderly who want or have to work past the traditional retirement age and also widows and widowers. With ever-greater life expectancies, it is worrisome to the elderly to require minimum distributions. They feel they may need the money later in their lives. Also, the tables used to compute minimum distributions are unisex tables. Because women have a higher life expectancy, their minimum required distributions are higher than they should be to match their life expectancies.

This area of the tax law is both overly complex and past its prime demographically.

CAPITAL GAINS AND SCHEDULE D

The capital gains rules are another area of unnecessary complexity. In 1996, the Form 1040, Schedule D, was a single page with 19 lines. Taxpayers whose only capital gains transactions came from mutual fund dividends were even excused from filing a Schedule D and could report their mutual funds capital gain on page 1 of the Form 1040. No longer!

After the 1997 Taxpayer "Relief" Act, Schedule D ballooned to 54 lines on two pages. The form became very confusing to the average taxpayer, not only because of the variety of tax rates—10%, 20%, 25%, and 28%—but also because it is sometimes so hard to determine what assets qualify for each of these rates.

ALTERNATIVE MINIMUM TAX (AMT)

We have two federal income tax systems, the regular tax and the alternative minimum tax, or AMT. Theoretically, the AMT is very similar to the flat tax one hears touted in tax policy circles. What makes the AMT so complicated, however, is its need to interface with the regular tax.

The individual AMT is now taxing taxpayers whom it was never intended to affect. Among the most important reasons for this is that tax brackets and exemptions are not indexed for the AMT as they are for the regular income tax. Furthermore,

some important credits are either directly or effectively not allowed against the AMT.[1]

In my firm we had several cases during the past filing season where taxpayers with adjusted gross incomes below $100,000 were subject to the AMT. Many taxpayers are not sophisticated in tax matters and have no idea that they may be subject to the AMT. It is easy to understand why many taxpayers fail to notice their AMT obligations when filing their return—it is so unexpected.

The disallowance of certain itemized deductions in the calculation of the AMT is another AMT feature that surprises taxpayers in the middle-income group. For AMT purposes, taxpayers lose itemized deductions, which are already reduced by the 3% AGI adjustment as well as the 2% miscellaneous deduction floor. Furthermore, medical expenses are disallowed to the extent that they do not exceed 10% of AGI. Under the regular tax, medical expenses are permitted to the extent they exceed 7½% of AGI. One of my colleagues faxed me a startling example. It involves a divorced mother of two who received $102,000 of alimony and had an AGI of $108,000. She paid nearly $7,800 of additional tax due to the AMT because $14,000 of state tax[2] and $10,000 of home mortgage interest was not deductible for AMT purposes.

I should also note that the AMT is rather unfair to taxpayers in high tax states such as New York and California. Taxpayers with the same AGI often will pay AMT if they live in high-tax states, but not trigger the AMT if they live in low-tax states.

Small businesses are also adversely affected by the Alternative Minimum Tax. One component of the AMT calculation, the ACE adjustment, requires the calculation of depreciation three different ways. Small business taxpayers who are not subject to the alternative tax must still make this calculation because a negative ACE adjustment could be of benefit to them in future years if they become subject to the Alternative Minimum Tax. Although the ACE adjustment for depreciation has been eliminated prospectively, those with assets placed in service prior to the enactment of that legislation are still required to calculate the ACE adjustment depreciation.

RECOMMENDATIONS FOR CHANGE IN THE AMT

The easiest way to eliminate the complexity of the Alternative Minimum Tax would be to repeal it. I understand this is a very political issue and is much easier said than done. However, if repealing the AMT is not a possibility, there are several changes that can be made to the individual Alternative Minimum Tax that would help reduce its complexity. These include the following:

- Index the AMT brackets and exemption amounts.
- Eliminate any add-back of itemized deductions and personal exemptions in calculating alternative minimum taxable income.
- Permanently allow certain regular tax credits as credits against the AMT.
- Exclude low- and middle-income taxpayers from being subject to the AMT by providing an exemption when adjusted gross income (AGI) is less than $100,000 (indexed).

Small business relief from the Alternative Minimum Tax could be accomplished by eliminating the ACE calculation completely and increasing the corporate exemption from AMT to eliminate small businesses under an indexed dollar amount of annual sales (higher than the current exemption).

THE "KIDDIE TAX"

The "kiddie tax" was enacted to keep parents from shifting income to lower-tax children. It was passed along with several other measures to curtail this practice, including the elimination of "Clifford trusts" and the prohibition against a child taking a full personal exemption while the parents take the dependency deduction. The lowering of the top tax bracket also reduced the incentive to shift income. I believe the kiddie tax was overkill and these other provisions were sufficient to curtail abuse.

In any event the kiddie tax is very complicated, requiring the running and rerunning of a family's tax return to arrive at the correct tax. Also, it is not designed quite correctly and can result in a higher tax than if the income were kept with

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[1] Congress passed legislation last year allowing these credits against the AMT for 1998 only, creating the need to extend this palliative in future years. The legislative technique of annual extenders is very unfortunate. An extender bill introduces unnecessary uncertainty into the tax law and significantly increases tax compliance costs when the extender bill is passed late and taxpayers have to file amended returns. *We strongly discourage you from resorting to short-term extenders.*

[2] $12,426 of real estate taxes and $1,619 of state income taxes. All numbers used in the example above are rounded.

the parent. Two examples in which this occurs are where the parents have capital losses while the children have capital gains and where the parents have investment interest limitations.

ADMINISTRATIVE REFORMS

We would also like to suggest two administrative reforms that would greatly simplify representation of individuals and small businesses. First interim extensions (July 15 for partnerships and trusts and August for individuals) should be eliminated and the initial extensions should be for six months. And second, powers of attorney are a perennial source of irritation in relations between the IRS and the practitioner community. Consideration should be given to a "check the box" power of attorney or "tax information authorization," whereby the taxpayer can check a box on the tax return at the time of filing giving the IRS permission to discuss the contents of the tax return with the preparer who has signed the tax return.

CONCLUSION

I sincerely thank you for the opportunity to testify here today. It is an experience I will always cherish. Let me end by reminding you of one of Adam Smith's four "maxims" of taxation—certainty. Specifically, Smith advised, "The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid ought all to be clear and plain to the contributor, and to every other person." This is good advice as you move to amend the Internal Revenue Code. If we regain the sense that taxes need to be "clear and plain to every contributor," tax complexity will never be an issue.

Chairman HOUGHTON. Thanks very much, Mr. Sokolski.

Mr. Smith.

STATEMENT OF STEPHEN B. SMITH, CPA, GENERAL PARTNER, WILLIAMS-KEEPERS CPA'S LLP, COLUMBIA, MISSOURI

Mr. SMITH. Thank you, Mr. Chairman. Mr. Chairman and Members of this distinguished Subcommittee, I am Stephen B. Smith. I am a practicing CPA from Columbia, Missouri. And I appear before you today with observations from the viewpoint of a practitioner with 30 years experience in the field of taxation.

Before drawing your attention to a few aspects of my prepared testimony and at the risk of appearing to curry favor, I would like to refer to the chairman's Tax Simplification and Burden Reduction Act. I did not have the benefit of the chairman's May 12 statement concerning that Act when I prepared my testimony prior to going on vacation. In summary, and without exception, it is an excellent start on the road to tax simplification. I believe it does not go far enough in the alternative minimum tax area, however.

Referring to my prepared statement, I draw your attention to the fact that my comments are divided into two areas: those requiring statutory changes, the logical province of this Subcommittee, and those requiring administrative action.

Dealing first with what I perceive to be the largest problem and, perhaps, somewhat repeatedly, the alternative minimum tax needs to be repealed outright. As I recall, this tax was conceived 20 years ago as a political reaction to a very limited number of high-income individuals who paid no income tax. It was instituted in order to collect taxes on fewer than 500 returns out of something on the order now of about 90 million returns that would be filed. It is to be repealed outright, as I said.

However, it traps more taxpayers each succeeding year and thereby generates revenue, the ability to repeal it in a revenue-neutral environment gets successively difficult. I am reminded of the commercial, one of the punchlines of which was you can pay me now or you can pay me later, but every year it gets to be more expensive to consider repealing this. This is a stealth tax. It is a parallel tax universe with significant impact and almost no ability to be predicted with any degree of certainty and economy of effort.

Few taxpayers can describe it at all. A substantial number of tax professionals such as Mr. Sokolski and I cannot accurately describe it. And I would throw myself into that group also. If it is politically impossible to abolish it outright, the bare minimum changes should be to exempt State and local income taxes from the calculations and to index the brackets for change.

The cumulative effects of complexity affect all of us. Although each individual rule may be capable of explanation, the cumulative effect of many different provisions, each requiring a unique understanding of income levels, facts, and circumstances to which they do apply, they don't apply, or they might apply causes many taxpayers to simply give up any attempt at preparing their own returns. This failure to prepare their own return produces a citizenry which is more removed from the tax laws of our country and more removed, more importantly, from the details of their own finances. Both are detrimental to our society.

The current code is so complex that many taxpayers are suspicious that someone else is gaining an unknown advantage on them. The result of this is a compensation for the perceived inequity and voluntary compliance goes down. This is a euphemism for the process whereby individual taxpayers don't report income or overstate deductions in order to decrease the amount of tax paid and, therefore, be fair. Even ignoring fairness completely, we believe that a significant minority of taxpayers' actions are influenced by alternating attacks of greed and fear. And with few or no IRS field audits to worry about, fear is the less dominant concern and compliance goes down.

A simplified filing process would be greatly to the advantage of all. The perceived complexity unnecessarily scares millions of taxpayers into hiring others to prepare a return which should be easy to self-prepare and the exclusion of a *de minimis* amount of interest and dividends from taxation, such as those that have been proposed on more than one occasion, would serve to remove many returns from the realm of the paid preparer.

Although I prefer the chairman's proposal for capital gains, the Coyne-Matsui Capital Gains Tax Simplification Bill would also solve the problem. And many parts of Mr. Neal's Individual Tax Simplification Act of 1999 addressed complexity which need attention. Thank you for the privilege of appearing before you today and I would be pleased to answer any questions you might have.

[The prepared statement follows:]

Statement of Stephen B. Smith, CPA, General Partner, Williams-Keeper CPA's LLP, Columbia, Missouri

INTRODUCTORY COMMENTS

Mr. Chairman, and members of this distinguished subcommittee: My name is Stephen B. Smith, and I am a general partner in Williams-Keepers CPA's LLP. Our firm is located in Mid-Missouri and encompasses the talents and efforts of more than 80 of my colleagues in our three offices. We assist over two thousand clients in their dealings with various taxing authorities. I am not notable for any historic interest in tax policy or lobbying for or against specific Internal Revenue Code changes. My comments are contributed as "observations from the Heartland."

Speaking personally from the perspective of thirty years of tax practice I have seen the Internal Revenue Code become increasingly complex, more expensive to comply with and viewed as unfair in many material aspects. The disdain of many taxpayers for the societal engineering which permeates the tax law is palpable. In addition, with reduced personal contact between taxpayers and the Internal Revenue Service, many taxpayers now view compliance as a lottery; and, voluntary compliance has declined. Many have no faith in the system and believe it to be inherently unfair. The significant majority of high-income taxpayers have never had an IRS field audit.

To be viewed as fair, we believe any tax system must be:

1. Uniform
2. Understandable
3. Administered impartially
4. Reasonable in relation to the income of the payer
5. Not unduly burdensome with which to comply

At the moment, we believe only #3 would be generally acclaimed to be present. Our experiences with the vast bulk of Internal Revenue Service employees prove them to be dedicated to their jobs. Many of them feel they do not have adequate support or adequate tools to do their job, but they do the best they can. There clearly is room for improvement and we refer below to some of the most-needed areas based on our day-to-day experiences.

We firmly believe a small group of trained tax practitioners could materially simplify the Internal Revenue Code, on a revenue-neutral basis, if exempted from the lobbying process. The Alternative Minimum Tax solution, referred to below, might require an exemption from the charge to make all changes on a revenue-neutral basis. I have divided my comments below into two areas: first, those requiring legislative change; second, those requiring administrative action alone.

Suggestions for Internal Revenue Code Changes

Repeal or drastically amend the Alternative Minimum Tax (AMT). This tax was conceived twenty years ago as a political reaction to a very limited number of high income individuals who paid no income tax. My recollection is that it was instituted in order to collect taxes on fewer than 500 returns. Originally designed to apply to a handful of wealthy taxpayers, it can reasonably be expected to apply to millions of taxpayers in the very near future. It ought to be repealed outright. However, it traps more taxpayers each succeeding year and thereby generates revenue. The ability to repeal it in a "revenue-neutral" environment gets more difficult each year. It is, practically speaking, impossible to determine without an unreasonable effort. Generally the only time the true amount of AMT tax can be calculated, if indeed it can be calculated at all, is annually during the tax preparation process. It is a "stealth" tax. It is a parallel tax universe with significant impact and almost no ability to be predicted with any degree of certainty and economy of effort. Few taxpayers can describe it at all. A substantial number of professional tax practitioners cannot accurately describe it. It would be far preferable, nationally, for the tax to be wiped out and to allow a relatively few persons to pay no tax at all than to cause the pain and suffering on the scale it currently produces. The AMT may be the single most unknown or unexpected tax and strikes taxpayers in many cases solely because of their state of residence. High-tax-state taxpayers are thus treated differently, nationally, solely because of the tax burden of a political subdivision below the Federal level. If it is politically impossible to abolish the tax, the minimum changes should be to exempt state and local income taxes from the calculations and index the brackets for inflation.

Change underpayment rules for the individual estimated tax safe harbor. For many years the underpayment of individual income tax safe harbor rules provided a simple test permitting 100 percent of the prior year's tax liability to serve as a safe harbor for avoiding penalties for failure to "quarterly" pay enough income tax.

As a revenue-raising measure the safe harbor was initially raised for several years, then subsequently structured to fluctuate up and down over a period of years, again solely as a revenue-balancing measure. The old rule was simple, effective and economical to compute and follow. The new rules are unduly complicated and for many taxpayers very expensive to compute. The new rules do not, in the end, change the amount of the tax. In many cases taxpayers are required to make elaborate calculations as many as three times a year. A return to the original safe harbor would be a significant simplification for many taxpayers who do not otherwise have complex returns, but have incomes which fluctuate from year to year.

Coordinate phaseout rules. Different rules for phaseouts should be coordinated. The lack of coordination among phaseouts that apply to different provisions should be remedied. Recent years have produced a plethora of "targeted" credits and special provisions that are phased in or out at different levels of income. Although the various levels may well have been set at different times based on fiscal cost estimates, the lack of a small group of homogenous rules for determining phase-in or phase-out produces a degree of complexity that cannot be overemphasized. Breaking phaseouts into two or three categories and applying uniform rules to each category would ease the ability to increase the utilization of all credits and phaseouts.

Reverse the effects of cumulative complexity. Although each individual rule may be capable of explanation, the cumulative effect of many different provisions, each requiring unique understanding of the income levels, facts and circumstances to which they apply, or don't apply, causes many taxpayers to simply give up any attempt at preparing their own returns. This failure to prepare their own return produces a citizenry which is more removed from the tax laws of our country and more removed from the details of their own finances. Both are detrimental to our society. The current Internal Revenue Code can be analogized to a family home which has been much remodeled over the years. Each successive remodeling "chopped up" the house into smaller and smaller unique spaces. Moving about the house increased in difficulty. New owners "gut" the house, opening it up, restoring the simplicity and beauty which was originally present. The current Internal Revenue Code needs new owners, statesmen who are prepared to withstand the lobbyists' incessant pressure, in order to return the tax code to a system which once again is sufficiently comprehensible as to inspire confidence and permit an economical system of self-assessment with a high degree of compliance. The Code is currently so complex that many taxpayers are suspicious that "someone else" is gaining an unknown advantage on them. In order to compensate for the perceived inequity, voluntary compliance goes down. This is a polite euphemism for the process whereby income is not reported and/or deductions are increased in order to cause the tax amount to be less, and, therefore, "fair." Even ignoring fairness completely, we believe a significant minority of taxpayers' actions are influenced by alternating attacks of "greed" and "fear." With few or no IRS field audits to worry about, fear is the less dominant concern. Compliance goes down.

Increase the number of taxpayers qualifying for a simplified filing process. An additional goal should be to remove taxpayers from the complexities of the filing process, to the maximum extent possible. Perceived complexity unnecessarily scares millions of taxpayers into hiring others to prepare a tax return which should be easy to self-prepare. Many taxpayers have only Forms W–2 and a relatively small amount of interest or dividends to report. The inclusion of the interest or dividend statements frequently causes an outside preparer to be engaged. In many cases, that is unnecessary. The exclusion of a de minimis amount of interest and dividends from taxation, such as proposed by The Savings Advancement and Enhancement Act, would serve to remove many returns from the realm of the paid preparer and at the same time encourage savings and investment.

The "marriage penalty." Those sections of the Code which produce a marriage penalty should be repealed and a married couple should be treated no worse than two single individuals who cohabit. Although this is a policy issue, computer software currently available at mass-market prices provides a diagnostic which alerts the user to the fact that a Married Filing Separately status may save a married couple money. Since this diagnostic is generated only after the completion of a MFJ return, the inefficiencies of dividing and re-entering information to capture the savings possible in MFS are notorious. The Marriage Penalty should be eliminated and two married individuals should individually be treated on a par with single individuals.

Suggestions for Administrative Changes Within the IRS

Filing by electronic means. The current process which permits the filing of tax returns by telephone for simpler returns should be expanded. Filing using the Internet, email and other electronic media should be developed and implemented as quickly as possible. In addition, sufficient taxpayer education should be undertaken

in order to inform the public about the availability of alternatives to mailed paper forms.

The IRS budget. Reverse the erosion of the IRS budget. Incredibly, as tax returns have grown exponentially more complicated, the IRS has constantly reduced face-to-face taxpayer contact opportunities, closed IRS offices and consolidated IRS personnel in increasingly isolated surroundings and generally removed the human factor from the tax collection process. Although this can and does reduce the nominal costs of collection, the toll it exacts in the form of expenses for hired professional help, confusion about tax law, reduced compliance and other more intangible detriments reduce the efficiencies claimed. Most taxpayers are not trained tax professionals. There is a significant need for increased opportunities for face-to-face contact with IRS professionals. Most individuals are visual learners. We need help in understanding that which we cannot understand. Telephone contacts will not replace human interaction for many of those taxpayers most in need of special assistance.

Increase investment in technology. As tax practitioners one of the greatest hindrances we face is the lack of good technology on the part of the IRS when we need to interact with them concerning a taxpayer's account. At the present time we believe that IRS accounts are updated on a weekly basis to reflect changes in a taxpayer's account. In a virtual Windows World we are forced to deal with a system based on Worse-Than-DOS computers and accounts that are only updated weekly. Powers of Attorney which permit a CPA to represent a client are regularly unable to be documented online, requiring a continuous stream of faxes in order to document our ability to speak for the taxpayer as we wind our way through the telephone maze. We are respectful of the needs to secure privacy, but the current system is inadequate for telephone contacts. Lengthy lag times following contact between the taxpayer (or his/her professional representative) and inclusion of any results in the IRS database guarantees significant confusion about whether a particular telephone or mail contact actually accomplished the promised results. This generates additional correspondence/contacts which further degrade efficiency. Increased reliance on other forms of electronic communications such as email as a substitute for taxpayer contact should be investigated and implemented at the earliest possible date. In addition, the IRS should consider adopting that portion of the airlines' reservations database technology which permits each IRS employee who deals with an account to record substantial detail as to the steps taken. Frequently repeated contacts are necessary because telephonic contacts are not documented or not capable of being documented. Subsequent contacts then re-commence from "square one."

Errors in overpayments. The number of tax overpayments applied to future tax periods which are refunded in error appear to be out of proportion to the expected number of such errors. In addition, it is clear that IRS computers do not adequately capture information on Form 2210 pertaining to the exceptions from penalty for underpayment of estimated tax utilizing annualization of income over 3, 5 and 8-month periods. This failure generates notices of penalty which should never be generated based on the information filed with the return.

Thank you for the opportunity to provide perspective on these matters.

Chairman HOUGHTON. Thank you, gentlemen, very much. We have to vote now, so let us try to go through the questions—I will hold off on my questions—and see whether we can do this so you won't have to wait. Then we will have a recess and go back to the next panel.

Mr. Coyne.

Mr. COYNE. No, Mr. Chairman.

Chairman HOUGHTON. No questions. Mr. Neal.

Mr. NEAL. Thank you, Mr. Chairman.

Mr. Smith, you touched upon it in your testimony. You spoke about a growing complexity of the Tax Code and the disgusting reaction from your clients. Would you elaborate on that a bit more?

Mr. SMITH. I think the disgust comes from the fact that several of us have alluded today. The code should not be beyond the province of an average American. It doesn't mean that every single one

of our citizens should be able to understand it completely, but certainly the average American should be able to understand how to prepare their own income taxes.

When they cannot and they can do nothing about it, they have only one reaction left and that is frustration. That is the last avenue. I can't fight it and I can't flee it. And, unfortunately, some of them don't flow it very well, either.

Mr. NEAL. Thank you. Thanks, Mr. Chairman.

Chairman HOUGHTON. Mr. Weller.

Mr. WELLER. Thank you, Mr. Chairman. And, Mr. Smith, I would like to direct my question to you. By the way, you have a fine representative in Kenny Hulshof, my seatmate here. He does a great job as a Member of this Committee.

You had, in your testimony, of course you focused as all of us are today, on the need to simplify the code and the taxpayers' frustration and you as a tax practitioner with the complications in the Tax Code. Over the last few years in particular, there has been the desire by some to focus every time there is a new initiative to provide tax relief, to target it. And I once had a gentleman say, you know what targeted tax cut means? That means very few get very little. And, as a result of that, you know, the various targeted tax relief that has been adopted by Congress and the initiative of the White House in the last few years has created quite a few targeted tax cuts.

What, from a general standpoint, in your view as a tax practitioner, how has this made your job more difficult? Or has it made it more easy, having so-called targeted tax cuts?

Mr. SMITH. First of all, it clearly has not made it more easy. So we can dispense with that side of it, immediately. And I am sure Mr. Sokolski would join me in saying that.

Second, targeted tax credits produce two reactions amongst my clients. One is palpable disdain for societal engineering.

The second is a little more complex. Essentially—and I address that in my prepared testimony—because if you are going to have—and that, of course, is a policy decision beyond my purview—if you are going to have them at all, targeted legislation should be subjected to phaseouts that are appropriate for high-income taxpayers, perhaps medium-income taxpayers, and a low-income group of taxpayers.

And I would urge this Committee to conform the definitions so that the same definition applies for "individual" and "exemption" and the other things, for example, in the ITC and HOPE credit and some of these. And to take the income levels that they apply and rationalize them so that they all apply at the same level. And if, in a revenue-neutral environment, you have to change those amounts a little bit in order to get the CBO numbers to come out right, then do it.

But there are something like 15 different phaseout levels and I can go to a book and find them, but I have the book. How many of the 90-million returns have people that have a book that is 2 inches thick right at their right hand where they can go look at it or have some chance of knowing it offhand? They don't. And they really have no real easy way to get it, although with the advent

of the Internet, I think we are going to find that some information will, be easier to obtain than it has been in the past.

Mr. WELLER. OK.

Mr. SMITH. And in my administrative comments, which I, in the interest of time, skipped over, I believe the IRS should clearly be making steps and plans now to utilize the Internet. It is extremely efficient. It can be dealt with once for a lot of people and it can be accessed millions of times, at no cost, as opposed to the rather unsatisfactory telephone contacts that have to be made now.

Mr. WELLER. Thank you. Mr. Chairman, I know Mr. Hulshof would like to ask questions so I will yield back.

Chairman HOUGHTON. Thanks. Mr. Hulshof.

Mr. HULSHOF. Thanks, Mr. Chairman. And let me just say how much I appreciate you allowing me to invite a constituent here to provide this testimony. And, Mr. Smith, let me just say, you need not worry about an attempt to curry favor with the chairman. Those of us on this side of the dais attempt to do the same thing on a daily basis, so we welcome you here. Just a couple of quick questions. And I want to associate myself with the remarks of Mr. Neal earlier today regarding the SAVE Act.

And you make reference to the fact that many returns would be removed from the realm of the paid preparer, to paraphrase your testimony. I think the actual numbers are 7-million taxpayers would no longer have to file a schedule B tax form if we were to enact the $200, $400 exclusion, and an additional 10-million taxpayers would be able to file the 1040 EZ form were we to implement this one change in the Tax Code.

You touched on this briefly, Mr. Smith. I want to give you a chance to expand just a bit. How well acquainted do you think that the average American citizen is with his or her finances?

Mr. SMITH. I think I have been quoted as saying that many of them are about as well acquainted with them as the father salmon is with one of their offspring. Not very, in other words. [Laughter.]

Mr. HULSHOF. And, as a result of that, not to have you run afoul of members of your profession of certified public accountants or paid preparers, but, I mean, how does this lack of acquaintanceship with one's own finances, how does that affect whether or not you involve a paid preparer?

Mr. SMITH. Well, frankly, it causes people to spend money with us unnecessarily. And, in doing so, many taxpayers take the position that it is in a box, the old, classic shoe box, and they hand it to us, at least at my level of practice they do, and that is sort of the end of it. It is sort of like putting the body in a bag and shipping it off. And then they come back and sign the return at the very end. It is a sort of casual process of dealing with the largest expense that many people have.

If you think about it, Federal and State taxes are larger for many people, although not for all, obviously, than any other expense, including their home. And yet, annually, they turn over their calculation of that tax to me, a relative complete stranger. I think many of them would be much better off to do it themselves. And I am sure my union will have some chat with me in the locker room afterward.

But, truthfully, for the good of the country, we would be a lot better off if we got 10 million or 15 million people just flat out of the system and head some way to turn it into a telephone filing system or an Internet filing system or, less acceptably, a mail filing system that is capable of even having the service match up their very good reports of wages and other income and then sending me a bill. And I think, hopefully, it will come to that someday.

Mr. HULSHOF. And I think that, probably, Mr. Chairman, is a good note to end on, recognizing our time is drawing close for a vote. Thank both of you gentlemen for being here.

Chairman HOUGHTON. Yes. Thanks very much, gentlemen. Certainly appreciate it.

[Recess.]

Chairman HOUGHTON. We will begin our next panel. We have Mr. Tucker, chairman of the Section on Taxation of the American Bar Association; David Lifson, chairman of the Tax Executive Committee, the American Institute of Certified Public Accountants in New York; the famous Mr. Harry L. Gutman, a partner with KPMG; Mr. Gerry Harkins, general manager and owner and operator of Southern Pan Services Company in Conley, Georgia; and, Mr. Eugene Steuerle, senior fellow of the Urban Institute, National Tax Association.

Gentlemen, thanks very much for being here.

Mr. Tucker, would you begin?

STATEMENT OF STEFAN F. TUCKER, CHAIR, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION

Mr. TUCKER. Yes, Sir, Mr. Chairman and Members of the Subcommittee. My name is Stefan Tucker. I am appearing today in my capacity as chair of the American Bar Association Section of Taxation and my testimony is presented on behalf of the Tax Section. As you probably know, we are comprised of approximately 18,000 tax lawyers. We are the largest and broadest-based professional organization of tax lawyers in the country, and we are the national representatives of the legal profession with regard to the tax system.

On behalf of the section, I would like to thank the Chairman and the Members of this Subcommittee for their focus on eliminating complexity in the Tax Code. Mr. Chairman, we are looking forward to your introduction of the Tax Simplification and Burden Reduction Act of 1999 and, frankly, we are quite pleased that the proposed legislation will include several of the Tax Section's proposals.

We are also pleased to have read Congressman Neal's Act and noted that, both as to the AMT and as to a number of other provisions, you have focused on items that we have focused on. And, Congressman Coyne, we were pleased to see, has taken a very careful look with Congressman Matsui at the capital gains provisions and their complexity. And, finally, Congressman Portman has looked at the pension and profit sharing complexities which are, in my mind, extraordinary. And we think that we really do need to focus on these complexities.

We have said for a long time in the ABA Tax Section, we have testified during my tenure as chairman of the ABA Tax Section on complexity and simplification and we believe very strongly in the

same. Now you may wonder why would tax lawyers want to see simplification? I can tell you that our membership in the Tax Section has gone down by 10,000 persons over the last 12 years. Complexity is not something that engenders confidence in either the taxpayers or the practitioners and we think that is something to know.

I think it is interesting to see that a number of our younger members are now specialists in anywhere from three to six provisions of the entire Internal Revenue Code. Whereas when I started 36 years ago, we were able to focus on the Internal Revenue Code as a code. You noted that there is one thick volume with very thin pages. The regulations are six volumes with very thin pages and there are virtually no regulations yet on the 1997 or 1998 legislation. And the more that we do, the more complex it becomes, the more we enhance people looking at ways to get around the system and to avoid the system and that does none of us any good.

Earlier this year, in February, I wrote a letter to Secretary Rubin with a concern and a great deal of disappointment that the President's budget proposals had added a multitude of proposed new tax credits to the income tax system. And we think that does none of us any good either. So we were very concerned in that, in particular on phaseouts. And we really think that, as Congressman Neal said before, you need to jump start the system of simplification. I learned a long time ago that a journey of 1,000 miles starts with one small step. Of course, it was stated by somebody whose political philosophy may not have been the most desirable, but it still does start with one small step.

We have a number of specific tax proposals in our written testimony. We would note that a number of them are the same as the AICPA and others have noted to you. We have a number of the same concerns. The first and foremost is the AMT, the alternative minimum tax. There are at least four significant tax problems with the AMT. No. 1, it no longer is necessary to fulfill its original intended purpose.

No. 2, it increasingly affects an unintended class of taxpayers, middle-class taxpayers who are not engaged in tax shelter or deferral strategies. As someone said, we started with a few people who were not paying any tax and we have broadened to the remainder of the world. It is too complex. It creates too much of a compliance burden. And a number of the adjustments and preference items are inappropriate from both a policy and a technical perspective.

We think you ought to repeal the individual AMT. If you don't repeal it, we think you need to raise the threshold so that people below an average AGI, for example, of $200,000 are not subject to the AMT. Or partially repeal it. We have noted before, time and again, that itemized deductions create AMT. Mortgage interest creates AMT. That is a very strange result. Real estate taxes and State and local income taxes create AMT. That is not an intended result. We think you ought to focus on at least, at the very least, indexing, which was never done and at least would pick up something.

We note there are problems with the phaseout of itemized deductions and personal exemptions. We concur with what was said be-

fore that people are more interested in eliminating these hidden taxes and seeing the real tax rates.

And then, finally, there are a number of items in our specific proposals that have come from our committees and we would just note three of them to you. One is we think you ought to repeal the 2 percent floor on miscellaneous itemized deductions. Second, we think you ought to simplify alternatives for family status issues. And, third, we think you ought to simplify subchapter S and maybe even consider, in light of limited liability companies, eliminating subchapter S and just recognize that for small business there ought to be a single tax regime. Thank you.

[The prepared statement follows:]

Statement of Stefan F. Tucker, Chair, Section of Taxation, American Bar Association

Mr. Chairman and Members of the Subcommittee: My name is Stefan F. Tucker. I appear before you today in my capacity as Chair of the American Bar Association Section of Taxation. This testimony is presented on behalf of the Tax Section. Accordingly, except as otherwise indicated, it has not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, accordingly, should not be construed as representing the policy of the Association.

As you know, the ABA Tax Section is comprised of approximately 18,000 tax lawyers. As the largest and broadest-based professional organization of tax lawyers in the country, we serve as the national representative of the legal profession with regard to the tax system. We regularly and continuously advise individuals, trusts and estates and small businesses, as well as exempt organizations and major national and multi-national corporations. We serve as attorneys in law firms, as in-house counsel, and as advisors in other, multidisciplinary practices. Many of the Section's members have served on the staffs of the Congressional tax-writing Committees, in the Treasury Department and the Internal Revenue Service, and the Tax Division of the Department of Justice. Virtually every former Assistant Secretary of the Treasury for Tax Policy, Commissioner of Internal Revenue, Chief Counsel of the Internal Revenue Service and Chief of Staff of the Joint Committee on Taxation is a member of the Section.

The Section appreciates the opportunity to appear before the Subcommittee today to discuss simplification. On behalf of the Section, I want to thank the Chairman and the Members of this Subcommittee for their focus on eliminating complexity in the tax code. We are truly looking forward to the introduction by the Chairman of The Tax Simplification and Burden Reduction Act; we are very pleased that the proposed legislation will include several of the Tax Section's proposals. As you are aware, we consider the elimination of complexity to be of the utmost importance, and the Section and its members are ready, willing and able to work with you in order to accomplish needed change.

SIMPLIFICATION AND COMPLEXITY

The ABA and its Tax Section have long been forceful advocates for simplification of the Internal Revenue Code. In resolutions proposed by the Tax Section and passed by the full ABA in 1976 and 1985, the ABA went on record urging tax law simplicity, a broad tax base and lower tax rates. We have reiterated this position in testimony before the House Ways and Means and Senate Finance Committees on numerous occasions.

In recent years, the Code has become more and more complex, as Congress and various administrations have sought to address difficult issues, target various tax incentives and raise revenue without explicit rate increases. As the complexity of the Code has increased, so has the complexity of the regulations that the IRS and Treasury have issued interpreting the Code. Moreover, the sheer volume of tax law changes has made learning and understanding these new provisions difficult for taxpayers, tax practitioners and Service personnel alike.

The volume of changes, especially recent changes affecting average taxpayers, has created the impression of instability and unmanageable tax complexity. This takes a tremendous toll on taxpayer confidence. This Subcommittee often hears how our tax system relies heavily on the willingness of the average taxpayer voluntarily to comply with his or her tax obligations. Members of the Tax Section can attest to the widespread disaffection among taxpayers with the current Code. The willingness

and ability of taxpayers to keep up with the pace and complexity of changes is now under serious stress.

Tax law changes are again under discussion. The Tax Section does not take a position with respect to the wisdom of particular levels of taxation or of particular broad-based tax reduction proposals. We do urge, however, that the members of this Subcommittee keep simplification and avoidance of complexity uppermost in their minds as any tax reduction packages are fashioned. Tax relief can be delivered in ways that avoid new, complicated rules, such as phase-outs, multiple choice elections and highly detailed conditions. While simple, broad-based tax reductions may not have the cachet of the newer style, more targeted provisions, they will avoid the layering of new complexity over old. If Congress chooses to reduce taxes, we urge you to do no harm.

To this end, I, on behalf of the Tax Section, earlier this year sent to Secretary Rubin a letter expressing our disappointment that the President's budget proposes to add a multitude of new tax credits to the Federal income tax system. Our point in that letter was that, although each credit taken in isolation could be viewed as meritorious, that kind of micro-balancing inevitably leads to the type of tax system that is, in total, overly complex and undeserving of public respect. Particularly in light of the various, complicated provisions added by the Taxpayer Relief Act of 1997, Congress and the Administration must focus on the cumulative impact of *all* new provisions sought to be added. We continue to urge that the leaders of the tax legislative process—including this Subcommittee—resist the accretion of income tax benefits and penalties that are unrelated to the administrable measurement of annual taxable income and ability to pay.

My letter to Secretary Rubin also urged that particularly close scrutiny be given to any proposals that include income phaseouts. These phaseouts have gained popularity in the last two decades and are responsible for a significant amount of the complexity imposed on individual taxpayers. Phaseouts create the effect of a marginal rate increase as a taxpayer's income moves through the phaseout range, and the effects of multiple phaseouts on the same taxpayer can create capricious results. Phaseouts also blunt the intended incentive effect, because taxpayers cannot predict whether benefits will be available to them. Phaseouts also play a significant role in the creation of marriage tax "penalties," and add to the difficulty in addressing that set of issues. We urge you to resist their continued use in the enactment of additional tax incentives.

We do not claim to have all the answers. The Tax Section will continue to point out opportunities to achieve simplification whenever possible, including several ideas that we will discuss later in this testimony. However, it is also necessary that we point out that simplification necessitates hard choices and a willingness to embrace proposals that are often dull and without passionate political constituencies. Simplification also requires that easy, politically popular, proposals be avoided if they would add significant new complexity. Simplification—and preventing greater complexity—may not garner political capital or headlines, but it is crucial. It requires leadership from the Administration and from the tax-writing committees.

To date, simplification has not achieved the commitment that we believe is required. Too often, other objectives have tended to crowd simplification out as a priority. We urge the members of this Subcommittee to adjust this balance by endorsing simplification as a bedrock principle and communicating that principle to all involved in the tax-writing process.

To that end, the Congress adopted as part of the IRS Restructuring and Reform Act of 1998 a procedure to analyze the complexity of proposals with widespread applicability to individuals or small business. By means of this complexity analysis, the Joint Committee on Taxation will call attention to provisions that could result in substantial increases in complexity, and will suggest ways in which the goals of those proposals can be achieved in simpler ways. We strongly support this increased focus on complexity and urge the members of this Committee, and especially this Subcommittee, to pay heed to the JCT analyses. Only by raising awareness of problems with proposals before they become law will Congress make substantial inroads into the problem.

SPECIFIC PROPOSALS

We would now like to address certain specific areas in which the Tax Section considers the need for simplification immediate. We begin with the alternative minimum tax, which is an area that we believe demands the immediate attention of this Congress. As this Subcommittee is well aware, there is an inherent problem with the individual AMT which, if not dealt with in one way or another, will result in approximately 9 million additional taxpayers becoming AMT taxpayers within the

next decade. Many have referred to this problem as a "ticking time bomb." Most of these additional taxpayers are not of the type envisioned as being subject to the AMT when it was revised in 1986. Moreover, many of these individuals will not even be aware they are subject to the AMT until completing their returns or, worse, receiving deficiency notices from the IRS. We are continuing to confer with our counterparts at the Tax Division of the AICPA concerning our respective positions on the AMT, and we have found that our two groups are in accord on the importance of addressing the AMT issue promptly.

We wish to acknowledge the Chairman's understanding of the problems attendant to the AMT, as reflected in the first three items of his list of provisions for his proposed legislation, and for his leadership in seeking to reduce complexity. We are pleased that Congressman Coyne (D–PA) has introduced a simplification bill. (See H.R. 1407 (106th Cong.).) We also would like to commend Congressman Neal (D–MA) for his recognition of the problems that the Tax Section perceives as associated with the individual AMT and for his proposal to repeal the personal exemption phaseout and the overall limitation on miscellanous itemized deductions—an issue which I will discuss in more detail later in this testimony. (See H.R. 1420 (106th Cong., 1st Session, 1999.)

A. Alternative Minimum Tax

1. *Background*

Individuals first became subject to an "add-on" minimum tax in 1969, enactment of which was precipitated by concerns that some taxpayers with significant economic income were paying little or no tax because of excessive investments in tax shelters. This add-on tax ultimately was repealed and replaced with a minimum tax payable to the extent that an individual's AMT liability exceeded his or her regular tax liability. This minimum tax—which eventually morphed into an entirely separate, parallel, tax system—has been modified several times since enacted.

The current law version of the minimum tax generally involves computing AMT liability by multiplying an AMT rate that is *lower* than the regular tax rate against a tax base that is *broader* than the regular tax base. Subject to year-by-year exceptions that have been made, most nonrefundable credits cannot be used to reduce AMT liability. This has the effect of making many credits unavailable to otherwise eligible individuals in cases where use of the credit would cause the amount of the regular tax liability to be less than the tentative AMT liability. The AMT rate brackets are mildly progressive, but are not indexed for inflation.

The base for the AMT is an individual's alternative minimum taxable income (AMTI). An individual's AMTI is determined by adding certain "preference items" to taxable income (such as tax-exempt interest on certain private activity bonds and a portion of the amount excluded from regular taxable income on sales of certain small business stock) and "adjusting" the treatment of certain items to eliminate or reduce benefits associated with the regular tax treatment of those items. Some of these adjustments relate to "business" type items—such as the requirement that depreciation be computed for AMT purposes using a separate system that provides for less accelerated depreciation deductions than under the regular tax system. Other adjustments are purely "personal." For example, adjustments for individuals include: (1) disallowing deductions for State and local taxes; (2) disallowing medical expenses except to the extent they exceed 10 percent of the taxpayer's adjusted gross income (AGI), and (3) disallowing standard deductions and personal exemptions. Other adjustments that affect individuals relate to investment or employment items. For example, (1) miscellaneous itemized deductions are not allowed, and (2) the special regular tax rules relating to incentive stock options (ISOs) are not allowed. Although an individual is allowed an exemption against his or her AMTI, the exemption amount is not indexed for inflation.

2. *Problems with the AMT*

As explained below, we believe that there are at least four significant problems with the individual AMT.

First, *the AMT no longer is necessary to fulfill its intended purpose*. As indicated above, the original AMT was enacted to address concerns that persons with significant economic income were paying little or no Federal taxes due to investments in tax shelters. This reason is no longer compelling in light of numerous changes that have been made to the Tax Code to specifically limit tax-shelter deductions and credits. For example, the Tax Reform Act of 1986 expanded the application of the at-risk rules and enacted rules limiting deductions and credits for passive activity losses, which greatly reduced shelter opportunities.

Second, *the AMT increasingly is affecting an unintended class of taxpayers*—middle class taxpayers who are not engaged in tax-shelter or deferral strategies. Studies indicate that the AMT increasingly is becoming *the* tax system for middle-income individuals. For example, a pamphlet prepared last year by the Joint Committee on Taxation ("JCT") indicates that, by 2008, 19.7 percent of taxpayers in the $75,000 to $100,000 bracket will be paying the AMT and that almost 1.75 million AMT returns will be filed by individuals in the $30,000 to $75,000 bracket. Joint Committee on Taxation, Present Law and Issues Relating to the Individual Alternative Minimum Tax ("AMT") (JCX–3–98), February 2, 1998. Another study indicates that, by 2007, almost 95 percent of the revenue from AMT preferences and adjustments will be derived from four items that are "personal" in nature and are not the product of any tax planning strategies—the personal exemption, the standard deduction, state and local taxes, and miscellaneous itemized deductions. In fact, the same study indicates that, in 1994, the disallowance of the deduction for state and local taxes accounted for approximately 47 percent of total AMT preferences; we expect this percentage is even larger today. Harvey and Tempalski, "The Individual AMT: Why It Matters," National Tax Journal, Vol. L, No. 3, September 1997. Further, even those individuals who ultimately do not pay any AMT liability increasingly will lose the benefits of credits that Congress decided were necessary and appropriate and, in some cases, may have been targeted to specific classes of taxpayers. For example, the 1998 JCT pamphlet projects that, by 2008, 7.9 million returns will receive zero or less than the full child care credit due to AMT limitations.

Third, *the AMT is too complex and imposes too great a compliance burden*. The existence of the AMT system literally requires *all* people to compute their taxes under two different sets of rules—the regular rules and the AMT rules. Given the complexity associated with the regular tax system, even a small amount of additional complexity from an additional tax system may be too much. However, the AMT involves more than a small amount of additional complexity. Even individuals who ultimately do not end up paying the AMT have to perform calculations to determine whether or not they need to pay it or whether they are restricted in their use of credits. For example, taxpayers trying to determine whether or not they owe the AMT must complete a 12-line worksheet first, then a 43-line form (and another 22-lines if they have long-term capital gains). Further, some of the adjustments (such as those for depreciation and net operating losses) require the taxpayer to keep two sets of records, one for regular tax purposes and the other for AMT purposes so that proper alternative calculations may be made in the *future*, even if there is no AMT liability currently. It is no wonder that many individuals fail to make the statutorily required calculations, either because they cannot imagine the AMT would apply to them, or because they simply cannot deal with the excessive complexity.

Fourth, *some of the adjustments and preference items are inappropriate* from both a policy and a technical perspective. While virtually all of the adjustments and preferences can be, and have been, sharply criticized from a policy standpoint, two adjustments that apply only to individuals seem particularly inappropriate for technical reasons as well. Neither the adjustment to disallow miscellaneous itemized deductions nor the adjustment for ISOs seems supportable from a policy or technical standpoint. The AMT's main purpose is to blunt the use of tax shelter or uneconomic deductions incurred to reduce income tax excessively. The regular tax system permits as a miscellaneous itemized deduction those expenditures that are employment related or are clearly related to the production of income or the management or maintenance of income-producing property. There is no AMT objective to deny a deduction for the remaining, clearly employment—or income-related, expenses. Certainly they are not the sort of deductions that individuals incur as tax-shelter items or "trump up" artificially to eliminate income tax.

The AMT system also denies regular tax benefits accorded to incentive stock options by requiring that the excess of the fair market value of the stock over the exercise price (i.e., the "bargain" element) be included in income in the year the option is exercised. However, this adjustment improperly taxes the ISO gain at a 28% rate rather than the top capital gain rate of 20%, the rate applicable under the regular tax system. There seems no justification for this denial of capital-gain character of the bargain element now that Congress has expressed its intention in the Taxpayer Relief Act of 1997 that long-term capital gain be taxed under the AMT system at no higher rate than under the regular system.

3. *Recommendations*

We respectfully suggest that the Subcommittee consider the following alternatives, which we state in our order of preference.

a. *Repeal the Individual AMT*. As indicated above, the individual AMT is no longer necessary to serve its intended purpose and, if kept in place, will become the

regular tax system for more and more individuals. Further, the additional burdens it imposes are not justified by a sufficiently clear policy objective and, if left unchecked, almost certainly will engender further dissatisfaction with the tax system. We realize that repealing the individual AMT is expensive and may raise a political problem if repeal is perceived as aiding people with economic income to avoid paying their fair share of taxes. However, we respectfully submit that, even though it may be expensive to repeal the individual AMT in its entirety now, the cost of repeal will only increase in the future as more people are affected. Further, it is doubtful that repealing the individual AMT will result in a significant "perception" problem akin to that which precipitated the enactment of the original add-on tax in 1969, given the reforms to the Tax Code that have been made in the interim and Congressional willingness to legislate against shelter transactions in general. Indeed, we believe there will be a much worse political problem if the AMT is not repealed and more and more Americans become subject to the AMT, lose credits to which they otherwise would be entitled, or are forced to endure the frustration of spending even more time and effort on filing their income tax returns.

b. *Exclude Taxpayers with Average AGI Below a Certain Threshold from the AMT System Entirely*. In the Taxpayer Relief Act of 1987, Congress struck a blow in favor of simplicity by excluding certain small corporations from the burden of AMT calculations. This was done on the basis of the average gross receipts of the corporation for the prior three years. Applying a similar approach to individuals could exclude many taxpayers from the individual AMT system while still retaining much of the revenue. For example, based on income distribution tables as of 1994, it might be possible to exclude approximately two-thirds of taxpayers from the AMT system, while retaining nearly two-thirds of the revenue, by excluding entirely from the AMT system any individuals whose average AGI for the prior three years was under $200,000, adjusted for inflation. See Harvey and Tempalski, Table 3 at p. 463. We emphasize, however, that this approach alone does not fully respond to the significant substantive problems with the AMT.

c. *Partial Repeal*. Another alternative would be to examine each preference and adjustment item separately and to determine whether it should be retained in the AMT system. However, in our view, proper analysis of each item of adjustment and preference would result in the AMT system being repealed. There is little, if any, justification for the "business" adjustments and preferences, and clearly is no justification for any of the personal adjustments and preferences. Still, if full repeal is not possible, major simplification could be achieved by (1) allowing all credits to reduce the individual's liability, without regard to the AMT (*i.e.*, making the temporary measure for 1998 returns permanent); (2) removing most of the adjustments and preferences, which are mostly "cats and dogs" anyway, while retaining at most the four or five "core" items that account for almost all the revenue; and (3) removing some of these core items depending upon revenue constraints. As indicated above, however, we strongly urge the Subcommittee to consider repealing the entire system. Individual items can be addressed directly under the regular tax rules, if necessary for revenue purposes.

d. *Fix Problems with the Existing Adjustments and Preferences*. Even if Congress decides to retain all or most of the existing preferences and adjustments for perception or revenue reasons, we recommend that Congress correct the glaring problems with two preference items that affect only individuals. First, the denial for AMT purposes of any deduction for miscellaneous itemized deductions should be repealed. The regular tax system already denies a deduction for a portion of those expenses, i.e., the portion equal to two percent of AGI. The remaining portion is either an employment-related expense or is clearly related to the production of income or the maintenance of income-producing property. It cannot be said that these deductions are "excessive," uneconomic or otherwise incurred primarily to reduce income tax. There is no reason for these items to be denied under the alternative system when they are sufficiently "income related" to be allowed under the regular tax system. Second, the adjustment for ISO stock should be modified or eliminated as it inappropriately taxes a portion of the gain at a rate in excess of the maximum 20% that Congress intended be applied to long-term capital gain. As noted earlier, because the entire gain will be treated as capital gain if the stock is held for more than 12 months after the option is exercised, the so-called bargain element should also be treated as capital gain under the AMT system and taxed at a top rate of 20%.

e. *Index the Rate Brackets and the Exemption Amount*. Studies have shown that indexing the rate brackets and exemption amount would solve a significant part of the second problem highlighted above—that more and more people will be affected by the AMT each year. For example, the above-cited article by Harvey and Tempalski indicates that, if the AMT exemption, the income level at which the phaseout of the AMT exemption begins, and the income level at which the AMT

marginal rate switches from 26 to 28 percent were indexed, approximately 8.2 million fewer taxpayers would be affected by the AMT in 2007 than if nothing were done. Indexing the parameters of the AMT is less optimal than full repeal, however, because it will do little to alleviate the compliance burden associated with the AMT system. That is, people will still have to make the calculations to determine whether they must pay the AMT or whether they will lose the benefit of certain credits. For these reasons, we view indexing as our last choice and as only a partial response to the problem.

We urge this Subcommittee in the strongest possible terms to solve the problems with the AMT once and for all. There is universal acknowledgement that the effects we have described are unintended and unjustified. It is also acknowledged that the revenue cost associated with a permanent solution will only increase over time and may eventually become prohibitive. It would be a travesty if a permanent solution to the AMT became caught on the merry-go-round of expiring provisions. A permanent solution should not be deferred merely because it competes with other, more popular proposals for tax reduction.

B. Phaseout of Itemized Deductions and Personal Exemptions

At the urging of the Tax Section, the American Bar Association earlier this year adopted a recommendation that the Congress repeal the phaseout for itemized deductions (the so-called "Pease provision") and the phaseout for personal exemptions (the "PEP provision"). The ABA also recommends that the revenue that would be lost by repeal be made up with explicit rate increases. This would address any revenue neutrality concern, as well as any concern with respect to the distributional effects of repeal.

It may be difficult for members of Congress to appreciate the level of cynicism engendered by these two phaseouts. Countless times, taxpayers who might not otherwise be troubled by the amount of tax they are paying have reacted in anger when confronted with the fact that they have lost—either wholly or partially—their itemized deductions and personal exemptions. They are no more comforted when told that these phaseouts should really be viewed as substituting for an explicit rate increase. Almost without exception, they react by asking why Congress refuses to impose the additional rate rather than trying to pull the wool over their eyes.

We have no answer to that question. We take pride in the fact that the ABA is willing to recommend a simplification proposal funded by a marginal rate increase on the same taxpayers benefiting from the simplification. We urge this Subcommittee to give serious consideration to the ABA's recommendation.

C. Additional Simplification Proposals

Although the alternative minimum tax certainly causes great complexity in the Code (and its application is much more widespread than ever envisioned), the Code is replete with numerous other provisions, the complexity of which are much greater than the perceived abuse to which the provision was directed or the benefit that was deemed gained by its addition. Furthermore, the Code contains many provisions which at the time of enactment may well have been desirable, but with the passage of time or the enactment of other changes, have truly become "deadwood." However, despite the lack of utility of such provisions (whether in a relative or absolute sense) analysis of the same may well be required either in the preparation of the tax return or in the consummation of a proposed transaction. The elimination of such provisions would greatly simplify the law. The following are examples of such provisions, that when analyzed do not justify their continuation in the law. Obviously, these are but a few such examples, and an extensive analysis of the Code would undoubtedly uncover a legion of the same. We have separated our recommendations into categories for individual, business, and administrative items.

1. *Individual Tax Provisions*

a. *Simplify Phaseouts*. Numerous sections in the Code provide for the phaseout of benefits from certain deductions or credits over various ranges of income based on various measures of the taxpayer's income. There is no consistency among these phaseouts in either the measure of income, the range of income over which the phaseouts apply or the method of applying the phaseouts. Even without the inconsistencies, the phaseouts cause problems. They add significantly to the length of tax returns, increase the potential for errors, are difficult to comprehend, and make it extraordinarily difficult for families to know whether the benefits the provisions confer will be available. The inconsistencies exacerbate these problems, causing inordinate complexity, particularly for taxpayers attempting to prepare their tax returns manually. Simplicity would be achieved by (a) eliminating phaseouts altogether, (b)

substituting cliffs for the phaseouts, or (c) providing consistency in the measure of income, the range of phaseout and the method of phaseout.

b. *Rationalize Estimated Tax Safe Harbors*. Section 6654 imposes an interest charge on underpayments by individuals of estimated income taxes, which generally are paid by self-employed individuals. This interest charge generally does not apply if the individual made estimated tax payments equal to the lesser of (x) 90 percent of the tax actually due for the year or (y) 100 percent of the tax due for the immediately prior year. The availability and computation of the prior year safe harbor has been adjusted regularly by the Congress over the past decade. Presently, for individuals with adjusted gross income exceeding $150,000, the prior year safe harbor percentage increases and decreases from year to year over a range from 105 to 112 percent. The purpose of these increases and decreases is to shift revenues from year to year within the five and ten year budget windows used for estimating the revenue effects of tax legislation. Congress should determine an appropriate safe harbor percentage and apply that amount for all years, avoiding the complexity the increasing and decreasing percentages bring.

c. *Repeal the Two Percent Floor on Miscellaneous Itemized Deductions*. The two percent floor on miscellaneous itemized deductions contained in Section 67 was enacted as a simplification measure intended to relieve taxpayers of recordkeeping burdens and the Internal Revenue Service ("IRS") of the burden of auditing deductions insignificant in amount. Experience indicates that taxpayers continue to keep records of such expenses to determine deductible amounts in excess of two percent of adjusted gross income. Moreover, the existence of the limitation and the need to identify the deductions to which it applies introduces needless computational and substantive complexity to the preparation of tax returns.

d. *Increase the Floor for Itemized Deductions for Medical Expenses and Increase the Personal Exemption Amount for Taxpayers 65 or Over*. A deduction is allowed for medical expenses in excess of 7.5 percent of adjusted gross income. Despite the current 7.5 percent floor, which limits the deduction to extraordinary unreimbursed medical expenses, the existence of the deduction requires taxpayers to identify medical as compared to personal expenses and to maintain detailed records of the former. An increase in the floor to 10 percent of adjusted gross income would reduce the number of returns claiming the medical expense deduction and alleviate substantiation and audit verification problems and numerous definitional issues. An increase in the floor to a catastrophic level would also likely reduce the number of taxpayers maintaining medical records. The personal exemption amount for taxpayers 65 and older could be increased to offset any adverse effect on elderly taxpayers.

e. *Reduce Family Unit Tax Complexity*. A number of provisions make the filing of tax returns and computation of tax liability particularly complicated for low and moderate income taxpayers. Certain provisions necessitate the filing of returns by individuals who would otherwise have no tax liability and no need to file. The complexity of the calculations coupled with definitional issues make it extremely difficult for low and moderate income taxpayers to complete their returns without paid assistance, which they cannot afford. These provisions result in a significant number of adjustments to tax returns, causing considerable administrative difficulties for the IRS in making the adjustments and collecting the amounts due. In addition, the adjustments result in additional liability for interest and penalties on the part of a group of taxpayers that has difficulty satisfying the tax liability, let alone additional sums.

f. *Earned Income Credit*. The Earned Income Credit (EIC) contained in Section 32 provides a substantial, refundable tax credit to low income workers, both with and without children. The EIC, as presently designed, creates several layers of complexity.

- The EIC requires many taxpayers to file a return whose income would otherwise fall below filing thresholds.
- The definition of a "qualifying child" under Section 32(c)(3) differs from the definition of a dependent child, and treats foster children differently from biological or adoptive children.
- The AGI tie-breaker rule does not resolve the perceived abuse it targets while its application often incorrectly denies the credit to people who should be eligible, insofar as it does not focus on a clear and reasonable definition of what constitutes a "household".

g. *Child Credit*. The Child Credit, contained in Section 24, on account of its multiple calculations and "integration" with the child and dependent care credit, the earned income credit, the alternative minimum tax, and social security tax creates unnecessary complexity for taxpayers who would otherwise be able to file simple returns.

h. *Dependent Care Credit*. The Dependent Care Credit, contained in Section 21, is of limited benefit to low income working families because it is not refundable. Further, it does not benefit higher-income working families because the credit rate caps at relatively low income levels and does not reflect the true cost of child or dependent care.

i. *Nondeductibility of Child Support Payments*. The treatment of child support payments as a nondeductible expense creates confusion and leads to many noncustodial parents claiming dependency exemptions for children without obtaining the required Form 8332. It places the burden on the IRS administratively to identify and audit such claims, and makes the dependency exemption an element of horse-trading in domestic relations disputes, catching taxpayers in a conflict between state domestic relations orders and Federal income tax laws. The disparate treatment of alimony and child support adds the complexity of the tax law to negotiations that are often difficult and unpleasant.

j. *Dependency Definition*. The current definition of "dependent" under Sections 151 and 152 is confusing and difficult to administer. In particular, problems arise with regard to the treatment of (1) children of separated or divorced spouses; (2) other "custodians" of dependent children; and (3) "custodians" of disabled or elderly individuals. Further, as noted previously, the definition of a dependent child is not harmonized with the definition of a "qualifying child" under the earned income credit, nor is the concept of "support" identical to the concept of "maintaining a household" for purposes of head of household status under Section 2(b). Finally, foster children are treated differently from biological or adopted children.

k. *Simplification Alternatives for Family Status Issues*. Simplification for low and moderate income taxpayers could be pursued at a macro level, with a wholesale revision of the provisions intended to provide benefits to this group of taxpayers, or at a micro level by addressing individual issues described above. On the macro level, replacing "head of household" status, dependent child exemptions, and the child credit with one "mega-" program that provides the economic value of these benefits to taxpayers with children, with the same overall distribution of benefits as under current law could result in significant simplification for low and moderate income taxpayers. Definitions would be coordinated with those utilized in the EIC program. The exemption amount could differ depending on whether the taxpayer is single or married (or married filing separately). With this kind of macro revision, taxpayers would only have to walk through two sets of coordinated rules—the mega-exemption and the EIC.

On a micro level, the following alternatives address particular problems and could significantly reduce complexity in those areas.

- Apply one standard for qualification as a dependent child, qualifying child for purposes of the EIC, and head of household status (if retained) that equates support with the cost of maintaining a taxpayer's household and is based on the child residing in the taxpayer's home for more than half the tax year. Provide safe harbors for taxpayers awarded custody by court order or other agreement. (Taxpayers could check a box signifying the existence of such an order or agreement.)
- Define dependent to include foster children residing in a home for more than half the tax year. In the case of a court order or other official "placement" of the child (e.g., by order of the local Department of Social Services, a child welfare agency, or other placement agency), qualification could be established by attaching a copy of the order to the return or checking a box signifying the existence of such an order. In the case of the informal placement of a foster child, the taxpayer would have to establish residence for more than half the tax year.
- Equalize the treatment of alimony and child support by making child support deductible by the payor and included in income by the payee. This will remove much of the "gaming" involved with duplicate claims for dependency exemptions, the earned income credit and head of household status, and problems arising from state domestic relations orders, since it gives taxpayers who pay child support some tax benefit for their payments. Since dependent exemptions will only be claimed by custodial parents or other custodial individuals, nonworking custodial parents will usually not have to file. Those custodial parents who do file will claim dependency exemptions and other child-related credits.
- Increase the dependency exemption to ensure it reflects the cost of maintaining a home for a child. An increase in the amount of the dependency exemption in conjunction with standard deductions that more accurately reflect minimum cost of living would reduce the number of taxpayers who must file returns.
- Replace the "AGI tie-breaker" rule in the EIC with a definition of "household" that more accurately targets the perceived abuse of two unmarried taxpayers living together and gaming the system.

• Facilitating or mandating advance EIC payments through integration of Forms W–4 and W–5 and employee withholding systems would eliminate the need for many taxpayers to file returns.
• Establish a uniform credit rate for the dependent care credit and make the credit refundable so it truly benefits lower income working families.

l. *Simplify the Capital Gains Provisions*. The capital gains regime applicable to individuals is frighteningly and unnecessarily complex. As a result of Congressional determinations that some assets are worthier of tax benefits than others and that investment in capital assets should be encouraged but only if the tax benefits affect revenue some time in the future, the Code contains a bewildering variety of rules under which different types of assets are subject to different rates and the rates applicable to long-term gains vary depending on the holding period. This system imposes difficult record-keeping burdens on taxpayers and encourages taxpayers to try to manipulate the system through investments in derivatives, short sales, and similar techniques. In addition, taxpayers holding property acquired before 2001 can elect to have the property treated as if it had been sold on the first business day after January 1, 2001, thereby becoming eligible for the special 18% rate if it is held for another five years. Determining whether to make this election will require taxpayers to make economic assumptions and do difficult present value calculations. While there may be some justification for each item of fine-tuning in this area, their cumulative effect has been to create a structure that is incomprehensible to taxpayers and to the people who prepare their tax returns.

Simplification can take several forms. First, different rates for different types of assets (e.g., collectibles) should be eliminated. Second, different rates for long-term assets held for different holding periods should be eliminated; there is no reason to have a special ultra-low rate for assets held for more than five years. Third, to assure that any benefit is extended to all taxpayers regardless of their tax brackets, the concept of special capital gain rates might be replaced by an exclusion for a percentage of long-term capital gains.

m. *Harmonize and Rationalize Education Incentives*. The Code contains a variety of provisions granting taxpayers educational incentives. These provisions include education IRAs, the Hope Credit, the Lifetime Learning Credit, exclusions for employer-provided educational assistance, and interest deductions on student loans. The sheer number of alternatives creates complication. Moreover, the targeting of the provisions makes them particularly complicated and difficult to comprehend. The restrictions on their use can mean that taxpayers unexpectedly find they have lost the benefit of a particular incentive. The education incentives should be harmonized and rationalized so that taxpayers have a simple and clear menu of options from which to choose in planning for educational expenses that yields predictable results.

n. *Eliminate Elections*. Many provisions allow taxpayers to elect special treatment. While some elections are necessary and appropriate (e.g., election to be treated as an S corporation), it is often the case that elections and safe harbors, even those enacted in the name of simplification, increase complexity. The availability of an election oftentimes requires taxpayers to make multiple computations to determine the best result, thereby adding significant complexity. For example, the various elections available under recently enacted Section 6015 with respect to innocent spouse relief increase planning and procedural complexity significantly. Likewise, some recent proposals for eliminating or reducing the so-called marriage penalty would effectively require married couples to compute their income twice to determine which approach yielded a lower tax payment. In lieu of providing multiple approaches to the same goal, Congress should develop a single legislative solution to address a specific problem, and should make such a solution as simple and fair as possible.

o. *Increase the Estate and Gift Tax Unified Credit.* The Code requires the estates of decedents with gross estates in excess of the exclusion amount ($650,000 in 1999) to file estate tax returns. According to the latest published IRS statistics (calendar year 1996), approximately 79,346 estate tax returns were filed that year. Fewer than half of the returns filed (47.5 percent) reported estates that were subject to tax. Of those subject to tax, the largest 14 percent of estates (over $2.5 million gross estate) bore 69 percent of the total estate tax paid. Conversely, the lowest 86 percent of gross estates paid only 31 percent of the total estate tax revenues received ($4.51 billion out of $14.49 billion). In 1997, Congress put in place a gradual phase-up of the exclusion amount to $1 million in 2006, which will eliminate the filing requirements for a substantial number of estates otherwise required to file returns and reduce to zero the tax owed by many of those estates. An additional increase in the unified credit (beyond $1 million) would further relieve an additional significant number of decedents' estates from the burden of filing returns and paying es-

tate tax without a significant decrease in Federal revenue. More importantly, such a change would relieve many such individuals during their lifetimes of the burden of estate planning oriented almost entirely toward minimizing their estate tax liability, rather than family and business succession considerations.

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

q. *Simplify Transfer Tax Valuation of Minority Interests in Non-Publicly Traded Family-Owned Businesses*. Significant taxpayer planning and government administrative expenses are incurred when a discount is claimed with respect to the value of ownership interests in non-publicly traded business enterprises controlled by a family. Significant simplification could be achieved if the value of stock in a non-publicly traded corporation were deemed to be equal to its pro rata share of all the stock of the same class in such corporation, unless a different value is established by clear and convincing evidence. Under this test, all stock held, directly or indirectly, by an individual or by members of such individual's family will be treated as held by one person. Similar rules would apply to ownership interests in other entities.

2. *Small Business Tax Provisions*

a. *Simplify the Minimum Distribution Requirements*. Under Section 401(a)(9), qualified retirement plan benefits must be distributed to a participant or his or her beneficiary(ies) within a prescribed period of time that is dependent upon a number of variables, including the identity of the participant's beneficiary(ies) and the circumstances under which benefits are paid. Section 408(a)(6) extends these distribution requirements to IRA benefits. The distribution rules in Section 401(a)(9) complicate the administration of qualified retirement plans and IRAs, and present conceptual difficulties for participants. Moreover, although intended to preclude the unreasonable deferral of benefits, benefits deferred are subject to income taxation upon eventual distribution and may be subject to estate taxation upon a participant's death. The provisions of Section 401(a)(9), other than those dealing with the required beginning date for distribution of retirement benefits, should be replaced with the incidental death benefit rule in effect prior to the enactment of the Employee Retirement Income Security Act of 1974 (hereafter "ERISA").

b. *Eliminate the Half-Year Age Conventions*. Section 401(a)(9) provides that retirement plan benefits must commence, with respect to certain employees, by April 1 of the calendar year following that in which the employee attains 70½. Section 401(k) states that plan benefits may not be distributed before certain stated events, including attainment of age 59½. Further, Section 72(t) provides that premature distributions from a qualified retirement plan, including most in-service distributions occurring before an employee's attainment of age 59½, are subject to an additional 10% tax. Changing these age requirements to age 70 and age 59, respectively, would simplify plan administration.

c. *Repeal or Modify the Top Heavy Rules*. Section 416 was enacted to limit the ability of a plan sponsor to maintain a qualified retirement plan benefiting primarily the highly paid. Section 416 is both administratively complex and difficult to understand. Furthermore, under current law, there are limitations on the compensation with respect to which qualified retirement plan benefits can be provided, there are overall limitations on qualified retirement plan benefits, and non-discrimination requirements limit the ability of sponsors to adopt benefit formulas favoring the highly paid. Given the other limitations in the Code, Section 416 adds an unnecessary layer of complexity to employee plan administration.

If Section 416 is retained, the rule attributing to a participant stock owned by a member of the participant's family for purposes of determining whether or not the participant is a key employee should be eliminated. This change would be consistent with the recent repeal of the family aggregation rules under Sections 401(a)(17) and 414(q).

d. *Replace the Affiliated Service Group and Employee Leasing Rules*. Sections 414(b) and 414(c) treat businesses under common control as a single employer for purposes of determining whether a retirement plan maintained by one or more of these businesses qualifies under Section 401. Two other Code provisions adopt an

aggregation concept as well. Specifically, Section 414(m) generally treats all employees of members of an affiliated service group as though they were employed by a single employer, and Section 414(n) states that, under certain circumstances, a so-called leased employee will be deemed to be employed by the person for whom the employee performs services. No regulations have been finalized under these provisions. They are difficult to comprehend and to apply.

Sections 414(m) and 414(n) should be replaced with provisions explicitly describing and limiting the circumstances under which employees of businesses that are not under common control must be taken into account for purposes of determining the qualified status of a sponsor's retirement plan, and the discretion granted under Section 414(o) to develop different rules should be repealed.

e. *Worker Classification*. Determining whether a worker is an employee or independent contractor is a particularly complex undertaking because it is based on a 20-factor common law test. The factors are subjective and given to varying interpretations and no guidance exists on how or whether to weight them. In addition, the factors are not applicable in all work situations, and, in some work situations, the factors do not provide a meaningful indication of whether the worker is an employee or independent contractor. The consequences of misclassification are significant for both the worker and employer, including retroactive tax assessments, imposition of penalties, disqualification of benefit plans, and loss of deductions.

Complexity would be significantly reduced by enactment of an objective test to replace the subjective 20-factor test and making it applicable for Federal income tax and ERISA purposes. In the alternative, changes could be made to reduce the differences between the tax treatment of employees and independent contractors. Efforts to make the tax law more neutral with respect to whether a worker is an employee or independent contractor would reduce the importance of the worker classification rules because the consequences of misclassification would be less significant.

f. *Expand the Use of the Cash Method of Accounting*. Small C corporations, qualified personal service corporations, sole proprietors and certain passthrough entities are excepted from the required use of the accrual method under Section 448. This exception does not cover more than *de minimis* amounts of inventory, however, and there are no specific rules delineating when inventory is *de minimis*. In addition, the applicability of the inventory rules, which were written for the industrial age, is not at all clear for businesses operating in the information age. For example, it is not clear whether a business developing software sold via the Internet is required to use an inventory method. Thus, some businesses cannot easily determine if they have inventory that requires the use of the accrual method of accounting. Moreover, many of these businesses otherwise use the cash method of accounting, so that requiring the use of the accrual method and the keeping of inventories subjects them to complex rules and recordkeeping.

Considerable simplification could be achieved by amending Sections 446 and 448 to allow small taxpayers to use the cash method of accounting. Consistent with Section 448, small taxpayers (even those with inventory) could be defined as those with average annual gross receipts in the three prior years of $5 million or less. This rule would enable small businesses (even those with inventory) to use the cash method should they find it simpler. This proposal should not result in taxpayers manipulating their income because such businesses generally cannot afford to maintain large quantities of inventory on hand and the inventory levels of small businesses, in particular, would not be extensive. Further simplification could be achieved by increasing the Section 448 gross receipts threshold to $10 million.

g. *Provide Clear Rules Governing the Capitalization and Expensing of Costs and Recovery of Capitalized Costs*. Although the IRS clearly stated that the Supreme Court's decision in *INDOPCO* v. *Commissioner*, 503 U.S. 79 (1992), did not change fundamental legal principles for determining whether a particular expense may be deducted or must be capitalized, nonetheless, since INDOPCO, whether an expense must be capitalized has become the most contested audit issue for businesses. A future benefit test derived from the INDOPCO decision has been used by the IRS to support capitalization of numerous expenditures, many of which have long been viewed as clearly deductible. Almost any ongoing business expenditure arguably has some future benefit. The distinction between an "incidental" future benefit, which would not bar deduction of the expenditure, and a "more than incidental" future benefit, which might require capitalization, generally is neither apparent nor easy to establish to the satisfaction of parties with differing objectives. In addition, the administrative burden associated with maintaining the records necessary to permit the capitalization of regular and recurring expenditures is significant. Development of objective, administrable tests governing the deduction of expenses or the capitalization of categories of expenditures would significantly reduce controversy, just as the enactment of Section 197 significantly reduced controversy regarding the amor-

tization of intangible assets. For example, repair allowance percentages such as those previously provided under the Class Life Asset Depreciation Range (CLADR) System would significantly reduce controversy regarding capitalization of repair expenditures. See Rev. Proc. 83–35, 1983–1 C.B. 745 (CLADR repair allowance percentages); see alsoSection 263(d) (repair allowance percentage for railroad rolling stock).

h. *Modify the Uniform Capitalization Rules*. The uniform capitalization ("UNICAP") rules in Section 263A are extraordinarily complex. Compliance with the UNICAP rules consumes significant taxpayer resources; yet, for many taxpayers, the UNICAP rules do not result in capitalization of any significant amounts not capitalized under prior law. Modification of the UNICAP rules to limit their application to categories of expenditures not addressed comprehensively under prior law (e.g., self-constructed assets) or to large taxpayers would reduce complexity for many taxpayers.

i. *Simplify S Corporation Qualification Criteria*. The definition of an "S corporation" contained in Section 1361 establishes a number of qualification criteria. To qualify, the corporation may have only one class of stock and no more than 75 shareholders. Complex rules provide that the shareholders must be entirely composed of qualified individuals or entities. On account of state statutory changes and the check-the-box Regulations, S corporations are disadvantaged relative to other limited liability entities, which qualify for a single level of Federal income taxation without the restrictions. The repeal of many of the restrictions would simplify the law and prevent inadvertent disqualifications of S corporation elections.

j. *Modify the S Corporation Election Requirement*. Section 1362(a)(2) requires all shareholders to consent to an S corporation election, as well as that the election be made on or before the 15th day of the third month of the taxable year. There are also election deadlines for qualified subchapter S subsidiaries and qualified subchapter S trusts, which adds complexity. Late elections are common occurrences because taxpayers are unaware of or simply miss the election deadline. If the election is filed late, Section 1362(b)(5) permits the IRS to treat the late election as timely if the IRS finds reasonable cause for the late election. This provision has saved hundreds of taxpayers from the consequences of a procedural mistake; it has also generated considerable administrative work for the IRS as is evidenced by the hundreds of rulings granting relief. The election deadline was intended to prevent taxpayers from waiting until income and expenses for the taxable year were known before deciding whether to make an S corporation election. The differences that exist between the taxation of S and C corporations are so significant, however, that it is unlikely a taxpayer's decision over whether to make an S corporation election would be determined by the events during a single taxable year. Even if that were the case, it is difficult to understand the compelling policy reason to require taxpayers to guess at their financial operations for the year in determining whether to make an S corporation election at the beginning of the year rather than making an informed decision. The ability to pass through losses has been substantially restricted by various provisions of the Code. Thus, concerns about passing through losses are likely more theoretical than real. In addition, as a practical matter, taxpayers cannot wait until the end of the taxable year to make a decision because the need to make estimated tax payments compels a decision before the date the first estimated tax payment is due. Thus, the separate filing of the election itself is a mere procedural requirement leading to frequent procedural foot faults, but little else.

The most obvious time for the filing of an election is with a filing that is otherwise required. Significant simplification could be achieved by requiring the election to be made on the corporation's timely filed (including extensions) Federal income tax return for the year of the election. The same rule should apply to the qualified subchapter S subsidiary and qualified subchapter S trust elections.

k. *Repeal or Simplify the Personal Holding Company Rules*. The personal holding company rules were enacted in 1934 to tax the so-called "incorporated pocketbook." With differentials in the corporate and individual tax rates, individuals could, for example, place their investments in a corporation and substantially lower the Federal income tax paid on income generated by those investments, especially if the income was held in the corporation and reinvested for a long period of time. The personal holding company provisions attack this plan by imposing a surtax on certain types of passive income earned by closely held corporations that is not distributed (and thus taxed) annually.

Over time, the personal holding company rules have been broadened to include many closely held corporations, both large and small, with passive income (whether or not such corporations are, in effect, "incorporated pocketbooks") and, thus, may create a trap for the unwary. In addition, the rules have become very complex and difficult for the IRS to administer and for taxpayers to comply with, and sometimes

require taxpayers to rearrange asset ownership to comply with the rules. With maximum corporate and individual rates coming closer together and the repeal of General Utilities, it is questionable whether the personal holding company rules should remain in the tax code at all. Regardless of this debate, however, the rules should be significantly simplified in order to eliminate the substantial burden they impose on closely held corporations.

l. *Repeal the Collapsible Corporation Provision*. Since the repeal of the General Utilities doctrine in 1986, Section 341—the "collapsible corporation" provision—is essentially deadwood. By definition, a collapsible corporation is a corporation availed of with a view to a sale of stock before a substantial amount of the corporate income has been recognized. After 1986, a sale of corporate stock or a sale of all of a corporation's assets prior to the realization of corporate income cannot escape corporate taxation. Section 384 assures that a purchaser of stock of a corporation with built-in gain property cannot utilize its losses to shelter that gain. Since 1964, a corporation could escape the rigors of Section 341 by effecting a Section 341(f) election, i.e., the corporation agrees to recognize gain on the disposition of subsection (f) assets, notwithstanding any otherwise applicable non-recognition provisions of the Code. The repeal of General Utilities renders Section 341(f) redundant. More accurately, it renders Section 341(a) redundant because no corporate gain can now escape corporate tax. Since it was that avoidance or potential avoidance that gave birth to Section 341, it is now deadwood and should be repealed. Its repeal would result in the interment of the longest sentence in the Internal Revenue Code—Section 341(e).

m. *Simplify the Attribution Rules*. The attribution rules throughout the Code contain myriad distinctions, many of which may have been reasonably fashioned in light of the particular concern of the underlying provision. For example, should siblings be included in the rules? Should the ownership test be 80% or 50%? Whatever the reasons originally driving the differences among the attribution rules, those reasons may simply be outweighed by the need to simplify the Code. Consequently, the attribution rules and the concerns underlying them should be reexamined in light of concerns about complexity with a view to harmonizing and standardizing the rules, unless there are truly compelling reasons to do otherwise. At a minimum, and without reexamination, it is clear the rules could be simplified by standardizing whether the percentage is equal to or greater than and not have both.

n. *Simplify the Loss Limitation Rules*. The Code contains multiple rules limiting the availability of a taxpayer claim to use losses. These include Section 465, which limits the deductibility of losses of individuals and certain C corporations to the amount at risk—that is, generally, the amount of the investment that could be lost plus the taxpayer's personal liability for additional losses; Section 469, which limits losses incurred in "passive activities" Section 704(d), which limits a partner's distributive share of a partnership's losses to the partner's basis in the partnership interest; and Section 1366(d), which limits an S corporation shareholder's loss in similar fashion.

There are numerous limitations and qualifications layered on each of these rules and definitions, and Sections 465 and 469, in particular, are extremely complicated and difficult to comprehend. Section 465 originally applied only to certain types of activities deemed especially prone to abuse, such as the production and distribution of films and video tapes, but, in 1978, it was extended to virtually all other income-producing activities. Since the enactment of Section 469, Section 465 has become superfluous because there are very few situations in which a deduction would be denied because of the applicability of Section 465 that would not also be denied because of the applicability of Section 469.

Substantial simplification could be achieved by combining, rationalizing and harmonizing the loss limitation provisions.

o. *Simplify Section 355.* Section 355 permits a corporation or an affiliated group of corporations to divide on a tax-free basis into two or more separate entities with separate businesses. Under Section 355(b)(2)(A), which currently provides an attribution or "lookthrough" rule for groups of corporations that operate active businesses under a holding company, "substantially all" of the assets of the holding company must consist of stock of active controlled subsidiaries. Under this rule, holding companies that, for very sound business reasons, own assets other than the stock of active controlled subsidiaries are required to undertake one or more preliminary (and costly) reorganizations solely for the purpose of complying with this provision. Treating members of an affiliated group as a single corporation for purposes of the active trade or business requirement will simplify numerous corporate transactions.

p. *Simplify the Consolidated Return Rules*. Affiliated groups of corporations can elect to file a single consolidated income tax return. The dominant theory governing the development of the consolidated return regulations is that the consolidated group should be treated as a single entity. As evidenced by the hundreds of pages

of regulations and excruciating detail, this seemingly simple concept has evolved into one of the most complex and burdensome areas of the tax law. These rules, which are laced with numerous traps for the unwary, are virtually incomprehensible, even to experienced tax practitioners if they do not spend an entire career in the consolidated return area. With the advent of single-member limited liability companies (LLCs) and the check-the-box regulations, many companies may be able to avoid or ameliorate the complexity of the consolidated return rules by simply inserting single-member LLCs into their corporate structure. For companies that desire or are required to use a C corporation, however, the consolidated return rules still present a major stumbling block in terms of complexity. Accordingly, simplification of the consolidated return rules would be a major step towards the ultimate goal of simplifying the tax laws.

q. *Simplify the PFIC Rules*. In 1997, the passive foreign investment company ("PFIC") rules were greatly simplified by the elimination of the controlled foreign corporation-PFIC overlap and by allowing for a mark-to-market election for marketable stock. However, a great deal of complication remains in the PFIC area, suggesting that further simplification is necessary. Considerable simplification could be achieved by eliminating the application of the PFIC rules for smaller investments in foreign companies whose stock is not marketable.

r. *Simplify the Foreign Tax Credit Rules*. The foreign tax credit area is subject to significant complication, particularly because of the nine separate baskets for allocating income and credits set forth in Section 904(d)(1). Consolidating these baskets for businesses that are either starting up abroad or that constitute small investments would provide some relief from the complexity. In addition, treating the European Union as a single country would eliminate another complication faced by US taxpayers competing in this newly unified marketplace. Lastly, the elimination of the alternative minimum tax credit limitations on the use of foreign tax credits would greatly simplify this area for all US taxpayers operating abroad without permitting tax motivated behavior.

s. *Simplify the Subpart F Rules*. The Subpart F rules present a host of difficulties in their application. While the rules may be necessary to prevent tax avoidance by large and sophisticated taxpayers, smaller taxpayers or smaller foreign investments could be excepted from the application of these rules, which would greatly simplify the tax system, without creating the potential for the tax avoidance the rules were intended to prevent.

t. *Clarify Treatment of Check-the-Box Entities for Subpart F Purposes*. Notices 98–11 and 98–35 caused considerable confusion in planning with respect to international tax matters. Notice 98–35 suggests potential rules that, once implemented, could adversely affect the use of so-called "check-the-box" entities (that is, entities that are either disregarded or treated as partnerships for Federal income tax purposes but are treated as taxable entities under local law) in international transactions. The suggested rules are leaving many taxpayers with uncertainly in their international planning. Congressional clarification of what factors should be relevant in computing "foreign personal holding company" income under Subpart F would greatly simplify the task of international tax compliance.

u. *Repeal Section 514(c)(9)(E).* In general, income of a tax exempt organization from debt financed property is treated as unrelated business taxable income. Debt financed property is defined in Section 514 as income producing property subject to "acquisition indebtedness," which generally does not include debt incurred to acquire or improve real property. Section 514(c)(9)(E) (the "fractions rule") provides, in general, that debt of a partnership will not be treated as acquisition indebtedness if the allocation of income and loss items to a tax exempt partner cannot result in the share of the overall taxable income of that organization for any year exceeding the smallest share of loss that will ever be allocated to that organization. This provision was enacted to prevent disproportionate allocations of income to tax exempt partners and disproportionate allocations of loss items to taxable partners. The provision has become a trap for the unwary as well as a tremendous source of planning complexity even for those familiar with it. Anecdotal evidence suggests that few practitioners understand the provision completely, and almost no IRS agents or auditors raise it as an issue on audits. Instead, because of its daunting complexity, it has become a barrier to legitimate investment in real estate by exempt organizations. At the same time, other provisions in the tax law (such as the requirement of substantial economic effect under Section 704(b)) substantially limit the ability to shift tax benefits among partners. Therefore, Section 514(c)(9)(E) could be repealed without substantial risk of abuse.

3. *Administrative Provisions*

a. *Deposit Penalty*. The failure to timely deposit taxes is subject to penalty, pursuant to Section 6656, in amounts ranging from 2 percent to 15 percent of the underdeposit, depending on the lateness of the deposit. The deposit rules are unnecessarily complex and adversely affect small businesses as they move from one payroll deposit category to another.

For example, professional corporations may be severely impacted where their payroll deposit is normally less than $100,000 per pay period which permits at least semi-weekly deposits (i.e., a three-day deposit rule). However, at each year end, in order to pay out all, or almost all, of the corporation's income, bonus compensation distributions are frequently required. The amount of the bonus distributions for each employee, a prerequisite to determining appropriate withholding tax, cannot be ascertained until the annual books are closed. Closing of the books requires receipts, expenses, etc. for the last day of the taxable year to be considered. Bonuses must also be paid by the last day of the taxable year (often December 31) to be tax deductible for such year.

Financial intermediaries generally require at least one day's advance notice to make electronic federal withholding tax deposits. Banks and taxpayer businesses are frequently shorthanded at year end and find it difficult to determine the amount of the Federal tax deposit due until after the financial intermediaries' cutoff time to make withholding tax deposits on the next business day. This is particularly true for taxpayers in the western U.S. time zones. A 2 percent penalty is excessive for a deposit that is only one day late, particularly where the depositor is normally a semi-weekly depositor but is required to make a one-day deposit.

Congress recently recognized that the changing of deposit requirement time frames is a complexity that causes great confusion and that waiver of the penalty should be permitted for the first change period. See Section 6656(c)(2)(B). While this solution helps, it does not fully address the problem. The current provision requires an administrative waiver request that may be expensive and time consuming and applies only to the first instance of a problem which by nature is likely to occur annually. Section 6302 (or the regulations) should be modified to require next day electronic depositing only in those instances where next day depositing (i.e., $100,000 or more deposit) is required of that taxpayer with respect to 10 percent or more of its deposits. Alternatively, taxpayers could be given a minimum of two days to make deposits of $250,000 or less.

b. *Information Returns*. Sections 6041 and 6041A generally require reporting of all payments made in connection with a trade or business that exceed $600 per year. The $600 per year has never been adjusted for inflation. Section 6045(f) now requires reporting of all gross payments to attorneys (includes law firms and professional corporations) where the portion constituting the legal fee is unknown even if the payment is less than $600. Many Form 1099 information returns from nonfinancial institutions cannot be processed by the IRS or do not provide truly useable information. Anecdotal evidence suggests the information on these information returns may not be used in examinations of the taxpayers and cannot be reconciled to tax returns. The reporting threshold should be increased to $5,000 (which harmonizes with Section 6041A(b)) and adjusted for inflation in full $1,000 increments.

c. *Penalty Reform.* The 1998 IRS Restructuring Act instructs both the Joint Committee on Taxation and the Treasury Department to conduct separate studies of the penalty and interest provisions of the Code and to make recommendations for the reform of the same.

The Tax Section believes that reform of the penalty and interest provisions is appropriate at this time and looks forward to working with the JCT and Treasury. There are many cases in which the application of penalty and interest provisions takes on greater significance to taxpayers than the original tax liability itself. The Tax Section is concerned that these provisions often catch individuals unaware, and that the system lacks adequate flexibility to achieve equitable results. In light of the significant changes being made by the IRS, the completion of this study and eventual enactment of the recommendations will be welcome.

The Tax Section has submitted preliminary comments to the staff of the Joint Committee on Taxation that we hope will be useful in developing alternatives.

CONCLUSION

Thank you again for the opportunity to testify at this very important hearing. We wish you, and concomitantly all individual and small business taxpayers, success in your endeavors. We would be happy to work with the Committee and this Subcommittee as legislation is developed to address the twin tasks of simplification and avoidance of complexity.

Chairman HOUGHTON. Thank you very much. We are having to work on our mechanics here because we have another vote. We will get around to some questions, Mr. Tucker. Thanks very much.

Mr. Lifson.

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

Mr. LIFSON. Mr. Chairman and Members of this Distinguished Committee, my name is David Lifson and I speak to you representing over 330,000 certified public accountants, as the chair of the Tax Executive Committee of the American Institute of CPAs.

Many of our members provide comprehensive tax services for all types of taxpayers, including businesses and individuals in various financial situations. They work daily with the tax provisions you enact and we are committed to helping make our tax system as simple yet as fair as possible. These days, the process of obeying the tax law is more daunting than ever. Our tax laws are too complicated. The current outcry for tax simplification is not new. In fact the AICPA has warned Congress for more than a decade that the tax law is growing so dense that it threatens to undermine voluntary compliance.

Chairman Houghton, I commend you on your commitment to reducing the complexity of the tax law. Your Tax Simplification and Burden Reduction Act represents an excellent starting point for reducing the tax compliance burden imposed on many individual taxpayers and small businesses.

In our written statement submitted for the record, we have included our top 10 list of tax law complexities, designed for individuals and small businesses. We share concerns about such areas of law as the individual AMT and the estimated tax safe harbor. We urge you to place a high tax policy value on tax simplification and would be pleased to work with you to try to make your tax legislative proposals as simple and as complete and as effective as possible.

Complexity has already led to a growing perception by taxpayers that the tax law is unfair, increased costs in funding the IRS to administer the tax law, increased taxpayer compliance costs, and, perhaps, most importantly, undue interference with business decisionmaking. Our tradition of voluntary tax compliance and self-assessment is a national treasure. By and large, our citizens obey the law, but it is only human to disobey a law if you do not or cannot understand the rules.

There are various types of simplification, such as simplification that reduces calculation complexity, like the earned income credit calculation. Simplification that reduces the filing burden such as electronic filing. Perhaps most importantly, simplification that reduces the chances of a dispute between the Internal Revenue Service and the taxpayer, such as worker classification reform.

The first two types of simplification are sometimes the easiest to identify, yet, politically, they may not be the easiest to address. But they should be the low fruit on the tax tree that you can see and capture most readily. The last type, adding certainty to the law

and thereby reducing the likelihood of disputes is the most difficult to effectuate, yet perhaps it is the most important. Please help us find simplification in all three areas. Clarifying law that is hard to understand must be a priority if we are to achieve a simpler system and to avoid unnecessary taxpayer unrest.

Our written submission offers a start. Inside are the 10 areas that require serious revisions. There are, in fact, hundreds of areas that could be improved. Because of their importance, I will simply mention four areas of particular interest today. I hope you will look into our full explanation in our submission for the record.

The alternative minimum tax is one of the most complex parts of the tax system. It should be eliminated or substantially simplified. The earned income credit has long been identified as an area in great need of simplification. The rules are so complex that the targeted taxpayers are often not always effectively able to claim the credit. Worker classification issues often paralyze startup businesses with uncertainty which leads to resentment of the tax system. Until taxpayers are provided with clear-cut rules by Congress, this area will continue to provide unintended traps for small business owners as well as a continuation of the many battles between the taxpayers and the IRS. Phaseouts should also be simplified and we have provided you with a comprehensive, detailed starting point for legislative action.

There is a good bit more detail in my written statement, both on the items I have mentioned here and in a number of other areas. We would only ask that you review that statement carefully. The AICPA thanks you for the opportunity to help. We want to simplify the system for everyone's benefit.

[The prepared statement follows:]

Statement of David A. Lifson, Chair, Tax Executive Committee, American Institute of Certified Public Accountants

Mr. Chairman, and members of this distinguished committee: My name is David A. Lifson, and I am the chair of the Tax Executive Committee of the American Institute of Certified Public Accountants (AICPA). The AICPA is the professional association of certified public accountants, with more than 330,000 members, many of who provide comprehensive tax services to all types of taxpayers including businesses and individuals, in various financial situations. Our members work daily with the tax provisions you enact, and we are committed to helping make our tax system as simple and fair as possible.

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 serious concerns for tax professionals.

Chairman Houghton, I commend you on your commitment to reducing the complexity of the tax law. The pending Tax Simplification and Burden Reduction Act represents an excellent starting point for reducing the tax compliance burden imposed on many individual taxpayers and small businesses. As you can see from the Top Ten List of Tax Law Complexities, we share concerns about such areas of law as the individual alternative minimum tax and the estimated tax safe harbor.

Many of our comments urge simpler solutions, particularly in the area of the individual alternative minimum tax and the proliferation of individual credits with complex income phase-out rules for families. We urge you to place a high tax policy value on tax simplification and would be pleased to work with you to try to make your tax legislative proposals as simple and as effective as possible.

There are various types of simplification such as: simplification that reduces calculation complexity, like the AMT calculation; simplification that reduces the filing burden, such as electronic filing; and, simplification that reduces the chances of a dispute between the Internal Revenue Service and the taxpayer. The first two types

are sometimes the easiest to identify and accomplish—the "low fruit" on the tax tree that you can see and capture most easily. The last type, adding certainty to the law and thereby reducing the likelihood of disputes, is the most difficult to effectuate yet, perhaps, the most important.

Clarifying law that is hard to understand must be a priority if we are to achieve a simpler system. There are numerous areas of the Code where this type of simplification is needed. One example is in the area of worker classification. The AICPA is on record as supporting S.344, the Independent Contractor Simplification and Relief Act of 1999, which was introduced by Senator Christopher Bond on February 9, 1999. At this time we are examining other proposed legislation in this area. It is our hope that the proper elements can be pulled together so that worker classification simplification can be accomplished. We welcome the opportunity to work with legislators and staffs to design an approach that provides certainty, while balancing the needs of service recipients and the rights of service providers.

Significant problems arise from the increasing complexity of the tax law. For example:

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

The end result is erosion of voluntary compliance. By and large, our citizens obey the law, but it is only human to disobey a law if you do not or can not understand the rules. In a recent Associated Press (AP) poll, 66 percent of the respondents said that the federal tax system is too complicated. Three years ago, just under one-half of respondents in a similar AP poll said that the tax system was too complicated.

The poll also showed that more than half of those surveyed, 56 percent, now pay someone else to prepare their tax returns. This is a serious indictment of our tax system. When over half our individual taxpayers have so little comprehension of (or faith in) their tax system that they have to hire another party to prepare their returns, something is not right. Consider, too, that only about 30% of individual returns claim itemized deductions. Thus, a significant segment of those paying to have returns prepared are standard deduction filers. The AICPA firmly believes that taxpayers with relatively simple financial affairs should not have to seek professional preparation services in order to 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, simplification must be an integral part of the tax legislative, regulatory, and administrative process. While a tax system that is simple for all taxpayers may never be designed, a "simpler" system is attainable, both through new legislative proposals and a review of existing tax law.

AICPA Blueprint for Tax Simplification and Complexity Index

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

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

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

• tax rules should build on common industry record keeping and business practices.

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

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

Internal Revenue Service Restructuring and Reform Act of 1998

The AICPA was greatly pleased when many of the concepts and factors contained in the Blueprint and Index were incorporated into the tax law complexity analysis mandated by the Internal Revenue Service Restructuring and Reform Act of 1998.

The Act requires an annual tax law analysis of sources of complexity in administration of the Federal tax laws to be conducted by the Commissioner of Internal Revenue. This analysis will draw on such information as: questions frequently asked by taxpayers; common errors on tax returns; areas of law which frequently result in disagreements between taxpayers and the IRS; and areas of law lacking published guidance.

The Act also requires the Joint Committee on Taxation, in conjunction with the IRS and the Treasury Department, to develop a complexity analysis of any proposed legislation that has widespread applicability to individuals or small business. This analysis will draw on such information as: an estimate of the number of taxpayers affected by a provision; the income level of affected taxpayers; the effect of a proposed change on tax forms and published guidance; any additional record keeping requirements imposed on taxpayers; and an estimated cost to taxpayers to comply with the provision.

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

Recent Legislative Proposals

In recent years, tax legislation has increasingly included complex thresholds, ceilings, phase-ins, phase-outs, effective dates, and sunset dates in an effort to provide benefits to numerous specific groups within the limits of revenue neutrality. For example, the President's Fiscal Year 2000 Budget tax proposals, as drafted, continue this trend through numerous, additional targeted credits. While these credits are well-intentioned, cumulatively they would further weigh down our tax system with complexity. Many average taxpayers do not understand the benefits to which they are currently entitled. While it is still early, we believe that taxpayers will, all too frequently, omit from their 1998 tax returns some of the benefits intended for them. In fact the Wall Street Journal just reported on April 12 that the IRS had discovered that 30,000 filers eligible for the child tax credit had filled out their tax return wrong. Other taxpayers will be disappointed to learn that they do not qualify for benefits that they have heard about because of complex phase-out rules written in fine-print. Taxpayers will have difficulty in complying, much less planning for, and this level of complexity.

We understand that delivering politically popular benefits within budget constraints often results in simplification being sacrificed. However, the Administration's current proposals are only the continuation of a growing trend to complicate our tax structure through targeted benefits. For example, the 1997 Taxpayer Relief Act enacted the new dependent child credit (up to $400 in 1998 for dependent children under 17 years of age) that had strong political support from both political parties. The AICPA opposed the proposal, not on policy grounds but solely based on simplification of the law. Rather than introduce a new form, a new set of calculations and a new set of income phase-outs, a rough equivalent of the desired objective

could have been achieved by increasing the dependency exemption available for children under 17. Since exemption deductions already phase-out for the wealthy, the increased amount would not have been available for our most affluent taxpayers. Obviously, we were politically incorrect. But, we think we were correct in the context of tax simplification.

The Administration's revenue proposals contain numerous provisions affecting individuals, such as: a new long-term care credit, a new disabled workers tax credit, the child and dependent care tax credit expansion, the employer-provided educational assistance exclusion extension, a new energy efficient new homes credit, the electric vehicles credit extension, AMT relief extension, a new D.C. homebuyers credit, optional self-employment contributions computations, a new severance pay exemption, a new rental income inclusion, etc. While we are not commenting on the policy need for these provisions, we note that Congress must consider the general administrability of these provisions.

We are very concerned about the increasing complexity of the tax law as a result of targeted individual tax cuts. The 1997 Taxpayer Relief Act contained several targeted individual tax cuts that were first effective for 1998 individual income tax returns. As discussed in the Wall Street Journal of February 17, 1999, these provisions, while providing tax relief to certain individuals, have greatly increased the complexity of the preparation of individual income tax returns. This increased compliance burden is born mostly by lower income taxpayers who can least afford the cost of hiring a professional income tax return preparer.

IRS National Taxpayer Advocate W. Val Oveson, in his first report to Congress, stated that increasing tax law complexity is imposing significant compliance and administrative burdens on the IRS and taxpayers. The report also cited the increasing complexity caused by the targeted individual tax cuts contained in the 1997 Taxpayer Relief Act.

The Administration's tax proposals contain 28 new targeted tax cuts. Many of these provisions have limited applicability; none are available to high-income taxpayers. Unfortunately, the way these provisions are drafted with different income limits for each provision, taxpayers need to make many additional tax calculations just to determine if they are eligible for the tax benefit. The Administration's tax proposals will add several additional income limits to the Internal Revenue Code.

Below are a few examples of provisions in the Administration's tax proposals that have different phase-out limits:

- The long-term care credit and disabled workers tax credit would be phased out "by $50 for each $1,000 (or fraction thereof) by which the taxpayer's modified AGI exceeds" $110,000 (married filing a joint return taxpayers), $75,000 (single/head of household), or $55,000 married filing separate.
- The first-time D.C. homebuyers credit phases out for individuals with AGI between $70,000 and $90,000 ($110,000 to $130,000 for joint filers).
- The severance pay exemption would not apply if the total severance payments received exceed $75,000.
- The expanded child and dependent care credit proposal would allow taxpayers the 50 percent credit rate if their AGI is $300,000 or less, then the credit rate would be reduced by one percentage point for each additional $1,000 of AGI in excess of $300,000, and taxpayers with AGI over $59,000 would be eligible for a 20 percent credit rate.
- The student loan interest deduction (to which the President's proposal would eliminate the current 60-month limit) phases out ratably for single taxpayers with AGI between $40,000 and $55,000 and between $60,000 and $75,000 for married filing a joint return taxpayers.

This type of law, with so many different phase-out limits, provides incredible challenges for middle-income taxpayers, in determining how much of what benefit they are entitled to. We suggest common phase-out limits among all individual tax provisions in order to target benefits to one of three uniform groups and simplify the law. Our phase-out simplification proposal is attached.

Another problem with these targeted tax cuts is that the impact of the alternative minimum tax (AMT) on these cuts is not adequately addressed. This is evidenced by the provision in the 1998 IRS Restructuring and Return Act and the provision in the Administration's tax proposals that provide temporary relief from the AMT for individuals qualifying for some of the targeted tax credits. We believe that the individual alternative minimum tax needs to be simplified; our proposal is attached.

Finally, much of the complexity in the individual income tax system is the result of recent efforts to provide meaningful tax relief to medium and low-income taxpayers. In order to aid simplification, we believe that Congress should consider alternatives to targeted tax cuts, including the new ones proposed by the Administration, with provisions such as the following:

- Increased standard deduction.
- Increased amount for personal exemptions.
- Increasing the taxable income level where the 28 percent tax and the 31 percent tax rate begins.
- Marriage penalty relief.

The AICPA would like to further study the complexity caused by the proliferation of credits with their complex provisions, and hopes to provide further specific comments as this legislation progresses.

AICPA Simplification Efforts

Over the years the AICPA has made numerous, regular submissions of specific tax simplification recommendations. Examples include the annual release of "The AICPA Top Ten List of Tax Law Complexities" and the April 1997 comprehensive package of simplification proposals which included recommendations to simplify the tax law for individuals, small businesses, employee benefit taxation, trust and estate taxation, corporation and shareholder taxation, financial service and product institutions taxation, and international taxation. The AICPA is once again initiating a project to develop a comprehensive package of tax simplification recommendations that we hope to share with this committee later in the year.

In the meanwhile, our statement below contains the AICPA 1999 Top Ten List of Tax Laws Complexities that would significantly simplify the tax law for individuals. We also encourage this committee to consider alternatives to targeted tax credits and cuts, including an increased standard deduction, increased personal exemption amount, reduction of the income level at which current rates apply, and relief from the marriage penalty.

Specific Simplification Recommendations—Top Ten List of Tax Law Complexities for Individual Taxpayers and Small Businesses

Simplification of the Individual Alternative Minimum Tax (AMT)

Present Law

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 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. If the Administration's budget proposal on temporary AMT relief expansion is not enacted, several tax credits included in the Taxpayer Relief Act of 1997 will have a dramatic impact on the number of individuals who will find themselves subject to the AMT. For many, this will come as a real surprise and, in all likelihood, will cause substantial problems for the Internal Revenue Service, which will have to redirect significant resources to this area in the future to ensure compliance, educate taxpayers, and handle taxpayer questions. We believe the Administration's proposal should be for permanent AMT relief rather than just temporary two-year relief.

Most sophisticated taxpayers understand that there is an alternative tax system, and that they may sometimes wind up in its clutches; unsophisticated taxpayers, however, 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—because 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. While Congress changed the law—for 1998 only—to allow these credits against AMT, it is now faced with the need to continue revisiting this issue if there is to be continuing relief. Thus, the question of nonrefundable credits as an AMT offset has joined the unenvied list of "expiring provisions" or "extenders" for which it becomes necessary to continue finding revenues to pay for another year or two of what should be a matter of simplicity and equity.

Indexing of AMT Brackets and Exemption. Numerous anecdotal examples now indicate the likelihood that taxpayers with adjusted gross incomes in the $60,000–

$70,000 range (or below) will be subject to AMT in the next few years. 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 compliance and administration problems. 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 otherwise 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 unwarranted criticism that should be directed elsewhere.

Recommended Changes

Due to the increasing complexity, compliance problems, and a perceived lack of fairness towards the intended target, the AICPA supports eliminating the individual AMT altogether. These provisions have been in the law since 1978 (with amendments from time to time), and substantive changes to the regular tax regime in the past 20 years have resulted in much of the AMT impact now coming from disallowance of itemized deductions, with a slowly growing secondary effect from the failure to index tax brackets and exemptions. Thus, the policy underpinning of the AMT which was present in 1978 has been greatly diluted.

While we are concerned with those who have to pay the AMT based upon mechanical rules that leave a lot to be desired from a policy perspective, we also note that many non-AMT payers must still be AMT filers. We would be interested in seeing statistics as to the number of individual taxpayers who struggle to fill out Form 6251 just to show they do *not* have an AMT liability. To fill this form out correctly is one of the most baffling experiences a taxpayer can go through -not because the IRS can't design forms (they do a terrific job overall), but because the law is so incomprehensible it defies being reduced to a set of easily derived numbers and simple instructions.

For these reasons, and others described above, we believe the individual AMT is an appropriate candidate for repeal. We do, however, recognize that there is no simple solution to the AMT problem given the likely revenue loss to the government. If repeal is not possible, Congress should consider the following:

1. Increasing and/or indexing the AMT brackets and exemption amounts.

2. 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).

A. At the very least, state income taxes should no longer be an adjustment. There is very little fairness in concluding that a resident of California, the District of Columbia, or New York should have a higher likelihood of incurring the AMT than a resident of Texas, solely for making a choice of state in which to live or work.

3. 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).

4. Allowing certain regular tax credits against AMT (e.g., low-income tax credit, tuition tax credits)—permanently, rather than just for the next two years.

5. Providing an exemption from AMT for low and middle-income taxpayers with regular tax AGI of less than $100,000.

6. The impact of AMT in all future tax legislation.

Contribution to Simplification

The fairness goal of the AMT has created hardship and complexity for many taxpayers who have not used preferences to lower their taxes. 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. Increasing and/or indexing the AMT brackets and exemption (recommendation 1) 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 phase out for high income taxpayers, 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 AGI, but who live in states with lower or no state income taxes, would not pay AMT. This unintentionally works to the disadvantage of residents of high tax states.

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 also be improved.

Under recommendation 5, fewer taxpayers will be subject to AMT and its 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.

In conclusion, we see the AMT as becoming more prevalent and causing considerable disillusion to many taxpayers whom do not see themselves as wealthy and who will believe they are being punished unfairly. The 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 address this problem.

SIMPLIFICATION OF EARNED INCOME TAX CREDIT

Present Law

The refundable earned income tax credit (EITC) was enacted in 1975 with the policy goals of providing relief to low-income families from the regressive effect of social security taxes, and improving work incentives among this group. According to the IRS, EITC rules affect almost 15 million individual taxpayers.

Over the last few years, the most common individual tax return error discovered by the IRS during return processing has been the EITC, including the failure of eligible taxpayers to claim the EITC, and the use of the wrong income figures when computing the EITC.

The frequent changes made over the past twenty years contribute greatly to the credit's high error and noncompliance rates. Some examples of frequent changes and complexities follow. As part of the health insurance deduction act that Congress passed in 1995, a new factor was added to determining eligibility—the amount of interest (taxable and tax-exempt), dividends, and net rental and royalty income (if greater than zero) received by a taxpayer, even if total income is low enough to otherwise warrant eligibility for the EITC. A threshold of this type of disqualified income was set at $2,350 in 1995, was then altered as part of the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 to be $2,200, and goes to $2,300 for 1998. In addition, in 1996, capital gain net income and net passive income (if greater than zero) that is not self-employment income were added to this disqualified income test.

In 1996, the credit computation became even more complicated, with the introduction of a modified AGI definition for phasing out the credit, wherein certain types of nontaxable income need to be considered and certain losses are disregarded. Specifically, nontaxable items to be included are: tax-exempt interest, and nontaxable distributions from pensions, annuities, and individual retirement arrangements (but only if not rolled over into similar vehicles during the applicable rollover period). The losses that are to be disregarded are:

- net capital losses (if greater than zero);
- net losses from trusts and estates;
- net losses from non-business rents and royalties; and
- 50 (changed to 75% in 1997) percent of net losses from businesses, computed separately with respect to sole proprietorships (other than in farming), sole proprietorships in farming, and other businesses—but amounts attributable to business that consist of performance of services by an individual as an employee are not taken into account.

In addition to the prior requirement that a taxpayer identification number (TIN) be supplied for all qualifying children, starting in 1996, individuals are also required to be authorized to be employed in the U.S. in order to claim the credit. Failure to provide a correct TIN is now treated as a mathematical or clerical error.

In 1997, as part of the Taxpayer Relief Act of 1997 (TRA 97), new restrictions are placed on the availability of the EITC. For example, taxpayers who improperly claimed the credit in earlier years are denied the credit for a period of years. If the

improper claim was due to fraud, the disallowance period is ten years after the most recent tax year for which the final determination is made. If it was due to reckless or intentional disregard of the rules, the disallowance period is two tax years after the most recent tax year for which the final determination was made. Taxpayers who are denied the EITC for any tax year as a result of tax deficiency procedures must demonstrate eligibility for the credit and provide additional information to the IRS in order to claim the credit in any later tax year.

In addition, the 1997 law increases from 50% to 75% the amount of net losses from carrying on trades or businesses that is disregarded in determining modified AGI. The 1997 legislation also includes the following items in determining modified AGI for the credit: tax-exempt interest received or accrued during the tax year; and non-taxable distributions from pensions, annuities, or individual retirement plans (if not rolled over into similar vehicles during the rollover period). The 1997 law provides that workfare payments are not earned income for EITC purposes.

The credit has been changed 13 times (1976, 1977, 1978, 1979, 1984, 1986, 1988, 1990, 1993, 1994, 1995, 1996 and 1997) and now is a nightmare of eligibility tests, requiring a maze of worksheets. Computation of the credit currently requires the taxpayer to consider 9 eligibility requirements:

- the number of qualifying children—taking into account relationship;
- residency test;
- age test;
- the taxpayer's earned income—taxable and non-taxable;
- the taxpayer's AGI;
- the taxpayer's modified AGI;
- threshold amounts;
- phase out rates; and,
- varying credit rates.

To claim the credit, the taxpayer may need to complete:

- a checklist (containing 9 complicated questions);
- a worksheet (which has 10 steps);
- another worksheet (if there is self-employment income); and
- a schedule with 6 lines and 2 columns (if qualifying children are claimed).

For guidance, the taxpayer may refer to 7 pages of instructions (and 28 pages of IRS Publication 596). The credit is determined by multiplying the relevant credit rate by the taxpayer's earned income up to an earned income threshold. The credit is reduced by a phase-out rate multiplied by the amount of earned income (or AGI, if less) in excess of the phase-out threshold.

While Congress and the IRS may expect that the AICPA and its members can comprehend the EITC intricacies and the many pages of instructions and worksheets, it is unreasonable to expect those individuals entitled to the credit (who will almost certainly NOT be expert in tax matters) to deal with this complexity. Even our members, who tend to calculate the credit for taxpayers as part of their volunteer work, find this area to be extremely challenging.

Our analysis suggests that most of the EITC complexity arises from the definitional distinctions in this area. While each departure from definitions used elsewhere in the Code can be understood in a context of accomplishing a specific legislative purpose, the sum of all the definitional variances causes this IRC Section to be unmanageable by taxpayers and even the IRS. We recognize that many of the additions and restrictions to the credit over the years were well intended. However, the rules are so complex that the group of taxpayers to be benefited finds them incomprehensible and are not effectively able to claim the credit to which they are entitled.

Recommended Changes

We recommend that Congress adopt the following changes to the EITC.

1. Simplify definitions and the calculation.

2. Define "earned income" as taxable wages (Form 1040, line 7) and self-employment income (Form 1040, line 12).

3. Modify the "qualifying child" rules.

A. Replace the "qualifying child" definition with the existing "dependent child" definition.

B. Increase the incremental amount of credit provided for two children versus one child.

C. Use the dependency exemption rather than the EITC to provide benefits relating to children.

4. Combine and expand the denial provision.

A. Deny the credit for taxpayers with: foreign earned income, alternative minimum tax liability, and AGI that exceeds earned income by $2,200 or more.

Contribution to Simplification

Instructions and computations would be greatly simplified. The error rate should be dramatically reduced.

SIMPLIFICATION OF PHASE-OUTS BASED ON INCOME LEVEL

Present Law

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 level 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 by hand; and the instructions for applying the phase-outs are of relatively little help. See the attached Exhibits for a listing of most current phase-outs, including their respective income measurements, phase-out ranges (for 1998) and phase-out methods.

Note that currently many 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 causes a marriage penalty when the spouses' incomes are relatively equal.

Recommended Changes

Simplification could easily be accomplished by eliminating phase-outs altogether. However, if that is considered either unfair (simplicity is often at odds with equity) or bad tax policy, significant simplification can be achieved by creating consistency in the level of income, the income range of phase-out and the method of phase-out.

Instead of the approximately 20 different phase-out ranges (shown in attached Exhibit A), we recommend only three—at levels representing low, middle, and high income taxpayers.

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

We propose that all phase-out ranges for MFS taxpayers should be the same as those for single and HOH taxpayers, which would be 50 percent of the range for MFJ taxpayers.

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 to low and middle income taxpayers, 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, the new education credits and education 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.

Additionally, instead of the differing methods of phase-outs (shown in attached Exhibit B), 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 Adjusted Gross 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

The current law phase-outs complicate tax returns immensely and impose marriage penalties. The instructions related to these phase-outs are difficult to understand and the computations often cannot be done by the average taxpayer by hand. The differences among the various phase-out income levels are tremendous. Either the phase-outs should be eliminated and the same goal accomplished with a lot less complexity by adjusting rates, or at least the phase-outs should be made applicable at consistent income levels (only three) and applied to consistent ranges using a consistent methodology. This would ease the compliance burden on many individuals. If there were only three ranges and only one methodology, it would be much easier to recognize when and how a phase-out applies. Portions of numerous Internal Revenue IRC Sections could be eliminated. By also making the MFJ phase-out ranges double the ranges applicable to single individuals, and by making the MFS ranges the same as single individuals, the marriage penalty associated with phase-out ranges would be eliminated. (See Exhibit A for selected AGI phase-out amounts and Exhibit B for current methods of phase-out.)

ELIMINATE THE MARRIAGE PENALTY

Present Law

Under the current tax system, a marriage penalty and marriage bonus exist. The marriage penalty/bonus results when two married individuals have a greater (penalty) or smaller (bonus) tax liability as compared to two similarly situated single individuals (i.e., individuals with the same total incomes). The marriage penalty is likely an unintended result from prior legislative efforts to be equitable. As each Congress introduces changes to the Code, complexity and unintended tax effects often result. There are at least 63 provisions in the Internal Revenue Code where tax liability depends on whether a taxpayer is married or single. Most of these differences were created to be fair; to target benefits to specific taxpayers, or to prevent abuses. Some examples are the tax rates, standard deduction, and earned income tax credit, as well as social security benefits taxation, capital loss limits, IRAs, dependent care credit, child credit, and education tax incentives.

The two major factors that have created the marriage penalty problems are:

1. The "stacking of income" problem, resulting from the different and progressive tax rate/bracket schedules applicable to different filing statuses, and
2. Different income thresholds and phase-outs of deductions and credits for single versus married taxpayers.

The progressive tax rate/bracket schedules impose a higher marginal tax on combined spousal earnings, as compared to two single persons. Additionally, the tax brackets for married filing joint are not twice as wide as the brackets for single taxpayers, and the tax brackets for married filing separately do not equate to the tax brackets for single taxpayers. We refer to this phenomenon as the "stacking of income" problem and there are a variety of ways to address it.

The second factor contributing to the marriage penalty is the large number of provisions that phase-out based on income levels that may or may not differ based on marital/filing status. The TRA 97 significantly increased the provisions with different phase-outs for different filing status (i.e., based on joint, single, or married filing separately).

Recommended Changes

The AICPA has been studying this area for many years and recommends that the marriage penalty be eliminated or reduced. There are a number of possible approaches to address the marriage penalty problem.

1. Provide a deduction to reduce the marriage penalty, such as the two-earner deduction. This would be the simplest solution to implement, and would eliminate some, but not necessarily all, of the marriage penalty and could add to marriage bonuses. It would have to apply for both regular tax and alternative minimum tax (AMT) and not be subject to an AGI phase-out to be fully effective.
2. Provide on one return, a separate calculation of each spouse's taxable income and use one tax rate schedule that would apply to all individuals. The income and deductions of each spouse could be allocated in a variety of ways, e.g., by property ownership, by AGI, by percentage of earned income, 50/50, or in the parties' discretion. In our opinion, conceptually, this one-return, separate calculation proposal could produce the most equitable system. However, any allocation of income and deductions adds complexity in return filing and tax administration. The total increase in complexity will depend on the allocation methods used. Many states that have an income tax, such as Virginia, use this approach.

3. Provide a tax credit to reduce the marriage penalty. This would eliminate some, but not necessarily all, of the penalty and could add to the marriage bonus. It would have to apply for both regular tax and AMT to be fully effective. Several considerations would have to be taken into account, such as the complexity in the calculation, the treatment of carryovers and carrybacks, and the priority ordering of the many tax credits that could apply.

4. Adjust/broaden the current rate/bracket schedules applicable to married individuals. The joint schedule could be modified to eliminate the marriage penalty (by increasing the joint brackets to twice the single brackets) or to reduce the penalty. Another approach would be to conform the married filing separate and single rate/bracket schedules (such as in Arizona). This approach would be better than the current system and could be viewed as elective complexity for those couples that chose to file separately.

5. Adopt standard phase-outs for three income levels—low, middle, and high-income taxpayers (rather than the 20 current levels), and adopt one standard phase-out method. This would eliminate marriage penalties related to phase-outs, since the joint amounts would be twice the single ranges, and the phase-out ranges applicable to married filing separate taxpayers would be the same as those for single taxpayers.

In addition, there are related tax problems that arise because of marriage and divorce, and we urge the Committee to give these matters consideration. For example, the treatment of carryover tax attribute rules and NOL computations in divorce situations need modification. We also note that various IRC regulations (i.e., under IRC Sections 108, 121, 154, 163, 1041, and 6013) regarding spouses and divorce situations need to be amended.

This recommendation discusses a number of possible approaches to address the marriage penalty problem. However, each of these provisions needs to be thoroughly analyzed in order to provide the economic, tax, and social benefits that Congress determines is appropriate. Further, to eliminate marriage penalties and improve simplification, standard phase-outs (with joint ranges being twice the single and married filing separate ranges) for three income levels—low, middle, and high-income taxpayers (rather than the 20 current levels)—and one standard phase-out method should be adopted.

Contribution to Simplification

By eliminating or reducing the marriage penalty and marriage bonus, the tax system would become "marriage neutral." Tax complexities arising out of marriage and divorce would be reduced and the tax system would be made more rational and equitable.

SIMPLIFICATION OF EMPLOYEE VS. INDEPENDENT CONTRACTOR

Present Law

The rules relating to classification of a worker as an employee or independent contractor are unclear. This results in needless confusion and potentially large tax assessments for businesses that are attempting to comply with the law.

Recommended Changes

A bill (S. 344 Independent Contractor Simplification and Relief Act of 1999) simplifying the classification of workers was introduced in the Senate on February 9, 1999 by Senator Christopher Bond (R–MO). This bill establishes a safe harbor for businesses classifying workers as independent contractors when either of the following two criteria are met:

- A worker demonstrates economic and workplace independence meeting a set of stipulated criteria, and a written agreement exists between the parties; or
- A worker conducts business through a corporation or limited liability company, the worker does not receive benefits from the service recipient, and a written agreement exists between the parties.

At this time the AICPA is examining other proposed legislation in this area. It is our hope that the proper elements can be pulled together so that worker classification simplification can be accomplished through an approach that provides certainty, while balancing the needs of service recipients and the rights of service providers.

Contribution to Simplification

Until taxpayers are provided with clear-cut rules by Congress, this area will continue to provide many uncertainties for small business owners, as well as a continu-

ation of the many battles between taxpayers and the Internal Revenue Service. This issue is a top priority of many small business organizations, including the 1995 White House Conference on Small Business and the U.S. Chamber of Commerce. Even the Treasury Department has testified that the 20-factor test, historically used by the Internal Revenue Service to classify workers, is confusing and does not yield "clear, consistent, or even satisfactory answers, and reasonable persons may differ as to the correct classification."

SIMPLIFICATION OF THE KIDDIE TAX

Present Law

The 1986 Tax Reform Act introduced the so-called "kiddie tax" which taxes the net unearned income of children under the age of 14 at the parents' tax rate. While at first this seems to be straight-forward approach, it has evolved into a very complicated calculation. When first enacted in 1986, there was not a preferential tax rate for capital gains. The introduction of the maximum 28% (now 20%) capital gain rate has further complicated the situation. Under certain limited circumstances, parents can elect to include their children's income on their return. However, the election in not available for parents of a child with any earned income, unearned income in excess of $5,000, capital gains, withholding or estimated tax payments.

Instructions for utilization of Form 8615, "Tax for Children Under Age 14 Having Investment Income of More Than $1,200," cannot be contained on the reverse of the form. Instead, the IRS has issued Publication 929, a 20-page booklet which provides the "hidden worksheets" that allow the taxpayer, or the return preparer, to calculate the child's taxable income, as well as the tax. In situations in which there are multiple siblings falling within this provision, the complexity expands. Similarly, if a child is subject to the AMT, additional calculations are required. In the overwhelming majority of situations, the additional tax revenue generated by the "kiddie tax" appears to be insignificant when compared to the complexity of the calculations. Also, the kiddie tax provision only considers the regular tax of section 1 and not the AMT of section 55. Therefore, the way the current rules are written, if a parent must pay AMT, the children's income is still taxed at the parent's regular marginal tax rate, while the parent is taxed at the AMT rate without taking into account the child's income or the child's regular tax liability. This results in taxpayers paying more tax than if the parent and children's income are both included in the parent's AMT calculation.

Recommended Changes

The linkage of a child's taxable income to parents' and other siblings' taxable income should be repealed. Income (other than capital gains) subject to kiddie tax should be taxed at a separate rate schedule (e.g., fiduciary income tax rates). The child's capital gains should be taxed at the capital gains rates. The election to include a child's income on the parent's return should be expanded to allow all income, regardless of its nature or amount, to be included. The election could apply whether or not the child has withholding or estimated payments. There could be a check-off, similar to the current nominee interest check-off, or column added to the Form 1040 Schedules B and D so as to indicate whether the item applies to another social security number, to avoid any matching problems.

Contribution to Simplification

The suggested change would allow children's returns to stand on their own. Issues regarding missing information on one return, matrimonial issues, and unintended AMT problems would be eliminated. The perceived loophole of shifting income to minors would remain closed since fiduciary income moves to higher tax brackets at significantly lower income levels than individuals.

Allowing across-the-board inclusion of a child's income on a parent's return could eliminate many children's returns and their associated compliance burdens for taxpayers and the government.

SIMPLIFICATION OF THE INDIVIDUAL ESTIMATED TAX SAFE HARBOR

Present Law

Individuals with adjusted gross incomes of $150,000 or less may base their current year estimated taxes on 100 percent of their prior year tax. As changed by TRA 97, individuals with adjusted gross incomes in excess of $150,000 may base their current year estimated taxes on a percentage of their taxes for the prior year as follows:

Current Estimated Tax Year	Percentage of Prior Year Tax
1998	100
1999	105
2000	106
2001	106
2002	112
2003 and thereafter	110

Recommended Changes

The percentage of prior year tax should be 100 percent for all years.

Contribution to Simplification

In general, the estimated tax rules are complex. Prior to TRA 97, the provisions for basing individual estimated taxes on their prior year taxes were straight-forward and simple. To change to different percentages for different years results in poor tax policy, and adds needless complexity. By basing all estimates on the same percentage for all years, such as 100 percent of the prior year tax, the complex calculations that are made quarterly by taxpayers are reduced and simplicity and year-by-year consistency is added to the Code.

SIMPLIFICATION OF CHILD CREDITS

Present Law

Effective for years beginning in 1998, taxpayers can claim a $400 ($500 in 1999 and later) credit for each qualifying child. The credit is phased out by $50 for each $1,000 of adjusted gross income over a threshold amount. The threshold amounts are $110,000 for married persons filing jointly, $55,000 for married taxpayers filing separately and $75,000 for single taxpayers.

The basic child credit is a non-refundable credit that is limited to the excess of regular tax liability over alternative minimum tax liability. (A special provision treats alternative minimum tax as equal to zero for 1998 only.) However, to the extent that the child credit is disallowed because of other refundable credits, a portion of the credit is converted into a supplemental refundable credit. Further, an additional refundable credit for taxpayers with three or more children is allowed.

Recommended Changes

We recognize that there is no one solution that will both continue to target the credit to its intended beneficiaries and limit the cost associated with its benefits. However, we recommend the following legislative changes.

1. Replace the three-tier child credit system (basic, supplemental and additional) with one universal, refundable credit.
2. Consider increasing the credit amount and eliminating the exemption amount for children eligible for the credit.
3. Change the phase out levels to correspond to one of the three levels included in the AICPA Phase out Simplification proposal.
4. Make permanent the provision that allows the credit against both regular and alternative minimum tax.

Contribution to Simplification

The purpose of the child credit is to allow a reduction in tax liability in excess of that provided by the existing exemption deduction amount. The use of an additional credit amount rather than a combined credit and exemption mechanism would allow additional use of credits to be provided to low income taxpayers without the significant revenue drain associated with providing benefits to high income taxpayers.

Combining the three-tier credit into one refundable credit would eliminate confusing computations for taxpayers with low income. The current system either fosters a system prone to errors or forces taxpayers with otherwise simple returns to seek professional advice whose cost would offset a portion of the benefit of the credit.

Simplification of the Generation Skipping Transfer Tax

PRESENT LAW

In 1986, Congress enacted the generation skipping transfer tax (GST tax), which is imposed on transfers to beneficiaries more than one generation below the transferor's generation at the maximum gift and estate tax rate (55%). To determine the rate applicable to a particular transfer, the 55% rate is multiplied by the inclusion ratio (a fraction based on the GST exemption amount allocated to the transfer). A trust with a zero inclusion ratio is exempt from GST tax. Every individual is allowed a $1 million GST exemption (indexed for inflation), that may be allocated to any property subject to estate or gift tax. Married couples may treat transfers as made one-half by each spouse, in effect giving them a combined $2 million GST tax exemption. While direct transfers to grandchildren qualify for an automatic allocation of the GST exemption, transfers to a trust do not. If a GST exemption is allocated to a lifetime transfer to a trust on a timely filed gift tax return, the portion of the trust protected is generally based on the property's value at the time of the transfer. However, if the allocation is not made on a timely filed gift tax return, the portion of the trust protected is based on the value at the time of allocation. The planning necessitated by the GST tax exemption rules is very complex and fraught with traps for taxpayers and their advisors.

Recommended Changes

We propose the following legislative changes:

1. Extend the automatic GST exemption allocation rule (that currently applies to direct skips) to transfers in trust where skips are generally expected. Those taxpayers that do not want the automatic allocation to apply could elect out.
2. Provide relief for GST tax exemption allocations for those taxpayers who do not make an election because of an inadvertent failure to timely file an appropriate return and for those who demonstrate intent to have a zero inclusion ratio for a trust (substantial compliance).
3. Provide a trust severance rule.
4. Allow retroactive allocations of GST exemption when there is an unnatural order of death.

Contribution to Simplification

The following examples demonstrate some of the common problems faced by taxpayers as a result of the current GST tax rules:

1. P, a parent, transfers $10,000 a year for 10 years to a discretionary trust for a child, C, and such descendants of C, which will terminate and distribute to C when C reaches age 35. If C dies before attaining age 35, the trust is distributable to the descendants of C. If C dies before age 35 with issue when the trust assets are worth $100,000, a taxable termination occurs. Unless P allocates a GST tax exemption before C dies, the GST tax would be $55,000.
2. P transfers $1 million of stock to a trust to pay income to C for life, remainder to P's grandchild, G. If the full $1 million GST exemption is allocated to this transfer on a timely filed gift tax return, and the stock's value is $5 million at the time the property passes to G, no GST tax results. However, if the GST tax exemption is not allocated until the property has grown to $5 million, a $2.2 million GST tax would result if the property that passes is still worth $5 million when it passes to G.
3. P transfers $1 million to a trust to pay income to C until C's 35th birthday, at which time the trust property will be paid to C. If C dies before his 35th birthday, the trust property is paid to C's children. If C dies before attaining age 35 at a time when the trust property is worth $5 million, and there was no GST tax exemption allocation before C's death, there would be no opportunity to allocate such exemption and a $2.75 million GST tax would be imposed.
4. P transfers $5 million to a trust for the benefit of his five children. If one child dies, current regulations do not allow the trust to be severed so that a GST tax exemption can be allocated to the one-fifth of the trust that will primarily benefit the deceased child's children. (If five separate trusts had been created instead of one, this problem could have been avoided).

Simplification would be achieved by making automatic an allocation of GST tax exemption to those taxpayers likely to benefit, rather than requiring taxpayers to elect such an allocation. The planning necessary to take advantage of the GST tax exemption allowed by law is overly complex and often leads to errors by taxpayers. These simplification proposals would allow some relief to taxpayers that fail to make timely allocations and allow retroactive allocation in situations involving an unnatu-

ral order of death. In addition, the trust severance rule would simplify the drafting of trusts and minimize the need for creating multiple trusts simply for GST tax planning purposes.

Simplification of Half Year Requirements

PRESENT LAW

The Internal Revenue Code uses &;-year age requirements to allow individual taxpayers to begin to withdraw from their pension plans without penalty. (Example, distribution must be made after the taxpayer reaches age 59 &; to avoid penalty).

RECOMMENDED CHANGE

Change the Internal Revenue Code by eliminating the various IRC Sections that use &; year requirements: A) Age 70 &; for mandatory IRA distributions and B) Age 59 &; for penalty free retirement plan withdrawals. Instead, use whole years: Age 70 and Age 59.

CONTRIBUTION TO SIMPLIFICATION

Many taxpayers, employers and banks are confused when calculating this part of the requirement. It would be easier to remember, calculate and administer, and be more user-friendly if the ages were changed.

EXHIBIT A—SELECTED AGI PHASE-OUT AMOUNTS

IRC Section	Provision	Ft Nt.	Current Joint	Current Single & HOH	Current Married/Sep	Proposed Joint	Proposed Single & HOH & MFS
		PHASE-OUT LEVELS FOR LOW-INCOME TAXPAYERS					
21	30 Percent Dependent Care Credit	(3)	$10,000–$20,000	$10,000–$20,000	No credit	$15,000–$37,500	$7,500–$18,750
22	Elderly Credit	(4)	$10,000–$25,000	$7,500–$17,500 $5,000–$12,500 $15,000– $37,500$7,500– $18,750			
32	EITC (No Child)	(2,3,4)	$5,570–$10,030	10,030	No credit	$15,000–$37,500	$7,500–$18,750
32	EITC (1 Child)	(2,3,4)	$12,260–$26,473	$12,260–$26,473	No credit	$15,000–$37,500	$7,500–$18,750
32	EITC (2 or More Children)	(2,3,4)	$12,260–$30,095	$12,260–$30,095	No credit	$15,000–$37,500	$7,500–$18,750
		PHASE-OUT LEVELS FOR MIDDLE-INCOME TAXPAYERS					
219	IRA Deduction w/retirement plan	(1,7,9)	$50,000–$60,000	$30,000–$40,000	No deduction	$60,000–$75,000	$30,000–$37,500
221	Education Loan Interest Exp.	(1,2,6)	$60,000–$75,000	$40,000–$55,000	No deduction	$60,000–$75,000	$30,000–$37,500
		PHASE-OUT LEVELS FOR HIGH-INCOME TAXPAYERS					
24	Child Credit	(1,5,6)	$110,000–	$75,000–	$55,000–	$225,000– $450,000	$112,500– $225,000
25A	Hope Credit & Lifetm. Lrng. Cr.	(1,2,6)	$80,000–$100,000	$40,000–$50,000	No credit	$225,000– $450,000	$112,500– $225,000
23 & 137	Adoption Credit/Exclusion	(1,7)	$75,000–$115,000	$75,000–$115,000	No benefit	$225,000– $450,000	$112,500– $225,000
55(d)	AMT Exemption	(1,8)	$150,000– $330,000	$112,500– $247,500	$75,000–$165,000	$225,000– $450,000	$112,500– $225,000
68	Itemized Deduction level	(2)	$124,500–	$124,500–	$62,250–	$225,000– $450,000	$112,500– $225,000
135	EE Bond int. Exclusion	(1,2,7)	$78,350– $108,350–	$52,250–$67,250	No exclusion	$225,000– $450,000	$112,500– $225,000
151	Personal Exemption	(2)	$186,800– $309,300	$124,500– $247,000 HOH$155,650– $278,150	$93,400–$154,650	$225,000– $450,000	$112,500– $225,000
219–(g)(7)	IRAw/spouse w/retrmt.plan	(1,6,7)	$150,000– $160,000	Not applicable	No deduction	$225,000– $450,000	$112,500– $225,000

408A	Roth IRA Deduction	(1,6)	$150,000–$160,000	$95,000–$110,000	No deduction	$225,000–$450,000	$112,500–$225,000
408A	IRA to Roth IRA Rollover	(1,6,7)	$100,000	$100,000	No rollover	$225,000–$450,000	$112,500–$225,000
469 (i)	$25,000 Rent Passive Loss	(1,7)	$100,000–$150,000	$100,000–$150,000	$50,000–$75,000	$225,000–$450,000	$112,500–$225,000
469 (i)	Passive Rehab. Credit	(1,7)	$200,000–$250,000	$200,000–$250,000	$100,000–$125,000	$225,000–$450,000	$112,500–$225,000
530	Education IRA Deduction	(1,6)	$150,000–$160,000	$95,000–$110,000	No deduction	$225,000–$450,000	$112,500–$225,000

[1] Modifications to AGI apply; (2) Inflation indexed; (3) Earned income limitations; (4) Low income only; (5) Phase-out range depends on number of children; (6) Newly enacted in 1997; (7) Also see section 221(b)(2); (8) Phase-out applies to alternative minimum taxable income rather than AGI; (9) Increases for future years are specifically provided in the statute.

EXHIBIT B—CURRENT METHOD OF PHASE-OUT

Code Section(s)	Tax Provision	Current Methodology for Phase-outs Application
21	Dependent Care Credit	Credit percent reduced from 30 percent to 20 percent in AGI range noted by 1 percent credit for each $2,000 in income
22	Elderly Credit	Credit amount reduced by excess over AGI range
23 & 137	Adoption Credit & Exclusion	Benefit reduced by excess of modified AGI over lowest amount noted divided by 40,000
24	Child Credit	Credit reduced by $50 for each $1,000 in modified AGI over lowest amount divided by 10,000 (single) and 20,000 (joint)
25A	Education Credits (Hope/Lifetime Learning).	Credits reduced by excess of modified AGI over lowest amount divided by 10,000 (single) and 20,000 (joint)
32	Earned Income Credit	Credit determined by earned income and AGI levels
55	AMT Exemption	Exemption reduced by 1/4 of AGI in excess of lowest amount noted
68	Itemized Deductions	Itemized deductions reduced by 3 percent of excess AGI over amount noted
135	Series EE Bonds	Excess of modified AGI over lowest amount divided by 15,000 (single), 30,000 (joint) reduces excludable amount
151	Personal Exemption	AGI in excess of lowest amount, Exemption divided by 2,500, rounded to nearest whole number, multiplied by 2, equals the percentage reduction in the exemption amounts
219	Traditional IRA w/Retiremt. Plan	Individual retirement account (IRA) IRA limitation ($2,000/$4,000) reduced by excess of AGI over lowest amount noted divided by $10,000
219(g)(7)	IRA w/Spouse w/Retiremt. Plan	Deduction for not active spouse reduced by excess of modified AGI over lowest amount noted divided by 10,000
221	Education Loan Interest Expense Deduction.	Deduction reduced by excess of modified AGI over lowest amount noted divided by 15,000
408A	Roth IRA	Contribution reduced by excess of modified AGI over lowest amount noted divided by 15,000 (single) and 10,000 (joint)
408A	IRA Rollover-Roth IRA	Rollover not permitted if AGI exceeds 100,000 or if MFS
469(i)	Passive Loss Rental $25,000 Rule.	Benefit reduced by 50 percent of AGI over lowest amount noted
530	Education IRA Deduction	Contribution reduced by excess of modified AGI over lowest amount noted divided by 15,000 (single) and 10,000 (joint)

Chairman HOUGHTON. Thank you very much, Mr. Lifson.
Mr. Gutman.

STATEMENT OF HARRY L. GUTMAN, PARTNER, KPMG LLP

Mr. GUTMAN. Thank you, Mr. Chairman. It is a pleasure to be sitting as a witness, I must say, as compared to other capacities I have been here. I appreciate the opportunity to appear before you and ask that my statement be included in the record. Before I get to the substance of my remarks, I want to commend you and Mr. Coyne and Mr. Neal for doing something tangible in the simplification area. Too often, we have simply heard words from those who have the responsibility to enact and administer the tax laws and you have taken some action and put some concrete proposals on the table and I think you need to be commended for that. This process, as has been said before, has to start somewhere.

I wish I had some good advice for Mr. Neal about how to jump start the process. That is extremely difficult. Revenue-neutrality is a key component. He has achieved that with his bill. And while a bill could get out of this committee and pass the House, unfortunately, as we know, the risk is not here, but rather on the other side of the Capitol. And, unfortunately, I think, as a practical mat-

ter, until one gets satisfied by what might happen to a tax bill when it goes over to the Senate, a free-standing bill is a problem. So I appreciate the difficulty, but urge you to continue to try to move forward with this legislation in a free-standing or whatever other capacity you are able to get it out of the committee and onto the floor.

Tax complexity causes serious systemic costs. Focusing on the taxpayer side of the equation, the most obvious is the cost of compliance. But complexity also affects planning and certainty. If complex rules are viewed as unfair or unnecessary, respect for the system is undermined. And the story doesn't end with taxpayers, complex rules also affect the administration of the tax system, requiring more guidance, training, and enforcement.

Understanding that inordinate complexity imposes unacceptable costs on the system and those who are affected by it does not, however, provide us with solutions. We are tempted to say, make the system simple and all our problems will disappear. But that is not really the case.

Tax simplification is considerably more subtle and tricky because it means a lot of different things to a lot of different people. For example, to some, simplification means a system that is easy to understand. To others, it is a system that requires little record keeping. To still others, it is a system that allows for ease of computation and return preparation. And, finally, to others, simplification means a system that is easy to administer. In truth, it is all of those things. But it is important to recognize that achieving simplification objectives involves real tradeoffs and that simplification cannot occur in a vacuum. Simplification needs to take place within the context of creating a tax system that is, and is perceived as, equitable, neutral, and administrable.

Complexity comes in many different forms and we must recognize that complex rules are often necessary to deal with complex transactions undertaken by sophisticated taxpayers. That complexity is not what we are talking about today. There are many other forms and sources of complexity that need not and should not be tolerated and those provisions are the subject of the bills that are under consideration today.

In addressing the problem, we need to recognize that complexity often occurs because of the desire to use the Tax Code to achieve social or political goals rather than simply collect revenue on an equitable and neutral basis. The history of the Tax Code is replete with efforts to use the code to achieve particular objectives and they are the principal sources, I believe, of the complexity that was identified in a Joint Committee print prepared for a similar hearing in the Finance Committee.

Another source of complexity is congressional attempts to tailor provisions to benefit specific taxpayers. The complexity of the law is also increased when Congress, for political expediency, disguises the substance of its legislative changes. Personal exemption and itemized deduction phaseouts, commonly known as PEP and Pease are prime examples of this. Mr. Neal's bill would repeal these provisions and substitute explicit rate increases. That is to be commended.

Turning to the bills that are under consideration today, I would like to review very briefly the provisions of H.R. 1407 and H.R. 1420. Title I of H.R. 1420, which is Mr. Neal's bill, and Chairman Houghton's proposed legislation would permanently waive the minimum tax limitations on nonrefundable credits and Mr. Neal's bill would also create a single phaseout range for the adoption credit, the family credit, and the education credits. These are sensible provisions and they should be enacted.

Title II of the bill, which is Mr. Coyne's provision as well as Mr. Neal's, would replace the present melange of capital gains provisions with a 38-percent deduction and would treat gain or loss from the sale of a collectible as short-term gain. Mr. Houghton's legislation would provide a 50-percent deduction. Both of these would be simplifying provisions. The question of the appropriate exclusion amount is a political issue, but the question of how to compute the tax is not and these would both be very favorably received.

Title III of Mr. Neal's bill would repeal PEP and Pease and that makes perfect sense. The provision repealing the individual minimum tax isn't quite as simple. It is clear that more taxpayers than ever anticipated will shortly become subject to the tax unless something is done. Moreover, many taxpayers who are not ultimately subject to the tax must make calculations to determine whether the tax applies to them. These facts argue for some adjustment. Mr. Neal would repeal the tax. Chairman Houghton would increase the alternative minimum tax exemption.

As currently structured, the minimum tax does not achieve the objectives for which it was originally designed. The passive loss rules have largely eliminated the real and perceived sheltering and fairness issues that previously existed. The current minimum tax base does not correspond in any meaningful way to economic income. Indeed, it is questionable whether a number of the preferences are conceptually correct. And, finally, it is shortly going to affect too many taxpayers. Chairman Houghton's solution limits the damage. Mr. Neal eliminates the problem. Unless the minimum tax base is expanded to measure economic income, I prefer Mr. Neal's solution. No taxpayer should have to bother with the minimum tax in its current form.

I am pleased to have had the opportunity to share some ideas with you. And I will be happy to answer any questions. Thank you.

[The prepared statement follows:]

Statement of Harry L. Gutman, Partner, KPMG LLP

Mr. Chairman and Members of the Subcommittee: I am honored to appear before the Subcommittee today as an invited witness to discuss tax simplification for individuals and small businesses, in general, and the Tax Simplification and Burden Reduction Act that is to be introduced by Chairman Houghton, H.R. 1407 introduced by Mr. Coyne, and H.R. 1420 introduced by Mr. Neal, in particular. This statement is made in my individual capacity and expresses my personal views. Nothing in this statement should be attributed to KPMG or to any of its clients.

TAX COMPLEXITY AND SIMPLIFICATION

Inordinate tax complexity creates serious systemic costs. Focusing on the taxpayer side of the equation, the most obvious is the cost of compliance. Complex rules and requirements mean that affected taxpayers need to take more time to understand, prepare, and substantiate tax returns. Complexity also affects planning and certainty. Time is required to master the rules so that the consequences of anticipated acts or transactions can be evaluated. If complex rules are also viewed as unfair or

unnecessary, respect for the system is undermined. But the story does not end with taxpayers. Complex rules also affect the administration of the tax system, requiring more guidance, training, and enforcement.

Understanding that inordinate complexity imposes unacceptable costs on the system (and those affected by it) does not, however, provide us with solutions. We are tempted to say, "Make the system simple and all our problems will disappear." That, however, is not the case. Tax simplification is a considerably more subtle and tricky topic because it means different things to different people. For example, to some, simplification means a tax system that is simple to understand. To others, it means a system that requires little record keeping. To still others, it means a system that allows for ease of computation and return preparation. Finally, to others, tax simplification means a tax system that is easy to administer. In truth, it is all of these things—and more.

It is important to recognize that achieving simplification objectives involves real trade-offs and that simplification cannot occur in a vacuum. Simplification needs to take place within the context of creating a tax system that is, and is perceived as, equitable, neutral, and administerable. An equitable tax system treats all similarly situated taxpayers the same. A neutral tax system is one that does not affect economic decisions. A tax system is administerable if the costs of administering the law and collecting revenue are comparatively low. Arguably, our tax system is none of the above.

SOURCES OF CURRENT TAX LAW COMPLEXITY

Complexity comes in many different forms. Complex rules are often necessary to deal with complex transactions undertaken by sophisticated taxpayers. They are not the provisions under consideration today. But there are many other forms and sources of complexity that need not—and should not—be tolerated, and many of those are addressed by the bills under consideration today.

In large measure, the complexity we are addressing today is the result of using the tax code to achieve social or political goals rather than simply to collect revenue on an equitable and neutral basis. The principal sources of complexity in our tax system—described by the Joint Committee on Taxation[1] as elections provided to taxpayers, definitional issues that taxpayers must consider, record-keeping and reporting requirements, limitations on the availability of tax benefits, and frequent changes in the tax laws—are often the consequences of congressional attempts to tailor tax provisions to benefit specific taxpayers.

The complexity of the tax laws is also increased when Congress, for political expediency, disguises the substance of its legislative changes. The personal exemption and itemized deduction phase-outs—commonly known as "PEP and Pease"—are prime examples. Rather than providing explicitly for a marginal rate increase when these provisions were added in 1990, Congress hid the real nature of these provisions as rate increases by calling them "phase-outs." Mr. Neal's bill would repeal these complex provisions and substitute explicit rate increases.

SIMPLICITY TRADE-OFFS

Attempts to achieve tax simplification require trade-offs. Simple rules often create inequalities because in real life, there are many disparate situations that cannot be dealt with by applying simple rules. Attempts to tailor tax rules to address disparate situations generally give rise to greater complexity in the system. Thus, ironically, complex rules generally promote greater equality in a tax system. The original issue discount rules as applied to zero coupon bonds held by individuals are a case in point.

The proposal to make all mortgage points paid in connection with a refinancing currently deductible is designed to add simplicity to the tax code, but it will result in trade-offs. Current deductibility of refinancing points would not reflect economic reality and would create abuse potential that should be addressed statutorily, thus complicating the proposed simple rules. If mortgage points are paid in connection with a 10-year refinancing loan, why does it make sense for the points to be deducted in the first year of the loan, rather than being allocated to and deducted over the course of the 10-year period? Would a simple rule of deductibility encourage refinancing, rather than allowing taxpayers to make refinancing decisions based on their personal economics? What would stop taxpayers from front-loading interest or points to obtain an accelerated interest deduction? Is it not a more sound ap-

[1] JCX–18–99, Overview of Present Law and Issues Relating to Individual Income Taxes, April 14, 1999.

proach—an approach in line with economic realities—to apply the costs of the refinancing over the life of the loan?

TWO AREAS WHERE SIMPLIFICATION IS NECESSARY

The array of education assistance programs now available in the tax code, from Lifetime Learning credits, to HOPE credits, to Education IRAs, to prepaid tuition plans and student loan interest deductions, are hopelessly intertwined, complex, difficult to understand, and difficult to compute—even for a person who has taken advantage of any of these programs to attain a good education. No rational individual could have concocted this scheme. Rather, it is the result of the political process. The program should be rationalized.

Another prime example of tax law complexity is the earned income tax credit (EITC). The EITC is, of course, a government subsidy programs for low-income taxpayers who are gainfully employed. The goal of the EITC is laudable; however, the complexity of the provisions is regrettable. Simplification is plainly necessary to reduce the burden on taxpayers least able to afford the compliance costs.

Recent testimony before the Senate Finance Committee by representatives of the American Bar Association and the American Institute of Certified Public Accountants, among others, described many other instances of tax complexity. These statements, and the bills under consideration today, suggest that the road to tax simplification is an incremental one. I agree. It is unreasonable to expect a complete revision of the Internal Revenue Code—to achieve simplification or otherwise. Consequently, simplification efforts should be devoted to identifying major areas of complexity for a large number of taxpayers and simplifying those provisions. I cited two examples above. The bills under consideration today identify a number of others. Accordingly, I now turn to the bills before the Subcommittee.

H.R. 1407 AND H.R. 1420

The basic substance of H.R. 1407 is included in Title II of H.R. 1420. Therefore, I will discuss the bills together.

Title I—Simplification Relating to Nonrefundable Personal Credits

Title I of H.R. 1420, and Chairman Houghton's proposed legislation, would permanently waive the minimum tax limitations on nonrefundable credits. H.R. 1420 would also create a single phase-out range for the adoption credit, the family credit, and the education credits. Both are sensible provisions and should be enacted.

Title II—Simplification of Capital Gains Tax

Title II would replace the present melange of capital gain provisions with a 38 percent deduction and would treat gain or loss from the sale of a collectible as short term. Chairman Houghton's legislation would provide a 50-percent deduction. The question of the amount of the preference to be accorded capital gain income is a political issue. The structure of the preference is not. The complexity of the current provisions reflects a number of political accommodations. They make little policy sense when originally adopted, and they make less sense today. The bills restore simplicity to the calculation of capital gain income, even if they fail to address the question of why the preference is required at all.

Title III—Repeal of Certain Hidden Marginal Rate Increases; Repeal of Individual Minimum Tax

As noted above, Title III of the bill would repeal PEP and Pease and replace them with a straightforward rate increase. I strongly support these changes, both from a simplicity and "truth in advertising" perspective. I am not as comfortable with the provision that increases the floor on itemized deductions for higher income taxpayers. I never understood the policy justification for the floor in the first place.

The provision repealing the individual minimum tax is not quite as simple. It is clear that more taxpayers than ever anticipated will shortly become subject to the minimum tax unless something is done. Moreover, many taxpayers who are not ultimately subject to the tax must make the calculations to determine whether the tax applies to them. These facts argue for some adjustment. Mr. Neal would repeal the tax. Chairman Houghton would increase the alternative minimum tax exemption.

What to do about the minimum tax depends in large measure on one's view of why the tax exists in the first place. Almost 15 years ago, in 1985, I testified about this very issue before the Senate Finance Committee. The discussion at that time focused on the fact that high-income taxpayers were able to use tax preferences to reduce substantially, or even eliminate, their income tax liabilities. At the 1985 hearing, I noted there were three reasons why a minimum tax should be enacted.

The first was revenue. In my testimony, I stated that while a need for revenue could lead to a search for an alternative source of tax receipts, this alone was not a compelling reason to adopt a minimum tax. Moreover, even with revenue as the principal justification for the tax, the structure of the tax was not provided.

The second reason for a minimum tax dealt with perceptions of fairness. Because of the existence of tax preference items, different taxpayers with similar economic income were allowed to pay different amounts of tax. The use of tax preference items by some taxpayers to minimize their tax liabilities fostered public resentment, and this resentment had two notable consequences: a loss of respect for the tax system; and pressure on the political process to do "something" about the problem. As I said at the time, while it was not perfectly clear what the "something" was, it appeared to be that steps should be taken to ensure that all taxpayers pay some tax.

The third reason for invoking a minimum tax was to broaden the income tax base. If broadening the tax base was the ultimate goal, a minimum tax was the appropriate vehicle. The tax base should approximate economic income.

I also noted that a minimum tax designed solely to assure that all taxpayers paid some tax created what I referred to as tax system "schizophrenia." On the one hand, a minimum tax had the effect of reducing the after-tax value of the preferences that are a part of the minimum tax base. On the other hand, the congressional objective that prompted the enactment of the preference in the first place would be undermined. I asked why the value of the preference should be reduced when a taxpayer did precisely what Congress intended.

Now, some 15 years later, we return to visit some of the same issues. As currently structured, the minimum tax does not achieve the objectives for which it was originally designed. The passive loss rules have largely eliminated the real and perceived sheltering and fairness issues I addressed in 1985. The current minimum tax base does not correspond in any meaningful way to economic income. Indeed, it is questionable whether a number of the preference items are conceptually correct. Finally, it will shortly affect too many taxpayers.

Chairman Houghton's solution limits the damage. Mr. Neal eliminates the problem. Unless the minimum tax base is expanded to measure economic income, I prefer Mr. Neal's solution. No taxpayer should have to bother with the minimum tax in its current form.

TAX SIMPLIFICATION AND BURDEN REDUCTION ACT

I have discussed a number of the provisions in Chairman Houghton's proposed legislation earlier in this statement. In the absence of legislative language, it is difficult to comment more than generally on the other proposals. However, I think it makes good sense to simplify the estimated tax safe harbors and to treat the postmark date as the filing date for all returns. Further Subchapter'S simplification is appealing, but the details are critical. The same is true with respect to reducing record-keeping requirements.

CONCLUSION

I am pleased to have had the opportunity to share my views on tax simplification with you. I am prepared to answer any questions you may have.

Chairman HOUGHTON. Thank you, Mr. Gutman.

Mr. Harkins.

STATEMENT OF GERRY HARKINS, OWNER AND GENERAL MANAGER, SOUTHERN PAN SERVICES COMPANY, CONLEY, GEORGIA, ON BEHALF OF NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. HARKINS. Thank you, Mr. Chairman, Committee Members. I am here to speak on behalf of the National Federation of Independent Business and its 600,000 small business owner members.

I am the owner and operator of Southern Pan Services Company in Conley, Georgia. Southern Pan Services was started in 1987. It is a construction subcontractor specializing in concrete form work.

We employ approximately 400 workers in the Southeast. I have been an adviser to the Internal Revenue Service for 9 years as chairman of the Commissioner's Advisory Group, and as a member of the District Director's Liaison Committee and as a member of the National Commission on Restructuring the Internal Revenue Service, of which Mr. Coyne served ably. I spent a year investigating the Internal Revenue Service.

I am here today to talk about several things and I would like to ask that my statement be entered into the record. First, tax simplification. Small business owners might best be described as the poster child for tax complexity victims. We could be compared to the slowest buffalo in the herd and the IRS as the lion. And, as tough as the IRS code is on everybody else, it is doubly tough on America's small businessmen and women. It has been estimated that tax-related paperwork costs are twice as high for small business, compared to large business.

About the chairman's bill, Chairman Houghton's bill, the NFIB has advocated a long list of items that would simplify the Tax Code for small businesses. I am pleased to say that many of these items are contained in the Tax Simplification and Burden Reduction Act proposed by Chairman Houghton. These provisions include: alternative minimum tax relief, expanded expensing opportunities, and pension simplification. Other legislation to be introduced by Congressman Talent also contains many of these provisions as does legislation introduced by Congressman Neal.

The chairman's proposals regarding AMT are targeted specifically at small businesses and represent a significant relief from the AMT. On behalf of small business, I would like to thank the chairman for including this provision in his bill. While the NFIB obviously would prefer the outright elimination of the AMT, which is the Neal approach, the Houghton bill would address the worst aspects of the tax.

Another pet peeve of small business and all property owners is the elimination of the death tax. One provision not addressed by the chairman's bill that would provide significant relief to small businesses is repeal of the death tax. For a family business like mine, the death tax is a storm on the horizon. It threatens everything I have accomplished over the past 19 years.

Death tax supporters argue that the tax only affects a small percentage of estates, but the costs are much deeper than that. I recently completed a series of lengthy meetings with my attorney and CPA to determine how my estate would be affected by my death. To my horror, I found out that my heirs would have to liquidate my business under duress to pay the estate taxes due upon my death. There is no way to avoid this tax upon a successful business. In my company's case, we would endanger the livelihood of all our employees and suppliers. The negative economic impact goes far beyond the business owner's heirs.

The death tax may provide government revenue in the short-run but, in the long-run, costs far outweigh the gains. Studies by the Joint Economic Committee and the Institute for Policy Innovation show the death tax actually costs the Federal Government in the long-run. NFIB supports eliminating the death tax. Two bills have been introduced in the House that we support. H.R. 8, introduced

by Representatives Dunn and Tanner and H.R. 86, introduced by Representative Cox.

Another area ripe for simplification is the Federal Unemployment Tax or FUTA. For small businesses, FUTA presents two problems. First, the rate is too high. Second, employers are required to pay two unemployment taxes, the Federal tax and the State tax. That means twice the collection points, twice the payments, and twice the complexity. NFIB supports reforming the nation's unemployment system, including cutting the rate and having just one point of collection. Once again, I am pleased to see that the chairman and other Members of the Committee have supported such reforms in the past. This week, Congressman McInnis plans to introduce legislation to eliminate the FUTA surtax, which is .2 percent or one-fourth of the tax and I hope the Committee will support his efforts.

Another area is the clarification of the definition of independent contractor. I understand the chairman has joined others in introducing legislation to address the independent contractor issue. We applaud the chairman for seeking to create objective standards to define who is and who is not an independent contractor. At the same time, I understand the chairman is aware that the NFIB has serious concerns about the direction this legislation takes. That said, something needs to be done to create a bright line between employee and an independent contractor. The current 20 common law factor test has handcuffed small business for too long. We need an objective standard that is simple and easily understood.

Mr. Chairman, Committee Members, I thank you for your attention and for inviting me to be here today. I will answer any questions.

[The prepared statement follows:]

Statement of Gerry Harkins, Owner and General Manager, Southern Pan Services Company, Conley, Georgia, on Behalf of National Federation of Independent Business

Good afternoon. On behalf of the 600,000 members of the National Federation of Independent Business (NFIB), I appreciate the opportunity to present the views of small business owners on the subject of tax simplification.

My name is Gerry Harkins. I am an owner and operator of Southern Pan Services Company of Conley, Georgia. Southern Pan Services was started in 1987 and is a construction subcontractor specializing in concrete formwork. We employ approximately 400 workers in the Southeast.

I have been an advisor to the IRS for 9 years as Chairman of the Commissioner's Advisory Group and a member of the District Director's Liaison Committee. As a member of the Commission on Restructuring the IRS, I spent a year investigating the Internal Revenue Service.

TAX SIMPLIFICATION

Small business owners might best be described as the poster child of tax complexity victims. As tough as the IRS Code is on everyone else, it is doubly tough on America's small businessmen and women. It has been estimated that the tax-related paperwork costs are twice as high for a small business compared to a large business.

While economists differ as to the actual cost of compliance, Professor Joel Slemrod, in testimony before the IRS Restructuring Commission, very conservatively estimated the cost to the taxpayers of complying with the current tax code is $75 billion annually. Other estimates put the cost closer to $200 billion. This is particularly staggering when compared to the IRS budget of $7.5 billion.

For that reason, NFIB believes the best solution for a fairer, simpler tax code is to scrap the current code and replace it with one that promotes investment and sav-

ings. This new system must be broad based. That is our long-term goal and we will continue to work towards it.

In the short term, however, there are specific tax provisions that are particularly onerous to small business. I believe addressing these issues would move us towards the fairer, simpler tax code we would all like to see. I am pleased to say that many of these items are contained in the proposed legislation outlined by Chairman Houghton, including Alternative Minimum Tax Relief, expanded expensing opportunities, and pension simplification. Other legislation to be introduced by Congressman Talent also includes many of these provisions.

ELIMINATE THE DEATH TAX

If you want to simplify the tax code and raise revenues at the same time, eliminate the death tax? Eliminating the death tax would remove an enormous source of compliance cost and complexity and remove an entire Subtitle of the IRS Code all at the same time.

For a family business like mine, the death tax is a storm on the horizon. It threatens everything I have accomplished over the past nineteen years. Death tax supporters argue that the tax only affects a small percentage of estates, but the costs are much deeper than that.

I recently completed a series of lengthy meetings with my attorney and CPA to determine how my estate would be affected by the death tax. To my horror, I found out that my heirs would have to liquidate my business under duress to pay the estate taxes due upon my death. There is no way to avoid this tax upon a successful business. In my company's case, we would endanger the livelihood of all our employees and suppliers. The negative economic effect goes far beyond the business owner's heirs.

The death tax is bad for family businesses, it is bad for employees, and if you take the economic and compliance costs into account, it is bad for the federal government too. The death tax may provide government revenue in the short run, but the long-run costs far outweigh the gains. Studies by the Joint Economic Committee and the Institute for Policy Innovation show the death tax actually costs the federal government in the long run.

NFIB supports eliminating the death tax. Two bills have been introduced in the House that we support—HR 8, introduced by Representatives Dunn and Tanner, and HR 86, introduced by Representative Cox. Either one of these bills would provide significant relief to millions of small business owners and dramatically simplify the IRS Code. I am pleased to see that many members of this panel, including the Chairman, are cosponsors of one or both of these bills.

REFORM PAYROLL TAXES

Another area ripe for simplification is the federal unemployment tax, or FUTA. For small business, FUTA presents two problems. First, the rate is too high. Federal payroll taxes have never been cut—they only go up. Since their inception, federal payroll taxes—including FUTA and Social Security taxes—have risen from 2 cents of the first dollar earned to over 16 cents. This represents an increase of 800 percent.

Second, employers are required to pay two unemployment taxes—the federal tax and the state tax. That means twice the collection points, twice the payments, and twice the complexity. Payroll taxes were listed as the most costly tax in an NFIB tax survey, just ahead of personal income taxes. And 53 percent of those surveyed said payroll taxes are less fair or much less fair than business income taxes.

NFIB supports making the following changes to our nation's unemployment system:

- *Eliminate the Surtax:* The temporary FUTA surtax was put in place in 1976 in order to repay loans from the federal unemployment trust fund. Even though this money was fully repaid in 1987, Congress has extended this temporary tax four times, imposing an annual $1.4 billion tax burden on America's workers and employers. The surtax should be eliminated. Repeal of the surtax is long overdue.
- *Cut FUTA Taxes:* Even if the surtax is eliminated, FUTA still collects far more than it needs. FUTA raised $6.1 billion last year, but only $3.5 billion was spent on FUTA-related expenses. The rest was used to pay for non-related government programs. Permanent FUTA taxes should be cut to reflect the lower costs of the program.
- *Send the Program to the States:* The current system is duplicative and inefficient, costing the federal government, state governments, and private employers hundreds of millions in unnecessary administrative costs annually. Unemployment taxes should be collected by the states alone to eliminate these unnecessary costs.

Once again, I am pleased to note that the Chairman and other members of this Committee have supported such reforms. This week, Congressman McInnis plans to introduce legislation to eliminate the FUTA surtax.

SMALL BUSINESS EXPENSING

Another positive step taken by Congress recently was to increase the annual limit on business expensing to $25,000 by the year 2003. Legislation has been introduced by Congressman English to increase this limit further, to $60,000.

The purpose of small business expensing is twofold. First, it simplifies tax calculations—deducting investments immediately is simpler than depreciating them over a number of years. Second, it encourages small businesses to invest by reducing their tax liability and increasing their cash flow.

Personally, I fail to understand why expensing isn't universal. There is no real revenue loss from expensing—any tax benefit I gain this year I will lose next year. Meanwhile, the money that I keep this year goes into the economy and may mean the difference between success and failure for my business. Long and complex depreciation schedules don't just add to tax complexity and cost; they are also a tax on investments.

One way to make Section 179 more effective, aside from increasing its limits, might be to expand the types of purchases that can be expensed. Right now, only tangible property like business equipment, office furniture, and computer hardware can be expensed. Even auto purchases are subject to a limit. Expanding Section 179 to include purchases of computer software and other investments like leasehold improvements would make the section more effective. Once again, expanded Section 179 expensing is part of the Chairman's proposal, and it is certainly something NFIB would support.

CLARIFY THE DEFINITION OF INDEPENDENT CONTRACTOR

I understand the Chairman has joined others in introducing legislation to address the Independent Contractor issue. I also understand the Chairman is aware that NFIB has serious concerns about the direction of this legislation.

That said, something needs to be done to create a bright line between an employee and an independent contractor. A recent NFIB Education Foundation Survey found that the issue of determining an independent contractor was one of the biggest problems facing small business today. The current 20 common law factor test has handcuffed small businesses for too long. We need an objective standard that is simple and easily understood.

The 1995 White House Conference on Small Business's top recommendation was to establish a new test based on the following four criteria: (1) realization of a profit or loss; (2) separate principal place of business; (3) making services available to the general public; and (4) paid on a commission basis.

These criteria formed the foundation of legislation introduced in both the House and the Senate—Senator Bond has a bill in the Senate—and I encourage the Members of this Committee to use that legislation as a starting point for resolving this longstanding issue.

CASH VS. ACCRUAL ACCOUNTING

Another area related to accounting has to do with shoring up Section 448 of the IRS Code. Section 448 permits businesses with less than $5 million in annual revenues to use the cash method of accounting. While my business is too large to take advantage of this provision, many small shops in my industry do use it to their advantage. Cash accounting simply allows a business to only recognize those revenues it has actually received.

There are two reforms that NFIB would like to see to this provision. First, the $5 million cap has been in place for some time. It would be helpful to increase this cap. I believe the Chairman has proposed to do just that.

Second, the IRS has begun to use other portions of the IRS Code to undermine Section 448. In some cases, the IRS has disallowed the use of the cash accounting system for businesses with annual revenues below $5 million because the IRS claims inventory is a material factor in their business. It is my understanding that the IRS's definition of "material" can be extremely imaginative.

Once again, a bright line is needed to ensure that businesses below the threshold and without extensive inventories can use cash accounting if they so choose.

ABOLISH THE ALTERNATIVE MINIMUM TAX FOR INDIVIDUALS

Finally, let me mention the Alternative Minimum Tax. I believe the individual Alternative Minimum Tax is misnamed. It should be called, "The Alternative Small Business Tax." Take a look at the adjustments required under the individual AMT. Most of them are targeted at business-related deductions.

And, like the death tax, the notion that the AMT is a rich taxpayer's problem is incorrect. According to the Joint Committee on Taxation, more taxpayers than ever will be subject to the AMT within a decade, with the largest increase coming from taxpayers earning between $50,000 and $100,000.

Finally, the AMT has the side effect of hitting small businesses when they can least afford the bill. If I have a bad year, I'm more likely to trigger the AMT than when I do well. 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 should be increased and indexed to shield taxpayers from this onerous tax. Once again, I am pleased to see that the Chairman has proposed to do just that.

CONCLUSION

I would like to thank the Chairman for the opportunity to testify before the Ways and Means Subcommittee on Oversight on the important issue of tax simplification. I would also like to thank him for taking on this issue with so much enthusiasm. Adoption of the reforms mentioned above would be a dramatic victory in the battle of tax simplification.

Chairman HOUGHTON. All right. Thank you very much. We will have them questions, Mr. Harkins.

Mr. Steuerle.

STATEMENT OF C. EUGENE STEUERLE, SENIOR FELLOW, URBAN INSTITUTE, ON BEHALF OF NATIONAL TAX ASSOCIATION

Mr. STEUERLE. Mr. Chairman and Members of the Subcommittee, thank you for the opportunity to testify on tax simplification on behalf of the National Tax Association. Founded in 1907, NTA is the leading association of tax professionals dedicated to advancing the understanding and theory of public finance. The association will be pleased to assist the Subcommittee in any discussion of tax simplification.

As has been expressed before, principles of tax law often conflict. In achieving a balance among principles, however, almost everyone would agree that simplicity has been given far too little weight in the legislative process. My congratulations go out to the Members of this Subcommittee for their willingness to tackle these problems and, in particular, to the three of you who have remained, Mr. Houghton, Mr. Coyne, Mr. Neal, for your special efforts. I realize that you will not be blinded by the TV lights for your giving attention to this issue, but I think, nonetheless, it is extremely important.

Needless tax complexity, I believe, serves as one of the more important barriers to a healthy relationship between a citizenry and its government. In my testimony, I include several items of needless tax complexity which I will list very briefly and then get onto an issue that I think is also equally important but perhaps has not been given enough attention—and that is the question of a *process* that might give simplicity more attention.

Among the items that I list are: an alternative minimum tax that treats items such as dependent exemptions as a tax shelter, there-

by threatening to tax millions who were never meant to be affected; the phaseout after phaseout of such items as itemized deductions, personal exemptions, and educational tax breaks, each of which is like a little mini-tax unto itself; pension and savings incentives that add administrative costs and perhaps even reduce net saving because of their multiple rules on withdrawals, penalties, allowing amounts of exclusion and deduction and so on; a tax treatment of dependent children that needlessly causes millions of unnecessary tax returns to be filed; a capital gains tax law with seven different tax breaks; multiple educational tax breaks that are poorly coordinated with each other and with direct expenditures for education; complicated rules for charitable deductions and charities, including multiple limits on giving and an excise tax on foundations that actually discourages charitable giving; child credits and dependent exemptions that could easily be folded into one; and unnecessarily strict estimated tax rules that pick up very little revenue for all the complexity they introduce.

I would like to concentrate, however, the remainder of my testimony not on particular proposals but on a broader issue. I believe that the complexity of the tax law is, at its heart, a failure of process. The process failure could be mitigated through the adoption of certain procedures that I have suggested for both the executive branch and Congress. The purpose of these procedures is simply to grant simplicity a higher priority in the overall process. I therefore suggest strong consideration be given to two types of process reforms: No. 1, those that require periodic reporting on existing law; and, No. 2, those that would apply to new legislation.

Let me turn first to the possible periodic reports that I believe would help you in achieving your goal. My first suggestion is that the Treasury or the Joint Committee on Taxation should publish a formal study, year after year, listing tax simplification options. If you don't believe how important this could be, I invite you only to look at the list of revenue options and expenditure options put out annually by the Congressional Budget Office and the attention that those receive. Or to the tax expenditure list prepared by the Treasury and the Joint Committee on Taxation. This latter list, however, is not a list of items for simplification.

Second, the Government Performance and Results Act of 1993 requires a performance plan review that has been extended on a very embryonic basis to Treasury's tax expenditure budget. Now Treasury made some very tentative steps there. I believe that they could be expanded significantly and help you in your roles. At the same time, I believe there is a fundamental failure in the IRS administrative structure. Because it is organized around tax returns and not tax programs under its jurisdiction, IRS does not prepare analyses of programs and it takes no responsibility for their success or failure. It is not surprising, then, that IRS almost always ends up behind the eight-ball when Congress suddenly decides it wants to examine the effectiveness of, say, the earned income credit or the compliance costs imposed upon charities.

I also suggest some procedures for giving simplicity greater weight in the legislative process. These include testimony on proposed bills that would always give at least some attention to witnesses who focus solely on simplification administrative issues.

When the markup of a bill occurs and when you go to conference, I suggest that at least one person at the witness table should have the sole assignment of providing information on administrative aspects of the bill. Before going to conference, the IRS could also provide mock tax forms showing exactly what has been wrought from bills. I actually succeeded in having them do this with one piece of legislation in 1987 and it did significantly change what was in the bill, although the bill itself still had major problems.

And, finally, the National Commission on Restructuring the IRS suggested the tax complexity assessment accompany future tax changes. Last year, the Joint Committee on Taxation did prepare a simplification analysis of the House bill at the request of Chairman Archer, even though it wasn't required that year. I am hopeful that this Subcommittee will devote some effort to making sure that these procedures continue to be set because precedents this year and next year are very important.

Of course, none of these process reforms guarantee that simplification will occur. Nonetheless, a combination of some if not all of these procedures, I believe, could serve as a major deterrent to new sources of unnecessary complexity and as a spur to further efforts in achieving the types of simplifications of the Subcommittee that it has fostered today. Thank you.

[The prepared statement follows:]

Statement of C. Eugene Steuerle, Senior Fellow, Urban Institute; on behalf of National Tax Association

Mr. Chairman and Members of the Subcommittee: Thank you for the opportunity to testify on tax simplification on behalf of the National Tax Association (NTA). Founded in 1907, NTA is the leading association of tax professionals dedicated to advancing understanding of the theory and practice of public finance. The Association is the premier forum for debating complex and controversial public finance issues; testing new tax theories, practices, and policies; and disseminating impartial, nonpartisan research of the highest quality. NTA is a tax-exempt 501(c)(3) organization and does not promote any particular tax program or policy. NTA's diverse membership brings together government, corporate, academic, and independent tax professionals: a rich mix of federal and state legislators and administrators; taxpayer representatives; tax lawyers and accountants; professors, librarians, and other scholars; and students and interested citizens.

With its long history of exploring tax issues, and its broad membership, the Association will be pleased to assist the Subcommittee in its discussion of tax simplification. Most recently, NTA convened the major national project on taxation of communications and electronic commerce, which is sorting out issues facing governments, industry, and users of these services.

Principles of tax law often conflict. For example, taxing all income on an equal basis is generally considered to promote both a more efficient and fair tax system, but carried to an extreme it can add to complexity. In achieving a balance among principles, however, almost everyone would agree that simplicity has been given far too little weight in the legislative process. There are many items in the tax law that add significant complexity with little gain in some other area like equity or efficiency. Almost no one would introduce many provisions now in current law, if designing a Code from scratch. Once there, however, these complexities are hard to remove. My congratulations go out to the members of this subcommittee who are willing to tackle these problems.

Complexity creates waste, not merely cost. One must distinguish between costs that might provide benefits and those that do not. A transfer of $1 from me to you may cost me $1, but there is an offset in the $1 that you pick up. Economists often focus on the distortions that this transaction might bring about, such as changes in behavior. However, among the most important distortions are the extra time and effort involved. Joel Slemrod of the National Tax Association has made special efforts over time to study this issue and has concluded that administrative costs are significant. If it now costs me $1.10 to transfer $1 to you—$1 in cash and 10 cents in human resources—then that 10 cents is lost to society as a whole.

Another cost, although more subtle, may be even more important. Many people do not mind paying their fair share of the cost of government, but they highly resent it when they see needless waste—including waste of their time in filling out an unreasonable number of forms. They gradually lose respect for government and its functions. I do not mean to imply that tax complexity is the only, or even the primary, factor at play in the public's increasing cynicism toward government—a cynicism that goes well beyond the healthy skepticism that Americans have always had. But needless tax complexity does serve as one of the important barriers to a healthy relationship between a citizenry and its government.

A Few Candidates for Reform

Included among the many items of needless complexity today are the following:

- An alternative minimum tax that treats items such as dependent exemptions as tax shelters, thereby threatening to tax millions who were never meant to be affected;
- Phase-out after phase-out of such allowances as itemized deductions, earned income tax credits, personal exemptions, eligibility for IRAs, eligibility for other saving incentives, eligibility for educational tax breaks—each of which is like an additional mini-tax system all to itself;
- Pension and saving incentives that add administrative costs and possibly even reduce net saving by providing different rules for withdrawals, penalties, Social Security tax treatment, allowable amounts of exclusion or deduction, and so on;
- A tax treatment of dependent children that needlessly causes millions of unnecessary tax returns to be filed;
- A capital gains tax law with at least seven different tax rates and that requires taxpayers to fill out pages of forms even when they have only a few dollars of gains;
- Multiple educational tax breaks that are poorly coordinated with each other and with direct educational expenditures, thus requiring duplicate administration and creating complexity for students, parents, educators, and the IRS;
- Complicated rules for charitable deductions and charities, including multiple limits on giving as a percent of income and a perverse excise tax on foundations that actually discourages charitable giving;
- Child credits and dependent exemptions that could easily be folded into one; and
- Unnecessarily strict estimated tax rules that pick up very little extra revenue for all the complexity they introduce.

In the appendix to this testimony, I elaborate a bit on the first three of these items. My purpose here, however, is not to go through a laundry list of provisions in need of reform. Instead, I would like to concentrate the remainder of my testimony not on particular proposals but on a broader issue. I believe that the complexity of the tax law is at its heart a failure of process. This process failure could be mitigated through the adoption of certain procedures that I have suggested for both the Executive Branch and Congress. The purpose of these procedures is simply to grant simplicity a higher priority in the policy process.

The issue, however, is not whether simplification should receive the top priority in every tax bill. It should not. There are often equally important, or more important, principles and issues at stake, such as financing government activity or providing equal justice to citizens in equal circumstances. After all, the government doesn't collect taxes merely to simplify its tax system. The issue, instead, is that simplification receives too little weight, especially given how complex the tax system has already become. Indeed, the good news in this bad news is that there are so many opportunities now for simplification that only a modest effort is required to ensure that most new tax enactments achieve net tax simplification.

Process

When I speak of process reform, I refer partly to the fact that no one in the Executive Branch or in the Congress is responsible for reporting on the consequences of tax law. I believe the way to alleviate this situation would be to assign this fiduciary-like responsibility and to formalize it in some very specific procedures. Below I list two types of process reforms: (1) those that would involve periodic reporting on existing law; and (2) those that would apply to new legislation.

Periodic Reports

- My first suggestion is that Treasury or the Joint Committee on Taxation should publish a formal study year after year listing tax simplification options. This would be similar to the package of potential expenditure cuts and tax increases prepared by the Congressional Budget Office and the tax expenditure list prepared by Treas-

ury and the Joint Committee on Taxation. I have become convinced that it is only through the publication of such a list that tax simplification is liable to get the greater attention it deserves, especially on an ongoing basis.

Note, by the way, that the tax expenditure list is not sufficient for this purpose. Among the many reasons are that not all tax expenditures are complex, or more complex than direct expenditures. The purpose of the tax expenditure list is not to provide ideas for simplification, but to give tax programs a budgetary weight that is equivalent to the expenditure programs that they might replace.

Some simplification options can be taken from Joint Committee on Taxation studies such as its recent overviews of individual income tax provisions on April 14, 1999 and of employer-sponsored retirement plans on March 22, 1999. The Treasury often makes some suggestions each year, especially at budget time. However, one should not discount the importance of assembling, packaging, and reissuing a much more comprehensive list on a regular basis.

• The Government Performance and Results Act of 1993 requires a performance plan review that has been extended on an embryonic basis to Treasury's tax expenditure budget. Treasury has made some very tentative steps here, although it complains about the lack of data (see comment below on IRS structural defects). While it would be foolish to think that Treasury could study each of these programs adequately each year—Congress continually mandates studies without providing the resources to back up the mandate—a cycle could be established that would lead to periodic review of each of them.

• At the same time, I believe there is a fundamental failure in IRS administrative structure that leads to the Treasury complaints about inadequate information. Indirectly it also leads to some of IRS' internal problems in managing itself. That defect is the failure of the IRS to partially organize itself on a programmatic basis. IRS organizes itself by tax return category, not by the programs under its administration. Therefore, it prepares few analyses of these programs and takes no responsibility for their success or failure. Only indirectly do we find out about these programs, as when IRS measures error rates by line item on returns. It is not surprising, then, that IRS almost always ends up behind the 8-ball when Congress suddenly decides it wants to examine the effectiveness of, say, the Earned Income Tax Credit, the tax exclusion for employer-provided health insurance, or the compliance costs imposed upon charities.

IRS sometimes excuses itself because it is in charge of administration, whereas Treasury and the White House are in charge of policy. While I am not unsympathetic with this argument, I still believe it is inadequate. No one can properly administer a program unless they understand how target-efficient it is and can analyze the costs of administration for both the government and their customer from a programmatic perspective. IRS does not have to make final judgment; it does have responsibility for better development and dissemination of the information it acquires in administering programs.

IRS is also scared to put out reports on administrative effectiveness. In reporting on the EITC during the 1990s, for instance, it has faced the political constraint that both President Bush and President Clinton favored an increase in the grants made under this program. Unless a regular schedule of reporting is established, IRS will fear that the timing of release of any report will appear to be politically motivated by one side or the other.

Reporting on New Legislation

Here are some methods for giving simplicity greater weight in the legislative process:

• Testimony on proposed bills should always include at least some witnesses who focus solely on the simplification and administration issues. Although affected persons should be invited, some of these witnesses should not represent anyone with a significant stake in the outcome.

• When the markup of a bill occurs, one individual at the witness table should have the sole assignment of providing information on the administrative aspects of the bill. This individual might be from the IRS, the Treasury's Office of Tax Policy, or the Joint Committee on Taxation, but the assignment must be separated from other issues so as to ensure that simplification concerns are not ignored.

• Before going to conference, the IRS should produce mock tax forms showing exactly what has been wrought from bills produced in both houses. Changes in number of users of forms and line items should also be provided, when possible.

• In conference committee, one person at the witness table should be held responsible for providing information only on the simplification aspects of the bills from both parts of Congress.

• The National Commission on Restructuring the IRS suggested that a tax complexity assessment accompany future tax changes. If interpreted in too legalistic a fashion, the requirement may be hard to implement, but the spirit of the suggestion could be met in a variety of ways. Last year the Joint Committee on Taxation prepared a simplification analysis of a House bill at the request of Chairman Archer, even though it was not required for that year. I am hopeful that this subcommittee will devote some effort to making sure the right precedents continue to be set and to guaranteeing that these analyses are given significant weight in future legislative efforts.

Of course, none of these process reforms guarantee that simplification will occur. Nor, as I noted at the beginning of my testimony, should simplification be the only factor under consideration. Nonetheless, a combination of some, if not all, of these procedures could serve as a major deterrent to new sources of unnecessary complexity and as a spur toward achieving the types of simplifications sought by this subcommittee.

APPENDIX

THREE MAJOR AREAS OF COMPLEXITY

Alternative Minimum Tax

Many efforts at reforming the AMT deal with the failure to index the system over time, so that more and more taxpayers would not be forced to pay this tax. Under current law, for instance, many married couples with two children, average income, and no more deductions than their state and local taxes are scheduled to pay AMT in the future. As their income and state and local taxes—which are counted as preference items—grow with normal inflation and economy-wide growth, these taxpayers are less likely to be excluded from the AMT. But while a reform that indexes the AMT is worthwhile, it still ignores whether or not the tax makes sense, whether its base includes items that should not be subject to taxation, and whether the administrative hassle and complexity are worth the trouble in the first place.

A few of the preference items in the AMT have attributes associated with preferential treatment, such as generous depletion allowances or the tax exemption for interest received on private activity bonds. In those cases the taxpayer may be excluding from taxable income a significant portion of real income received. But most of these items are not large in terms of alternative minimum tax collections. Other items included at different times, such as an alternative depreciation schedule, are more debatable since they seem to deny to some taxpayers even those deductions that would be allowed if economic income were calculated accurately. Some of these provisions are enormously complex, as well, for they require the taxpayer to keep multiple records for years under alternative methods of calculation.

There is little excuse for inclusion of items that are legitimate deductions reflecting a lower ability to pay tax. The standard deduction allowed to nonitemizers is treated as a preference item under the AMT. So also are extraordinary and legitimate work expenses when deducted as miscellaneous itemized deductions. The inclusion of personal exemptions as a preference item implies Congress believes that a dependency exemption is not an appropriate adjustment to ability to pay tax, but instead accords the taxpayer special treatment. In effect, for AMT purposes, the law implies that a family of four has the same ability to pay tax as a family of two with equal income.

Finally, there are those items that under some theories might not be deductions under an income tax, but under other theories are quite reasonable. It is inconsistent and arbitrary to try to tax them through an AMT. These include state and local tax deductions and those few medical deductions allowed for regular tax, but not minimum tax, purposes. If there is a rationale for further limiting these deductions, it should be applied directly in the normal income tax, not through the more complex AMT.

Tax System after Tax System & the High Implicit Marginal Tax Rates

In recent decades the tax and expenditure laws have witnessed the establishment of one new tax system after another. These tax systems derive from attempts to cut back or pare various "benefits" as income increases. As one consequence, they create a strange tax rate schedule with a number of side effects such as rising and increasing marriage penalties on individuals.

The difficulty is that the tax systems are created in happenstance manner. They derive from nothing more than a glance at what might look politically salable when each part of a bill is up for adoption. For example, child credits are meant to apply to the middle class, so they will at least be limited for those with incomes of, say, $75,000 or $110,000 or more. Yet almost every one of these phase-outs has its own set of rates, base, and phase-out region. Should one of these income taxes apply at one level and the next at a very different level? Maybe, but no rationale is or has been provided. Moreover, granting some benefit at high income levels is not necessarily regressive if those individuals have more than paid for the benefit with their taxes.

Meanwhile, there are now multiple tax systems implicit in expenditure programs as well. Consider all the possible interactions among the following: a federal income tax, a state income tax, the phaseout of an earned income tax credit, phaseouts of the benefits of nontaxation of social security income, phaseouts of personal exemptions, phase-ins of limits on itemized deductions, phase-ins of alternative minimum taxes, phaseouts of existing higher educational benefits like Pell grants, and phaseouts of various welfare benefits like Temporary Assistance to Needy Families, food stamps, Supplemental Security Income, and various forms of housing subsidies.

For low and moderate income taxpayers—the primary group for which simplified filing at one time seemed possible—earned income tax credits, child credits, dependent care deductions, educational credits, and presidential campaign check-offs, among others, have been added to returns. Unlike the traditional personal exemption and standard deduction, these various provisions often require additional information by the taxpayer. Whatever their other merits, therefore, they have complicated filing significantly. To top matters off, the IRS has discovered that many of the errors in EITC filing and other allowances are related to claiming children incorrectly, especially when the parents of children are separated, divorced, or never married. To deal with this problem, the IRS has sought additional information from taxpayers to verify their eligibility for different allowances related to children.

Most of the allowances for low and average income individuals, ranging from the EITC to child credits and dependent exemptions, could be combined or simplified significantly, even if some variations had to be eliminated. For example, there's little reason that the personal exemptions for dependents couldn't be folded into the child credit.

Pension and Saving Plan Simplification

The number of rules and regulations applying to pension and saving plans is overwhelming (see attached table). This derives from an extraordinary number of so-called saving and retirement incentives in the tax code, each with its own separate limits, exceptions, and requirements on both individual taxpayers and employers. The consequent complexity reduces the net rate of return available to saving, in part because of the very large expenditure of time and paid labor that must be employed to interpret, administer, and seek to understand this universe.

Thus, the issue is not whether there should be rules regarding eligible deposits, discrimination among employees, penalties for withdrawals, and so on, but whether there needs to be so many inconsistent rules and regulations across so many different plans.

One type of reform does not address how many incentives might be offered, but, whatever their number, seeks to apply a more common set of rules on as many of them as possible. For example, there might be a single, common limit on deductible contributions for all types of employer-provided plans and a common income eligibility standard for individual plan options such as individual retirement accounts. The limit might be expressed simply as a dollar amount, rather than as percent of income. For withdrawals, a common but limited set of exceptions might be established, and a common penalty for early withdrawal might be applied. A simple standard could be adopted as to whether contributions are subject to social security tax or not.

More complicated to design, but highly desirable, would be a simpler rule or set of rules regarding when plans "discriminate" against lower-paid workers in a firm. A second approach to simplification would reduce the number of retirement and saving options. Do we need both traditional IRAs and Roth IRAs, both profit-sharing and employee stock option plans, both money purchase and profit-sharing plans, both 401(k) and 403(b) plans? My feeling is that the gains from these differentiations are small, if any, and the costs of administration are almost inevitably higher than any gains.

Private Pension Plans
Plan Characteristics

	Individual Accounts				Small Business Plans		
Plan Characteristics	Non-qualified *Employer-Sponsored Pensions*	IRA	Traditional Nondeductible IRA	Roth IRA	SEP-IRA	Salary Reduction SEP	SIMPLE IRA
Eligibility	*Top hat only**	Taxpayers not in an employer plan, unless earning less than $35,000 for individuals and $50,000 for couples (1)	All taxpayers	Taxpayers with earnings less than $110,000 for individuals and $160,000 for couples (2)	Employees of all employers	Employees of taxable employers with 25 or fewer employees (3)	Employees of employers without another plan and with under 100 employees
Overall Dollar Limit	None	$2,000 reduced by other IRAs	$2,000 reduced by other IRAs	$2,000+reduced by other IRAs (4)	$30,000 (5)	$30,000 (5)	NA
Overall Maximum % of Pay	NA	100%	100%	100%	15%	15%	NA
Employer Limits	None	NA	NA	NA	Lesser of $30,000 or 15%	Lesser of $30,000 or 15%	Matching contribution up to 3% of pay or fixed 2%
Employee Limits	None	$2,000	$2,000 (after-tax)	$2,000 (after-tax)	NA	$9,500	$6,000
Aggregate Employer Deduction Limits	*None*	NA	NA	NA	15% of aggregate compensation for all qualified plans	15% of aggregate compensation for all qualified plans	None
Exclusion from SS Tax	No (*except after vesting*)	No	No	No	Yes	No for employee contributions	No for employee contributions
Subject to Early Withdrawal Penalty Tax(6)	No (*unless annuity purchased*)	Yes	Yes	Yes	Yes	Yes	Yes
Penalty Tax Exceptions (7)	None (*unless annuity purchased*)	Medical expense, 1st home purchase, higher education expense, and health insurance payments for unemployed	Medical expense, 1st home purchase, higher education expense, and health insurance payments for unemployed	First time homebuyer (up to $10,000 limit)	Medical expense, 1st home purchase, higher education expense, and health insurance payments for unemployed	Medical expense, 1st home purchase, higher education expense, and health insurance payments for unemployed	Penalty is increased to 25% if funds are withdrawn in 1st 2 years
Conditions for In-service Withdrawal	No additional limitations	No additional limitations	No additional limitations	5-year waiting period	No additional limitations	No additional limitations	No additional limitations
Loans Available	*Yes*	No	No	No	No	No	No

Private Pension Plans
Plan Characteristics

	Individual Accounts				Small Business Plans		
Plan Characteristics	Non-qualified *Employer-Sponsored Pensions*	IRA	Traditional Nondeductible IRA	Roth IRA	SEP-IRA	Salary Reduction SEP	SIMPLE IRA
Nondiscrimination rules (8)	None	None	None	None	Uniform percent of pay to all eligible employees	HCEs 125%(9)	Required matching up to 3% or 2% fixed contribution
Salary Cap for Nondiscrimination testing	NA	NA	NA	NA	$160,000	$160,000	$160,000
Integrated with Social Security	NA	NA	NA	NA	Yes	No	No
Spousal Protection	None	None	None	None	None	None	None
Vesting	Immediate *for employee; deferred for employer*	Immediate	Immediate	Immediate	Immediate	Immediate	Immediate
Special Restrictions and Benefits	*Taxed when paid or made available (or when vested for tax-exempts)* *May be DC or DB*	*None*	None	Based after-tax contributions	Employer does not have to contribute every year	No new plan may be established after 12/31/96	Employees may direct investment after 2 year waiting period

Note: All dollar values are indexed, and the given figures are as of 1997.
Sources: Harry Conaway, WILLIAM M. MERCER, and C. Eugene Steuerle and Andrea Barnett, THE URBAN INSTITUTE, 1997.
For footnotes see end of second table.

**Funding is required for a pension plan that is not limited to a select group of officers or highly compensated employees. (This does not apply to certain section 415 benefit plans or church or government plans.)*

Private Pension Plans
Plan Characteristics

	Defined Contribution Plans						Defined Benefit
Plan Characteristics	Eligible 457 plans	403(b)	401(k)	Profit Sharing	Employee Stock Ownership Plan	Money Purchase	Defined Benefit
Eligibility	Employees of state and local government and *officers of* tax-exempt organizations	Employees of tax-exempt organizations and public schools	All employees except state & local governments	Employees of any employer	Employees of taxable employers	Employees of any employer	Employees of any employer
Overall Dollar Limit	$7500 ($15,000 limit for last 3 years before retirement as catch-up allowance) Reduced by contributions to 403(b), SEP and 401(k) plans	$30,000 (5)	$30,000 (5)	$30,000 (5)	$30,000 (increased *by forfeitures and allocations related to interest payments* if not more than 1/3 of employer contributions are allocated to HCEs)	$30,000 (5)	Benefit limit= $125,000
Overall Maximum % of Pay	33 1/3%	25%	25%	25%	25%	25%	Benefit limit = 100% *except for state and local government
Employer Limits	Lesser of $7500 or 33 1/3% reduced by employee contribution	Exclusion allowance = 20% of pay times years of service reduced by employer annuity purchase	*NA*	Lesser of $30,000 or 25% reduced by employee contribution	Lesser of $30,000 or 25% reduced by employee contribution	Lesser of $30,000 or 25% reduced by employee contribution	Normal cost for the year plus amortization over 10 years or 150% of current liability (10)
Employee Limits	Lesser of $7500 or 33 1/3% reduced by employer contribution	$9500 (plus catch-up allowance if more than 15 years of service)	$9,500	*After-tax*	*After-tax*	*After-tax*	*After-tax*
Aggregate Employer Deduction Limits	NA	NA	15% of taxable compensation	15% of taxable compensation	25% of taxable compensation for leveraged (15% - nonleveraged) plus deductions on ESOP dividends paid out	Based on funding requirement	Based on funding requirement (11)
Exclusion from SS Tax	Yes	No	No	Yes (12)	Yes (12)	Yes (12)	Yes
Subject to Early Withdrawal Penalty Tax(6)	No	Yes	Yes	Yes	Yes	Yes	Yes

Private Pension Plans
Plan Characteristics

	Defined Contribution Plans						Defined Benefit
Plan Characteristics	Eligible 457 plans	403(b)	401(k)	Profit Sharing	Employee Stock Ownership Plan	Money Purchase	Defined Benefit
Conditions for In-service Withdrawal	Unforeseeable emergency (14)	Financial Hardship (13)	Financial Hardship (13)	Minimum 2 year holding period for each contribution	Minimum 2 year holding period for each contribution	Not allowed	Not allowed
Loans Available	Unclear	Yes	Yes	Yes	Yes	Yes	Not usually
Nondiscrimination rules (8)	Can favor HCEs	ACP for matching funds, general test for nonelective deferrals, and uniform availability for elective deferrals. (16)	ADP, ACP and Safe Harbors (16)	General Rule (15)	General Rule (15)	General Rule (15)	General Rule (15)
Salary Cap for Nondiscrimination testing	NA	$160,000	$160,000	$160,000	$160,000	$160,000	160000
Integrated with Social Security	NA	Yes	No	Yes	No	Yes	Yes
Spousal Protection	None	Death benefit (17)	Death benefit (17)	Death benefit (17)	Death benefit (17)	Survival Annuity, Consent and Death Benefit	Survival Annuity, Consent and Death Benefit
Vesting	Immediate usually	Immediate	Immediate	Deferred	Deferred	Deferred	Deferred
Special Restrictions and Benefits	Unfunded plan. All assets part of employer's general assets and subject to creditors until distribution. Must be held in trust after 1/1/99 for public sector. May also be a DB plan.	May also be structured as a DB plan	SIMPLE 401(k) follow same regulations except they follow SIMPLE IRA rules for eligibility, employer and employee contribution limits, and vesting	None	* 100% Employer Securities Allowed._* Required opportunity for divestiture at 55. * Put option and voting rights	Minimum funding required in full each year	* Pension Benefit Guaranty Corporation premium of $19 per employee * Special rules for Multi-employer plans *PBGC . guarantee

Private Pensions: Plan Characteristics - Footnotes

1)IRA phase-out schedule: in 1997 $25,000 to $35,000 for individuals and $40,000 to $50,000 for married couples filing together. These phase-outs are scheduled to increase to $50,000 to $60,000 for individuals and $80,000 to $100,000 for joint filers by 2007 with incremental increases starting in 1998. There are also special limits for non-working spouses.

2)The phase-out schedule for Roth IRAs is $95,000-110,000 for individuals and $150,000-160,000 for married couples filing jointly.

3)Public sector employees and employees of tax-exempt organizations are not allowed to make elective deferrals into a SEP.

4)Deposit limits for contributions to Roth IRAs actually have a greater value than traditional IRAs because it is an after tax contribution.

5)The $30,000 overall dollar limit is a cumulative limit for employers and employees across all qualified plans.

6)The general exceptions to the standard IRS 10% penalty for early withdrawal include death, disability, separation from service and plan termination.

7)Withdrawals for medical expenses in excess of 7.5% of AGI are exempt from the IRS penalty for all plans.

8)State and local plans are exempt from all nondiscrimination tests.

9)The 125% HCE rule says that a Highly Compensated Employee (HCE), which are defined under the IRC to include employees who are 5% owners during the current or preceding year or who received compensation in excess of $80,000 in the preceding year, may not defer more than 125% of the average deferral of all Non-Highly Compensated Employees (NCHEs).

10)Under the Taxpayer Relief Act of 1997 the 150% limit for Defined Benefit plans will be increased to 170% by 2005 with incremental increases starting in 1999.

11)There is an additional combined deduction limit of the greater amount of the maximum funding limit for defined plans and 25% of compensation, when an employee participates in both a defined benefit and a defined contribution plan.

12)Since the employees contributions are only after-tax contributions that are not excludable from Social Security tax.

13)Financial Hardship is defined as, immediate and heavy financial need where the funds are not available from other sources. The need may be either foreseeable or voluntarily incurred. The distribution cannot exceed the amount required to meet the immediate financial need created by the hardship.

14)Unforeseeable emergencies are defined as severe financial hardship to the participant as a result of sudden illness or accident to the participant or a dependent, property loss due to casualty or other extraordinary and unforeseeable circumstances beyond the control of the participant. No payment will be made if there are other ways to satisfy the financial need. Specifically not included: college and home purchase.

15)The general nondiscrimination rule says that no HCE may receive a contribution or benefit that is a higher percentage of pay than the contribution or benefit of any NHCE.

16)The Aggregate Contribution Percentage test (ACP) applies to employer and after-tax employee contributions. It requires that either (1) the ACP for the group of HCEs I not more than 125% of the ACP for all other eligible employees or (2) the excess of the ACP for the group of HCEs in not more than 2 times the ACP of all other eligible employees. The Actual Deferral Percentage test (ADP) applies to elective employee contributions and is designed to limit the contributions of HCEs based on the average deferred percentages of NHCEs. It requires that:

For ADP of NHCEs:	ADP of HCEs may be:
Less than 2%	2 times the ADP of the NHCEs
2% to 8%	ADP of the NHCEs + 2%
8% or greater	1.25 times the ADP of the NHCEs

Additionally, the 401(k) ADP test is based on an aggregate average of deferrals and therefore allows a higher disparity than the 125% HCE rule for SEP plans.

17) *Unless thye plan offers an annuity*, the death benefit provides the remaining value of the plan to the *widow or widower* in a lump sum payment *unless the spouse consents to another distribution. (This assumes the plan is subject to ERISA and not a church or government plan).*

Chairman HOUGHTON. Thank you very much, Mr. Steuerle.

Let me ask, is there anybody from the Internal Revenue Service in the audience? Interesting—with all this testimony. Well, I will be their advocate.

It is very difficult to separate tax reduction from tax reform because you get all tangled up here. We are, however, really interested in the simplification issue. I mean, as we looked at the numbers, the No. 1 target for simplification was the AMT; it has just spread like an octopus far beyond the boundaries of what was intended.

If you take a look at it—and I have just gotten the figures from Mac of our staff here—that over 10 years, this would cost $135 billion. It starts off at a $7 billion rate and ends up, in the 10th year, at a $27 billion rate. Now you can say, well, if those are the numbers, you better get at it pretty soon or it is going to strangle you. But are there any adjustments we can make? I am looking at it from the practical standpoint. We don't have a lot of money to play with, and there is the great concept of a 10-percent across-the-board tax cut out there. We are not going to do that.

Yet, at the same time, there are so many things we can do. What—and several of you listed 10 issues—what are those things we can do? I don't mean to be cheap about this thing—but what are the things we could do right now, and you could say to the leadership of the House, this thing is not going to cost us an arm and a leg. It will help the taxpayers tremendously. It will be a first cut in terms of overall simplification. What do you think are those things? Now, Hank, you mentioned compliance. What could we do in that area, without talking about billions and billions and billions of dollars?

Mr. GUTMAN. Well, I think, Mr. Chairman, Mr. Neal said his bill was revenue-neutral. There is the start. If what we are worried about is cost, there is something on the table that has got revenue-neutrality and achieves enormous simplification. It has got elements that are in your bill as well. Capital gains is a mess. The AMT, as everyone has pointed out, is reaching into an area where it was never intended to be. And if the revenue raisers which Mr. Neal has proposed are acceptable, that ought to work.

I have a little bit of doubt about increasing the floor under itemized deductions from 2 percent to 4 percent. I never understood, as a policy matter, why the floor was enacted in the first place. I do understand the pragmatics.

You eliminate a huge amount of complexity with the elimination of Pease and PEP, the elimination of the alternative minimum tax and the rationalization of the capital gains structure.

A second area, which may end up actually raising some money, depending upon how you do it, is rationalization of the education credits. The educational assistance programs that are in the code came in at different times with different objectives. They are impossible to figure out and you may be able to move them around, get some money and achieve significant simplification. So I think those are areas to focus on because people have already begun to focus on them.

Chairman HOUGHTON. Right now. Mr. Neal, have you got a comment? Because I would like to end it at any time, gentlemen. But why don't you go ahead, Rich.

Mr. NEAL. I would like to ask the other panelists about PEP and Pease since Mr. Gutman raised it and then I would like to come back to him with a specific question. The other——

Mr. STEUERLE. I was around then although I would like to claim that I am not fully responsible for the complications. I was coordinator of Treasury's study when we first put forward tax reform in 1984 to 1986 and PEPs and Pease ended up to be the result of a back-door attempt to basically hide tax rate increases by creating what then was called a bubble which——

Mr. NEAL. So you were part of it?

Mr. STEUERLE [continuing]. Meant your rate went up and then went down, but then leveled out. That bubble was not actually in the original Treasury proposal. It provided a way of saying "We cut rates," but then raise them on the side. As a professional in the tax field, I don't like hidden taxes and, therefore, I don't like PEPs and Pease. I would much prefer to put them in the rate schedule. I realize, however, that that causes considerable political consternation; that is, if hidden rates are all right, but direct rates aren't, then there is a real problem. But, for the most part, these phase-outs are nothing more than back-door rate increases. Outside of some slight differences across families, you could work them into a rate schedule, if you want to create a bubble in the rate schedule, but it would be explicit.

Mr. NEAL. The others? Would you like to comment on that?

Mr. TUCKER. The Tax Section has pointed out a number of times that we would far prefer to see rates raised than do it the indirect way through PEP and Pease and AMT and other phaseouts that come in and come out. We think that, No. 1, is really simplicity. No. 2, we understand it is politically difficult, but it is also very difficult to explain to our clients who are in the 39.6 bracket they think, when in actuality they are in the 42 percent bracket in most circumstances and we get a lot of anger. We get a lot of, you know, you are not helping me. You are telling me something I don't want to hear. And we think it ought to recognized. That that truly would be simplification.

Mr. NEAL. Mr. Gutman, yes, I know it is not a topic that we were to focus on today, but corporate tax shelters, the Treasury's approach. Do you have a comment?

Mr. GUTMAN. Well, that is an interesting question, Mr. Neal. I guess from a congressional perspective, one of the things that I would have thought you and Chairman Houghton and others would want to focus on is the extent to which the Treasury proposals represent a shift of legislative authority from you to the Internal Revenue Service and the Treasury. That is something I would have thought would be of some concern to you, particularly given the IRS restructuring legislation which in large measure was directed to limiting the scope of authority that the Internal Revenue Service has to exercise power over taxpayers. From an institutional viewpoint, this is an issue that you ought at least to think about.

From the point of view of practitioners, I think the Treasury proposals raise a number of issues. The first is simply the ambiguity

of the proposals. That is a consequence, I think, of the attempt to create a one-size-fits-all rule. And, if nothing else has emerged from the debate so far, it ought to be clear that there is little consensus about the kinds of transactions that fall within the rule. And so, I think, one of the things that needs to be addressed is an attempt to make clear that we know what it is we are talking about.

The second part of the Treasury proposals goes to what I call proportionality. Does the punishment fit the crime? The Treasury proposals impose strict liability penalty on taxpayers without regard to the nature of the advice they have received in connection with a transaction. And it is strict liability for transactions that are undefined. That is a big problem. If the motive for the imposition of strict liability is a perception that people aren't getting straight advice, then I think you should deal with the question of what kind of advice is required. But a no-fault penalty when it is not clear to what the penalty is going to apply, and when the Internal Revenue Service and the Treasury are the ones who define the scope of the penalty, seems to me to be problematic.

And finally, there is, a very practical side to this. There will be an awful lot of power bestowed on the IRS in the audit process by these kinds of proposals and that is something, too, that you have evidenced concern about in the past. No matter how much people say that this won't happen, the fact of the matter is that agents who are armed with these kinds of weapons will use them to extract concessions from taxpayers. I think you ought to be concerned about that.

Mr. NEAL. Mr. Lifson. Mr. Lifson, you were nodding in the affirmative. Do you want to comment, too?

Mr. LIFSON. I would say that what petrifies the American Institute of CPAs is the effect of this legislation on a whole broad class of unintended participants, which are small business people and bestowing IRS agents with this extra level of authority absolutely petrifies us. On a second layer, the idea that it is a good idea to make a law that is fuzzy and nobody knows where they stand so they stand way back from the line, isn't consistent with our view of American justice.

Mr. NEAL. Thank you, Mr. Chairman.

Chairman HOUGHTON. Yes. Mr. Harkins. You run a business and you are concerned about a variety of things—the death tax and the independent contractor. Talk a little bit about those things.

Mr. HARKINS. Yes, Sir. The estate tax, death tax as we prefer to call it, is probably the most unfair tax there is. If a man works his whole life, pays his taxes, takes his after-tax income, hangs on to it, when he dies, the government, you know, sticks out their hand for another 37 to 55 percent of it. You know, the original intent of the law was to break up I guess large family monopolies. But I think it has been proven and the Joint Economic Committee study really made the point that the estate taxes cost almost $500 billion this century, or 3.2 percent of the stock of capital, reduction in capital in the country. The cost of compliance is about $23 billion, which is almost the same amount as the tax takes in. It destroys families; it destroys farms; it destroys small businesses.

Now that in my opinion is revenue-neutral. Now, I am not in favor of revenue-neutrality. I am in favor of less taxes being paid. You know, I think we have a projected surplus in this country and that surplus means that somebody has paid too much in taxes. And if somebody has paid too much in taxes, it would appear to me that the best thing to do would be to find a way to give some of it back. So I am totally not convinced by any revenue-neutrality logic.

I would like to see the AMT eliminated because it punishes small businesses, especially. A lot more than it punishes anybody else. I just studied the IRS for a year and I worked with them for 9 years and I don't trust the IRS to make tax law. Congress needs to make tax law and they need to make it very specific so it is not subject to interpretation because it just costs the system a lot of money when you let a bureaucrat make the law and that is what happens.

Chairman HOUGHTON. What about the independent contractor issue?

Mr. HARKINS. Well, I am concerned about that. Your legislation, Chairman Houghton, is excellent. When I served as a delegate to the White House Conference on Small Business in 1995, our No. 1 issue—and there were 2,000 small business owners from all over the country—and they all agreed that the No. 1 issue was the independent contractor issue. And what we said was we needed an objective standard. We were tired of the IRS interpreting the 20 common law factors. Because if you got, you know, 11 of them right or maybe you got 19 of them right and one of them wrong, then you were subject to reclassification. So there was a lot of uncertainty.

What we said was you need to make it objective. But then what you need to do is you need to have safe harbors for industries who have been established and who have thrived on certain interpretations of that classification. You can't just throw them to the dogs by allowing the Internal Revenue Service to write regulations.

And I assure you, if you let the Internal Revenue Service decide who is an employee and who is an independent contractor, there will be no independent contractors. They will all be employees because that is the line of least resistance with the Internal Revenue Service and it gives them the ability to collect more revenue which is what their job is. They are going to maximize revenue to the detriment of the taxpayer.

Chairman HOUGHTON. OK. What—I don't know how you feel about this, Mr. Neal, but I would like to end up with 4, or 5, or 10, specific things we can do to start this tax simplification process. As I mentioned earlier, we have got to be careful of the money, because we will just run up against a stone wall here. I have heard a lot of things; we have your testimony.

I think it might be helpful—I hate to throw more work at you, but obviously you have invested enough as it is. However, I would appreciate your giving Mr. Neal and myself, a one-pager in terms of those specific things that you think are important, priority-wise, that will go with our report, and then we will take a look at our respective legislation and see what we can do together on this thing. I think if there ever was a time to do something, it is now, while the economy is going particularly well.

[The information was not available at the time of printing.]

Mr. NEAL. Mr. Chairman, just a quick observation. To have a Democrat propose eliminating the AMT is a good starting point. It seems to me that—I have talked with Mr. Archer a couple of times about this. He is all excited about that aspect of it. I think our goal is to convince him that there are other aspects of this that are doable as well.

Chairman HOUGHTON. OK. That is your No. 1. I don't disagree with it either. Have you got any other comments to make.

Mr. HARKINS. Sure. Mr. Chairman, pardon me, but I do have one issue that I think could be revenue-neutral, as Mr. Neal would——

Mr. NEAL. You were against that a few minutes ago, Mr. Harkins.

Mr. HARKINS. No, but I am just—let me explain this, Sir. Is the capitalization, increase in capitalization for businesses? You know, if a business buys a piece of equipment for $10,000 and they have to depreciate it over 10 years, now they end up getting $1,000 a year in write-offs for that piece of equipment over the 10 years. If you let them expense that piece of equipment in year one, they would get to keep more of their money, but, in fact, they end up paying the same amount of tax.

So it really—all it gives them is a break in the first year, which increases their working capital, which increases their ability to create jobs and to stimulate the economy, but yet it costs the Federal Government nothing except you might say, "Well, what is the interest on the money that you would have gotten in the first year versus in the second or third or fourth?" But, in my opinion, that is a very simple way of doing two good things without creating any problems for the budget process. But perhaps I am naive to think that.

Chairman HOUGHTON. I don't think you are naive, but I do think we have problems with that. I mean, the whole structure of the concept of long-term pay-out and short-term is at risk here. I wish, as a matter of fact, that we had the reverse in the Federal Government, because you have to expense everything. It is a cash system rather than an accrual system, and we get all tangled up in our scabbard on this thing. But let us take it into account, and if you feel strongly about this, maybe you can put that into your one-pager.

Mr. HARKINS. Yes, Sir. Thank you.

Chairman HOUGHTON. Anything else? Any other comments?

Mr. TUCKER. Just, I guess, there are two other items. No. 1, we would ask at the Tax Section of the ABA that, as you think through these items, that you not add more exceptions and more complexities and more phaseouts, because we are concerned that what you may see on the one hand as burden reduction creates more complexity and not more simplification.

Second, I think if we were to have our most-favored list, we would certainly focus on the alternative minimum tax and its elimination.

Chairman HOUGHTON. Right.

Mr. TUCKER. But if you can't eliminate it, there are some major concerns that every taxpayer has, including, particularly, the loss of itemized deductions and personal exemptions. Second, is the simplification of long-term capital gains and short-term capital

gains and simplifying the rules. I mean, adding all the lines as a result of the 1997 Act had absolutely no benefit for anybody. And, third, we would look at the ability to eliminate the phaseouts. And I recognize that they are considered an offset to certain things, but I think really focusing on maybe rate brackets rather than phaseouts in a number areas and not just PEP and Pease would be very important.

Mr. STEUERLE. Mr. Chairman, can I also suggest that your efforts and yours, Mr. Neal, to make a bipartisan bill is extremely important. It is so much easier. Having served at Treasury, I can tell you, and perhaps Hank can tell you from the Joint Committee perspective that it is much more easy, in a bipartisan context, to pull together staff from different places to work together and really pull together. There are a lot of people at Treasury, the Joint Committee, ABA, the ICPA, National Tax Association, other places, who have no agenda at all.

They can sit down and they can list items that are on these lists, on other lists. They can tell you the ones they agree with. They can say, "Well, you know, this pushes a little bit toward simplifying, but we think you might have some equity concerns." With a deliberate bipartisan effort, you could come up with a longer list and build some momentum.

Just as a trivial example, I have suggested a number of simplifications in the area of charitable deductions that I don't think cost revenue. You could add those to the bill. That might build you a little momentum in the charitable community. So there are a lot of areas where you could think about expanding what I think all of us at this table feel is a very, very commendable process.

Mr. LIFSON. You know, from the AICPA's perspective, we also have a list to further what you are saying, of simplification ideas that could lead to greater tax compliance. Now if you can combine simplification with improved tax compliance so that people pay their taxes more voluntarily than they do now and move your rate from 86 percent to 87 or 88 percent and attack people that are not paying the right amount of tax now, then sometimes your simplification vehicle can be a revenue-positive item without hurting anybody in the political structure.

Chairman HOUGHTON. Well, I think there are certain, fundamentals here. I think I can speak for you Rich; we are really serious about this. I mean, this isn't just a hearing to have a report and go on; we really are serious and, also, I think we are serious about doing something important. You know, time is the most precious thing we have and we ought to use it. If it is important, it must be bipartisan, because on any big issue, you know, one party can't do it.

So, gentlemen, thank you very much for your time and your great thoughtfulness in these reports; I hope to hear from you. Thank you.

[Whereupon, at 4:25 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

Statement of American Network of Community Options and Resources, Annandale, VA

INTRODUCTION AND OVERVIEW

This testimony outlines the comments and suggestions of the American Network of Community Options and Resources ("ANCOR") relating to the current complexity of section 131 of the Code of 1986, as amended (the "Code"), which provides rules on the tax treatment of foster care payments received by individual taxpayers.

ANCOR was formed in 1970 to improve the quality of life of persons with disabilities and their families by coordinating the efforts of concerned providers of private support services. ANCOR is comprised of more than 650 organizations from across the United States together providing community support to more than 150,000 individuals with disabilities.

ANCOR strongly recommends that section 131 of the Code be amended to eliminate current law's complexity by uniformly allowing individual taxpayers to exclude from income the foster care payments they receive from State and local governmental sources. ANCOR believes that amending section 131 in this manner would (i) simplify the tax treatment of foster care payments for individual taxpayers, (ii) eliminate an impediment to State and local governmental efforts to reduce bureaucracy and costs for their foster care programs, and (iii) support State and local governmental efforts to encourage much-needed individuals to participate in foster care programs.

DESCRIPTION OF CURRENT LAW AND PROPOSAL

Current Law

Section 131 of the Code as it currently exists creates a complex dichotomy in the tax treatment of individuals who serve as foster care providers for individuals in foster care under 19 years of age and for those who provide treatment to individuals in foster care over 19 years of age. For children under 19 years old, section 131 of the Code permits individual taxpayers to exclude foster care payments from taxable income when a government entity or charitable tax-exempt organization directly places the child and makes the foster care payments to the provider. For individuals 19 years of age or older, section 131 allows an individual taxpayer to exclude foster care payments from taxable income only when a governmental entity makes the placement and the payment. Thus, an individual's ability to exclude foster care payments, even if all such payments are derived from government funds, is linked to the type of agency that places the individual with the provider.

Proposed Change

Congress should amend section 131 to allow all individuals who serve as providers of foster care the ability to exclude from income those foster care payments that they receive from a governmental source, regardless of whether a governmental entity placed the individual, provided that a governmental entity has either certified or licensed the placement agency. Amending section 131 in such a way would not only simplify the tax treatment of foster care payments and reduce the administrative burden on the Internal Revenue Service ("IRS"), but the change would also support the efforts of State and local governments to address the needs of their communities more effectively.

A. *Current law is confusing to taxpayers and to the IRS.* As illustrated by Table 1, incongruent treatment of individual taxpayers who are foster care providers has created a complex system for determining when such providers can exclude their foster care payments from income.

Table 1.—Excludability of Foster Care Payments from Income Under Section 131

Placement Agency	Payor	Age of Foster Care Individual	Payment Excludable?
State or political subdivision.	State or political subdivision	<19 years	Yes
State or political subdivision.	State or political subdivision	≥19 years	Yes
State or political subdivision.	501(c)(3)	<19 years	Yes

Table 1.—Excludability of Foster Care Payments from Income Under Section 131—Continued

Placement Agency	Payor	Age of Foster Care Individual	Payment Excludable?
State or political subdivision.	501(c)(3)	≥19 years	No
State or political subdivision.	Not 501(c)(3)	<19 years	No
State or political subdivision.	Not 501(c)(3)	≥19 years	No
Licensed 501(c)(3)	State or political subdivision	<19 years	Yes
Licensed 501(c)(3)	State or political subdivision	≥19 years	No
Licensed 501(c)(3)	501(c)(3)	<19 years	Yes
Licensed 501(c)(3)	501(c)(3)	≥19 years	No
Licensed 501(c)(3)	Not 501(c)(3)	<19 years	No
Licensed 501(c)(3)	Not 501(c)(3)	≥19 years	No
Not 501(c)(3)	State or political subdivision	<19 years	No
Not 501(c)(3)	State or political subdivision	≥19 years	No
Not 501(c)(3)	501(c)(3)	<19 years	No
Not 501(c)(3)	501(c)(3)	≥19 years	No
Not 501(c)(3)	Not 501(c)(3)	<19 years	No
Not 501(c)(3)	Not 501(c)(3)	≥19 years	No

The confusion presented by current law is exemplified by the recent Tax Court decision in *Micorescu* v. *Commissioner*, T.C. Memo 1998–398. In *Micorescu*, the court held that an Oregon family providing foster care services to adults in the family's home could not exclude from income payments received from the private agency that placed the individuals with the family. The court reasoned that because the adult individuals were placed with the family by a private agency rather than by the State or an agency of the State, those individuals were not "qualified foster individuals" within the meaning of section 131. The court reached this conclusion even though the organization that placed the adults in the family's home both contracted with and received funds from the State of Oregon. Equal treatment of all families providing foster care services (i) who receive payments from an agency that operates under a license or certification by a government entity or (ii) who receive payments directly from a government entity would reduce the confusion that currently exists. Provider families, like the family involved in the *Micorescu* case, would know with certainty whether they could exclude their income.

Individual taxpayers are not alone in their confusion. Section 131 has proven so confusing that our members have reported many instances in which IRS officials and experienced certified public accountants and tax attorneys also have difficulty ascertaining when a payment is excludable. Our members can site various examples of situations in which individual providers have been told informally by an IRS official and/or an experienced tax advisor that their foster care payments were to be excluded from taxable income, when in fact those payments were not excludable. Amending section 131 would, therefore, prevent not only the confusion individuals and their tax advisors have over whether foster care payments are excludable, but also the confusion experienced by the IRS officials that are charged with administering the law.

B. *Current law fails to support the decisions of State and local governments.* Governmental entities are becoming increasingly reliant on private agencies to place both children and adults with special needs in foster care. Governmental entities have found that foster care for adults with special needs reduces the expense that is usually incurred when maintaining group homes and institutional settings. In particular, the National Association of State Directors of Developmental Disabilities Services has found that over the past several years there has been a considerable increase in pressure on state agencies to reduce waiting lists. Additionally, State and local governments often use outside entities to make case-specific decisions (such as identification of those individuals who would benefit from foster care and those providers with whom such individuals should be placed) as a means of reducing bureaucracy in an already trying situation. Current law, however, fails to provide the same tax treatment to those individuals identified by private entities acting under a license or certification with States, counties and municipalities as is provided to individuals that are identified directly by the State. Disparate treatment exists despite the fact that from the governmental entities' perspectives, the activities are the same. As a result of the difference in treatment, State and local governments are discouraged from contracting with private agencies to make placement

decisions. The tax code should support State and local governments that decide to cut costs, reduce bureaucracy and support individuals with special needs in their communities through expanding their foster care programs.

C. *Current treatment of foster care payments discourages much-needed individuals from participating in foster care programs.* The confusion created by section 131's complex rules discourages many potential foster care individuals from participating in these programs. Despite the fact that individual taxpayers could, under these rules, offset taxable foster care payments (paid by non-qualified agencies) by treating expenditures made on behalf of a foster individual as a business expense deductions, such deductions are permitted only if the families maintain detailed expense records. Accordingly, otherwise willing providers are discouraged from accepting foster individuals placed by non-qualified agencies, because such providers are forced to endure the time and inconvenience associated with keeping extensive records. The result is a smaller pool of available, qualified and willing providers and a growing pool of individuals with special needs for whom group housing or institutional living is inappropriate. Amending section 131 as suggested would help address the increasing demand for providers of foster care services.

D. *Legislation introduced this year would remedy these problems.* Bills were introduced in the House (H.R. 1194) and in the Senate (S. 670) that propose to simplify the current rules under section 131 for individuals receiving foster care payments. These bills would allow individual providers to exclude from income foster care payments received, regardless of the age of the individual in foster care and the type of entity that placed that individual. The exclusion would apply only if either (i) a state or local government or (ii) a "qualified foster care placement agency" made the foster care payments. Such payments would have to be made pursuant to a foster care program of such governmental entity. Further, to be qualified, a foster care placement entity would have to be licensed or certified by a state or local government to make foster care payments to providers of foster care.

CONCLUSION

ANCOR recommends amending section 131 of the Internal Revenue Code so that all governmental foster care payments received by individual taxpayer providers are treated the same. If enacted, current law's confusing and unfair tax rules would no longer discourage much-needed individual providers from participating in foster care programs. Amending section 131 in this fashion also will support State and local governments in their efforts to reduce bureaucracy and cut costs, provide more alternatives to institutionalization, while simplifying tax administrative burdens.

Statement of Associated General Contractors of America (AGC)

The Associated General Contractors of America (AGC) is pleased to provide the House Ways and Means Subcommittee on Oversight with this written statement on the "Impact of Complexity in the Tax Code on Individual Taxpayers and Small Businesses." AGC is the nation's largest and oldest construction trade association, founded in 1918. AGC represents more than 33,000 firms, including 7,500 of America's leading general contracting firms. AGC's general contractor members have more than 25,000 industry firms associated with them through a network of 101 AGC chapters. AGC member firms are engaged in the construction of the nation's commercial buildings, factories, warehouses, highways, bridges, airports, waterworks facilities, waste treatment facilities, dams, water conservation projects, defense facilities, multi-family housing projects, site preparation, and utilities installation for housing developments.

While AGC's membership is diverse, the majority of AGC firms are closely-held businesses. AGC member firms are 94% closely-held, 81% are owned by fewer than four persons, and over 80% are small businesses with an average construction project size under $5 million.

AGC supports tax simplification for general contractors in the following complex tax areas:

LOOKBACK METHOD OF ACCOUNTING

AGC supports efforts in Congress to eliminate the burdensome lookback method of accounting for long-term construction contracts.

The 1986 Tax Act extensively revised the methods of accounting available for long-term contracts, including enactment of a provision mandating the use of the

lookback method for all long-term contracts accounted for on the percentage of completion method of accounting (PCM). The lookback method of accounting was adopted to address abuses in the application of the PCM in other industries that have long-term contracts spanning many years. The lookback method essentially requires a construction contractor to file amended tax returns each year for every prior year in which a currently completed contract was in progress. It also requires similar amendments for every year in which post completion changes occur. The difference between the theoretical taxes that would have been due if all facts were known in the year the contract was entered into, and the taxes actually paid in prior years, is calculated. Interest is then calculated on this change in prior-year tax liabilities. The lookback method does not result in any change in total tax liability. It does result in an interest adjustment based on this theoretical change in tax liabilities.

The lookback method is exceedingly complex. It imposes tremendous compliance and administrative burdens on construction contractors. The lookback method diverts valuable time, labor, and resources of construction financial and accounting professionals from worthwhile functions. The lookback method is exceedingly burdensome for all construction contractors, but it poses special problems for smaller contractors that have to hire outside accounting experts in order to calculate lookback.

The Taxpayer Relief Act of 1997 attempted to address this issue by providing an election to forego application of the lookback method if the estimated gross profit recognized in each contract falls within 10 percent of the retroactively determined gross profit for each year the contract was in progress. However, this provision provides no relief from the paperwork burden. Election to apply this provision requires most of the above calculations as well as additional calculations in order to determine whether each contract falls within this 10 percent variance in each prior year.

The lookback method is an overwhelming burden for both small and large contractors. Further, many contractors receive refunds of interest, which, in AGC's estimation, makes this a revenue loser for the Department of Treasury.

PERCENTAGE OF COMPLETION METHOD OF ACCOUNTING

The Tax Reform Act of 1986 revised the long-term contract accounting rules for contractors. These rules—contained in Section 460 of the Internal Revenue Code—place unfair burdens on smaller contractors and should be modified by Congress to account for inflation growth since 1986.

In 1986, Congress enacted changes to the Internal Revenue Code (Section 460) requiring contractors to use the percentage of completion accounting method for reporting taxable income from long-term contracts. Long-term contracts are contracts for the manufacturing, building, installation, or construction of property that are not completed within the tax year in which they are entered into. The percentage of completion method requires contractors to calculate what percentage of the contract is complete in a tax year and then pay taxes on that percentage. Prior to the 1986 change, a contractor could pay taxes on their income from a long-term contract when the contract was completed.

The 1986 tax law change was intended to prevent large contractors from deferring taxes for years on large contracts. Congress created an exception to Section 460 for smaller contractors. Those contractors whose contracts will be completed within two years of the contract commencement date, and whose average annual gross receipts for the three tax years preceding the tax year the contract is entered into do not exceed $10 million, are exempt from the percentage of completion requirements.

Unfortunately, the $10 million threshold was not indexed for inflation. Today, more and more small contractors are crossing this threshold and are being forced into the burdensome and costly percentage of completion method. Congress clearly recognized the burden this change places on smaller contractors forced to switch to the percentage-of-completion method. AGC advocates that the $10 million exemption be updated to account for inflation since 1986.

CASH METHOD OF ACCOUNTING

AGC recognizes the cash method of accounting as a legitimate accounting method for small contractors that adhere closely to the Internal Revenue Code. AGC advocates clarifying that construction materials are not "merchandise" or "an income producing factor," updating the small business exemption and mitigating unreasonable retroactive penalties. AGC strongly supports legislation by Chairman Houghton to update the threshold for cash accounting to $10 million. AGC also supports legislation by Chairman Jim Talent of the Small Business Committee to clarify that businesses under $5 million can use the cash method regardless of IRS inventory or merchandise tests.

For small contractors, the cash method of accounting is the most practical method because it recognizes income and expenses when the cash is actually paid to the company or by the company. The accrual method requires recognition of income before the cash is received; that is, income is recognized when the right to the money arises even though it may never ultimately be received. Under the accrual method, the company is required, in effect, to pay taxes with money it doesn't have, which can be quite a burden for small contractors. The IRS has long favored the accrual method over the cash method, with little thought of small businesses that often find the accrual method a financial burden.

Although I.R.C. § 448 places limitations on the use of the cash method of accounting, a specific exception is provided for entities with average annual gross receipts of $5 million or less for three previous taxable years. Accordingly, small contractors should be able to use the cash method of accounting. The IRS has largely ignored the $5 million exception for small contractors and has aggressively sought to enforce the accrual method on small contractors. The IRS has done so by requiring contractors to inventory on-site supplies, because the IRS says that these supplies are an income-producing factor. Once the IRS requires an inventory to be kept, then a small contractor must switch to the accrual method and even pay substantial underpayment penalties.

In a nutshell, the IRS is attempting to ignore certain sections of the Internal Revenue Code which allow the cash method, thus giving the IRS the luxury of using the method of accounting that most aggressively accelerates revenue recognition. The IRS position on the cash method ignores the sections of the Internal Revenue Code specifically allowing corporations with average annual gross revenues of less than $5 million to use the cash method of accounting. Regardless of what the Internal Revenue Code clearly states, the IRS has continued its assault on small contractors by administratively repealing the $5 million protective statute.

ALTERNATIVE MINIMUM TAX RELIEF

AGC supports total elimination of the alternative minimum tax. Short of total elimination, AGC supports legislative relief from the burdensome calculations required of smaller contractors under the alternative minimum tax. In this regard, AGC legislation by Chairman Houghton to increase the AMT gross receipts exemption for small businesses from $7.5 million to $10 million.

The computation of AMT is administratively complex and inhibits the formation of capital, including complicating equipment and property acquisition decisions. The AMT long-term contract adjustment was enacted to require large contractors to report certain income from long-term contracts using the percentage-of-completion method (PCM). The AMT requires contractors with long-term contracts at their fiscal year end that are not subject to current regular taxation to add back to regular taxable income the unreported gross profit on the long-term contracts, and subject the long-term gross profit to an alternative minimum tax of 20% for corporate taxpayers or 28% for individual taxpayers. Therefore, a contractor is currently required to make the difficult and time-consuming cost-to-cost percentage-of-completion calculations for every long-term contract in progress at the fiscal end.

The Taxpayer Relief Act of 1997 provided relief for a number of small contractors from the alternative minimum tax. The Act allowed C corporations with three-year average gross receipts of $5,000,000 or less with tax years beginning after December 31, 1996 to be exempt from the alternative minimum tax. This law allowed these corporate contractors to grow their business to a three-year average of $7,500,000 before they would once again become subject to the alternative minimum tax. However, S corporations and non-corporate contractors with the same three-year average of gross receipts continue to remain subject to the alternative minimum tax.

Due to changes in the tax code following 1986, primarily small contractors are the only taxpayers subject to the AMT long-term contract adjustment. Small contractor's contracts typically are completed within one year, so any deferral is realized within the following year. The tax effect of any deferral cannot be abusive for small contractors.

Thank you for this opportunity to submit this statement to the Ways and Means Subcommittee on Oversight.

Statement of Hon. Christopher S. "Kit" Bond, a U.S. Senator from the State of Missouri

Mr. Chairman and Members of the Subcommittee, I am pleased to submit this statement regarding the need for tax simplification. As the Chairman of the Senate Committee on Small Business, I am particularly concerned about the burden our overly complicated tax code places on small businesses and the self-employed. Over the past several years, my Committee has focused considerable attention to this issue, most recently with a hearing on April 12, 1999, to examine the tax filing and reporting burdens that small-business owners face nearly every day. What my Committee learned in that hearing was nothing short of startling. According to the General Accounting Office, a small-business owner faces more than 200 IRS forms and schedules that could apply in a given year. While no business will have to file them all, it is a daunting universe of forms, including more than 8,000 lines, boxes, and data requirements, which are accompanied by over 700 pages of instructions.

Even more surprising was that 76% of small-business owners in 1995 (the most recent data available) hired a tax professional to help them fulfill their tax obligations. When we consider the complexity of the forms, rules and regulations, no one should be surprised. And these tax professionals are far from inexpensive. By some estimates, small-business owners pay more than 5% of their revenues just to comply with the tax law—five cents out of every dollar to make sure that all of the records are kept and the forms completed—all before the tax check is even written. In light of these burdens, I commend the Subcommittee for addressing this important issue.

While the list of tax provisions crying out for simplification has grown considerably in recent years, I shall focus on a particularly troubling and long-standing area of complexity for America's businesses and entrepreneurs—the status of independent contractors.

A New Business Paradigm

Throughout this decade, there has been an important shift in the American workplace, with an increasing emphasis on independent business relationships. The traditional single-employer career is rapidly being supplanted by independent entrepreneurs who provide specialized services on an "as needed" basis. They seek out individual contracts, apply their expertise, and move onto the next opportunity, bound only to their creativity and stamina. The members of this new workforce are often described as independent contractors, temps, freelancers, self-employed, home-based businesses, and even free agents. Whatever their title, they are a rapidly growing segment of our economy and one that cannot be ignored.

There are a number of reasons for this new business paradigm. Recent innovations in computer and communication technology have made the "virtual" office a reality and allow many Americans to compete in marketplaces that a few years ago required huge investments in equipment and personnel. In addition, many men and women in this country have turned to home-based business in an effort to spend more time with their children. By working at home, these families can benefit from two incomes, while avoiding the added time and expense of day-care and commuting. Corporate downsizing, glass ceilings, and company politics, too, contribute to the growth in this sector as many skilled individuals convert their knowledge and experience from corporate life into successful enterprises operated on their own.

The rewards of being an independent entrepreneur are also numerous. The added flexibility and self-reliance of having your own business provide not only economic rewards but also personal satisfaction. You are the boss: you set their own hours, develop your own business plans, and choose your customers and clients. In many ways, this new paradigm provides the greatest avenue for the entrepreneurial spirit, which has long been the driving force behind the success of this country.

With these rewards, however, come a number of obstacles, not the least of which are burdens imposed by the Federal Government. In fact, the tax laws, and in particular the Internal Revenue Service (IRS), are frequently cited as the most significant problems for independent entrepreneurs today. Changes in tax policy must be considered by this Congress to recognize this new paradigm and ensure that our laws do not stall the growth and development of this successful sector of our economy.

Legislative Advances

In the last two Congresses, we have made substantial headway on a number of tax issues critical to these independent entrepreneurs. In the Taxpayer Relief Act

of 1997, we restored the home-office deduction putting home-based entrepreneurs on a level-playing field with storefront businesses. The Small Business Job Protection Act of 1996 and the Taxpayer Relief Act also made some important strides forward on the unbelievably complex pension rules so that the freelance writer, home-based webpage designer, and other small businesses have the opportunity to plan for their retirement as they see fit. Finally, and arguably most importantly, through several pieces of legislation in the last four years, we have finally made the self-employed health-insurance deduction permanent and placed it on a path to full deductibility by 2003—still four years too long in my view. These examples are just a few of the tax law changes that are helping men and women who chose to work as independent entrepreneurs to enjoy a level-playing field with their larger competitors and still maintain the flexibility of their independent business lives.

CLASSIFICATION BURDENS

Amid this progress, however, one glaring problem still remains unsolved for this growing segment of the workplace—there are no simple, clear and objective rules for determining who is an independent contractor and who is an employee. As the Chairman of the Senate Committee on Small Business, I have heard from countless small-business owners who are caught in the environment of fear and confusion that now surround the classification of workers. This situation is stifling the entrepreneurial spirit of many small-business owners who find that they do not have the flexibility to conduct their businesses in a manner that makes the best economic sense and that serves their personal and family goals.

The root of this problem is found in the IRS' test for determining whether a worker is an independent contractor or an employee. Over the past three decades, the IRS has relied on a 20-factor test based on the common law to make this determination. On first blush, a 20-factor test sounds like a reasonable approach—if our home-based webpage designer demonstrates a majority of the factors, she is an independent contractor. Not surprisingly, the IRS' test is not that simple. It is a complex set of extremely subjective criteria with no clear weight assigned to any of the factors. As a result, small-business taxpayers are not able to predict which of the 20 factors will be most important to a particular IRS agent, and finding a certain number of these factors in any given case does not guarantee the outcome.

To make matters worse, the IRS' determination inevitably occurs two or three years after the parties have determined in good faith that they have an independent-contractor relationship. And the consequences can be devastating. For example, the business that contracts with a freelance writer is forced to reclassify the writer from an independent contractor to an employee and must pay the payroll taxes the IRS says should have been collected in the prior years. Interest and penalties are also piled on. The result for many small businesses is a tax bill that bankrupts the company. But that is not the end of the story. The IRS then goes after the freelance writer, who is now classified as an employee, and disallows a portion of her business expenses—again resulting in additional taxes, interest and penalties.

Mr. Chairman, all of us recognize that the IRS is charged with the duty of collecting federal revenues and enforcing the tax laws. The problem in this case is that the IRS is using a procedure that is patently unfair and subjective and one that forces today's independent entrepreneurs into the business model of the 1950s. The result is that businesses must spend thousands of dollars on lawyers and accountants to try to satisfy the IRS' procedures, but with no certainty that the conclusions will be respected. That is no way for businesses to operate in today's rapidly changing economy.

For its part, the IRS has adopted a worker-classification training manual, which according to then-Commissioner Richardson is an "attempt to identify, simplify, and clarify the relevant facts that should be evaluated in order to accurately determine worker classification. . . ." While I applaud the agency's efforts to address this issue, the manual represents one of the most compelling reason for immediate action. The IRS' training manual is more than 150 pages in length, riddled with references to court cases and rulings. If it takes that many pages to teach revenue agents how to "simplify and clarify" this small-business tax issue, I think we can be sure how simple and clear it is going to seem to the independent day-care provider who is trying to figure it out on her own.

INDEPENDENT CONTRACTOR SIMPLIFICATION AND RELIEF ACT OF 1999

In recognition of the new paradigm and the IRS' archaic 20-factor test, I introduced in the Senate earlier this year S. 344, the "Independent Contractor Simplification and Relief Act of 1999." I understand that a companion bill will be introduced in this body shortly. My bill removes the need for so many pages of instruc-

tion on the IRS' 20-factor test by establishing clear rules for classifying workers based on objective criteria. Under these criteria, if there is a written agreement between the parties, and if our freelance writer demonstrates economic independence and independence with respect to the workplace, based on objective criteria set forth in the bill, she will be treated as an independent contractor rather than an employee. And the service recipient will not be treated as an employer. In addition, individuals who perform services through their own corporation or limited-liability company will also qualify as independent contractors as long as there is a written agreement and the individuals provide for their own benefits.

The safe harbor is simple, straightforward, and final. To take advantage of it, payments above $600 per year to an individual service provider must be reported to the IRS, just as is required under current law. This will help ensure that taxes properly due to the Treasury will continue to be collected.

The IRS contends that there are millions of independent contractors who should be classified as employees, which costs the Federal Government billions of dollars a year. This assertion is plainly incorrect. Classification of a worker has no cost to the Government. What costs the Government are taxpayers who do not pay their taxes. The Independent Contractor Simplification and Relief Act has three requirements that will improve compliance among independent contractors using the new rules we propose. First, there must be a written agreement between the parties—this will put the home-based webpage designer on notice at the beginning that she is responsible for her own tax payments. Second, the new rules will not apply if the service recipient does not comply with the reporting requirements and issue 1099s to individuals who perform services. Third, an independent contractor operating through his own corporation or limited-liability company must file all required income and employment tax returns in order to be protected under the bill.

In the last Congress, concerns were raised that permitting individuals who provide their services through their own corporation or limited-liability company to qualify as independent contractors would lead to abusive situations at the expense of workers who should be treated as employees. To prevent this option from being abused, I have added language that limits the number of former employees that a service recipient may engage as independent contractors under the incorporation option. This limit will protect against misuse of the incorporation option while still allowing individuals to start their own businesses and have a former employer as one of their initial clients.

Much has also been made of the improperly classified employee who is denied benefits by the unscrupulous employer. This issue raises two important points. First, the legislation that I have introduced would not facilitate this troubling situation. Under the provisions of our bill, it is highly doubtful that a typical employee, like a janitor, would qualify as an independent contractor. In reality, this issue relates to enforcement, which our bill simply makes easier through clear and objective rules. Second, the issue of benefits, like health insurance and pension plans, is extremely important to independent entrepreneurs. But the answer is not to force them to all be employees. Rather, we should continue to enact legislation like the Small Business Job Protection Act, the Taxpayer Relief Act, and the tax provisions of last fall's omnibus appropriations bill, that permit full and immediate deductibility of health insurance for the self-employed and better access to retirement savings plans.

REPEAL OF SECTION 1706

A special concern of technical-service providers, such as engineers, designers, drafters, computer programmers, and systems analysts is section 1706 of the 1986 Tax Reform Act. In certain cases, Section 1706 precludes businesses engaging individuals in these professions from applying the reclassification protections under section 530 of the Revenue Act of 1978. When section 1706 was enacted, its proponents argued that technical-service workers were less compliant in paying their taxes. Later examination of this issue by the Treasury Department found that technical-service workers are in fact more likely to pay their taxes than most other types of independent contractors. This revelation underscores the need to repeal section 1706 and level the playing field for individuals in these professions.

In the last two Congresses, proposals to repeal section 1706 enjoyed wide bipartisan support. The Independent Contractor Simplification and Relief Act is designed to level the playing field for individuals in these professions by providing the businesses that engage them with the same protections that businesses using other types of independent contractors have enjoyed for more than 20 years.

RELIEF FROM RETROACTIVE RECLASSIFICATION

Another major concern of many businesses and independent entrepreneurs is the issue of reclassification. My bill provides relief to these taxpayers when the IRS determines that a worker was misclassified. Under S. 344, if the business and the independent contractor have a written agreement, if the applicable reporting requirements were met, and if there was a reasonable basis for the parties to believe that the worker is an independent contractor, then an IRS reclassification will only apply prospectively. This provision gives important peace of mind to small businesses that act in good faith by removing the unpredictable threat of retroactive reclassification and substantial interest and penalties.

Mr. Chairman, the Independent Contractor Simplification and Relief Act is a common-sense measure that answers the urgent plea from independent entrepreneurs and the businesses that engage them for fairness and simplicity in the tax law. As we work toward the day when the entire tax law is based on these principles, we can make a positive difference today by enacting this legislation.

TROUBLING ALTERNATIVES

Until recently, those that opposed positive improvements like the Independent Contractor Simplification and Relief Act have mainly expressed their objections and preferred to maintain the status quo—an alternative that few have been eager to embrace.

With the introduction of H.R. 1525 by Congressman Kleczka and Chairman Houghton, a new alternative has been put on the table. While I am pleased that we now have broader recognition that worker classification is a problem in need of a solution, I am troubled by the regressive nature of this bill. From my reading, H.R. 1525 will rollback the progress we have made in the last 21 years in recognition of independent entrepreneurs and their contribution to the unprecedented growth of our economy. Instead, the Federal Government would dictate business relationships through the tax code—an alternative that we cannot afford to embrace.

My concerns about this legislation are three-fold. First, as its title suggests, the bill is intended to "clarify" the independent contractor rules. Regrettably, it accomplishes that objective by establishing a presumption that everyone is an employee until proven otherwise. While seemingly simple, such a presumption would abandon all hope of neutral worker-classification rules and put independent entrepreneurs at an even greater disadvantage than they are today.

Second, according to the bill's author, all one need do to rebut the presumption is satisfy "a simple, easy to understand 3 point test." Upon taking a closer look, an independent entrepreneur like our home-based webpage designer is likely to be nonplused. One part of the test is indeed clear cut—she must make her services available to other customers. A second requirement is more complicated—she must demonstrate "entrepreneurial risk." The final requirement is the antithesis of simplicity—she must demonstrate that her client has no "control" over the webpage she designs.

Unfortunately for the independent entrepreneur, the bill does not define what constitutes "entrepreneurial risk" or "control." These two terms are exactly what the IRS' subjective 20-factor test was designed to determine. But under H.R. 1525, our webpage designer will no longer be able to rely on the common-law precedents underlying the 20-factor test. Instead, the Treasury Department and the IRS will once again be permitted to write all the rules and regulations. With the events leading up to the Revenue Act of 1978, which established the ban on Treasury and IRS regulations concerning independent contractors, I have a good idea how fair and unbiased those rules will be for our independent entrepreneur.

Third, H.R. 1525 repeals section 530 of the Revenue Act of 1978. For the last two decades this provision has been the only protection for businesses that utilize independent contractors. It is by no means a simple test to meet, but it permits small businesses and the independent contractors they utilize to rely on established industry practice as a roadmap for classifying their business relationships. By removing this protection, the value of which Congress reaffirmed with the 1996 legislative modifications, the bill will put countless businesses at the mercy of the IRS. With the extraordinary efforts over the last two years to improve taxpayer rights and IRS' customer service, do we really want to magnify the environment of fear surrounding worker classification, let alone expose even more businesses to huge tax bills at the whim of the IRS?

One final point on H.R. 1525. Buried under the ostensible simplicity of the bill's requirements is an enormous hidden cost for small businesses and independent contractors. These individuals will have to spend more time and hire even more expensive lawyers and accountants just to sort out all of the undefined terms of the bill,

not to mention the cost of proving that a particular business relationship meets the bill's strict requirements for recognition of an independent-contractor relationship. That time and money will not produce a single job and will contribute nothing to our economy or society. It is simply time taken away from the business and money thrown down the drain.

CONCLUSION

For too long, independent entrepreneurs and the businesses with which they work have struggled for a neutral tax environment. For an equally long time, that tax environment has been unfairly and unnecessarily biased against them. It is well past time that the tax code embraces one of the fundamental tenets of our country—the free market. We must allow individuals the freedom to pursue new opportunities in the ever-changing marketplace through business relationships that make the best sense for them. Our tax code should facilitate those opportunities through fair and simple rules that permit the freelance writer, home-based webpage designer, and every other independent entrepreneur to pay their taxes without undue interference from the Government. Trying to force today's dynamic workforce into a 1950s model serves no one and only stands to stifle the entrepreneurial spirit in this country and dampen the continued success of our economy.

Thank you for the opportunity to present my views on this critical issue for independent entrepreneurs in this country.

Statement of Hon. Gerald D. Kleczka, a Representative in Congress from the State of Wisconsin

Mr. Chairman, and members of the Subcommittee, I would like to take this opportunity to discuss H.R. 1525, the Independent Contractor Clarification Act of 1999. Working on a bipartisan basis, Chairman Houghton and I recently introduced H.R. 1525. Ten other members of the Ways and Means Committee joined us as original cosponsors of this legislation.

The bipartisan spirit of this legislation cannot be underestimated. Congress has struggled with this issue since 1978. Unfortunately, legislation introduced in recent years has tended to favor employers and only served to polarize the debate on this issue. Congressman Houghton and I have worked with groups representing both employers and employees for most of the past year to develop H.R. 1525.

The current 20 point test used to determine an individual's employment classification and the section 530 safe harbor are burdensome and unworkable. The 20 point test is a series of tests that provide employers with a general guideline as to how they are supposed to classify their workers. However, these tests do not provide employers with a clear definition of who is an independent contractor and who is an employee. This lack of clarity has led to countless workers being misclassified.

For example, one of the criteria used in the 20 point test is the level of training of the worker. Some have interpreted a level of training to be a college degree while others would argue it is a person's general work experience. Another criteria is furnishing significant tools and assets. For a computer programmer, significant equipment and assets might be an expensive computer system whereas in the case of a laborer an employer might deem a significant investment to be some basic tools.

The lack of clarity in the 20 point test has been compounded by the fact section 530 of the 1978 tax bill has prohibited the Department of Treasury from writing regulations to clarify the 20 test. Section 530 was intended to be a temporary, one-year solution to a dispute over the Department of Treasury's efforts to bring about the proper classification of workers. A few years later, section 530 was made permanent.

As a result of the lack of clear direction, many businesses have misclassified their workers as independent contractors. Such misclassifications have resulted in workers being denied essential benefits such as health coverage, a retirement plan, or the employer's share of FICA taxes. Workers who are actual employees and who work at the direction of and under the supervision of a superior are entitled to these benefits as part of their employment.

The Independent Contractor Clarification Act would replace the current 20 point test with a three point test. An individual would be classified as an independent contractor if the employer does not control the manner in which the individual completes his or her assigned tasks; the individual is able to solicit and undertake other business opportunities; and the individual encounters entrepreneurial risk. The last point would include the ability of the independent contractor to generate a profit or bear the risk of financial loss.

Detractors of the legislation have asserted that the three tests in H.R. 1525 is too vague and do nothing to clarify the employer-employee relationship. That is a red herring. In fact, other legislation that has been introduced on this issue would only add to the confusion by adding a layer of a new tests on top of the 20 point tests.

For example, S. 344, the Independent Contractor Simplification and Relief Act of 1999 was recently introduced by Senator Bond. S. 344 establishes a set of criteria to help businesses classify their workers as independent contractors. One of the criteria is whether a person "has a significant investment in assets." As I previously indicated, the concept of a significant investment in assets is already one of the most confusing aspects of the current 20 point test. Another criteria is whether a person "operates primarily from equipment not supplied by the service recipient." That can hardly be considered a clear, concise standard. Finally, S. 344 would not allow the Department of Treasury to provide any clarification to those new tests.

Instead of prolonging the confusion of current law, H.R. 1525 would move forward. By allowing the Department of Treasury to issue guidance, further clarification of the three criteria in H.R. 1525 will be developed. Congress, the Administration, and interested parties will have ample opportunity to express their views in this process. Congress will be able to write lengthy report language to specifically direct the Department of Treasury as to how the tests are to be interpreted. The issuance of regulations by the Department of Treasury will follow the established process of issuing proposed regulations, public hearings and comment on the proposed regulations, and final regulations.

I would also like to point out that any person who has a statutory exemption would maintain that exemption under H.R. 1525. For example, current law says that real estate agents and direct sellers such as newspaper delivery persons are independent contractors, and they would maintain that status under the Independent Contractor Clarification Act.

Finally, H.R. 1525 would give many businesses something they do not have under current law—protection from retroactive taxes. The single largest hurdle to employers reclassifying their workers as employees is the fear the IRS is going to take the reclassification as an admission of wrongdoing and, as a result, assess retroactive employment taxes. Under this legislation, the IRS would be prohibited from collecting back taxes if an employer meets certain criteria.

The effective date of this legislation is January 1, 2001. This is designed to give businesses a reasonable amount of time to implement the changes in the independent contractor statutes. Furthermore, any business that is told to reclassify its workers would have 60 days after final notification from the IRS to implement the change.

H.R. 1525 is a bipartisan solution to a difficult and longstanding problem. The Independent Contractor Clarification Act attempts to balance the interests of employers and their workers. If enacted, this legislation will provide employers the guidance they need to properly classify their workers. It will also serve the interests of hard-working Americans and their families.

Statement of National Association of Home Builders

On behalf of the 197,000 member firms of the National Association of Home Builders (NAHB), we would like to express our support for Congressman Amo Houghton convening a hearing on the impact of complexity in the tax code on individuals and small businesses. This issue is important to all taxpaying Americans who desire to comply with the tax code's thousands of confusing rules and regulations while at the same time operating a business or running a household. This hearing is both very timely and necessary and NAHB applauds the Chairman on his efforts.

CASH METHOD OF ACCOUNTING

NAHB would like to also support a key provision in the "Tax Simplification and Burden Reduction Act" that is sponsored by Subcommittee Chairman Amo Houghton. This provision would increase the gross receipt threshold for the cash method of accounting from $5 million to $10 million. Not only does Representative Houghton believe that the tax code is forcing far too many small businesses to use the accrual method instead of the cash method but builders and small contractors experience this costly and burdensome change annually.

Home builder subcontractors who supply both service and materials have traditionally used a cash method for tax accounting. The Internal Revenue Service (IRS) has a long history of enabling small contractors to use the cash method of comput-

ing taxes; however, the IRS has now begun to enforce a tax court ruling that requires these firms to use an accrual method of tax accounting. The result has been that some small firms must pay taxes on income not yet realized or are not allowed to deduct expenses actually paid. Some of the builders and small contractors do not have the cash available to pay taxes on funds that have not been received and these small firms are sometimes forced to close because of the tax change. The IRS code does allow service businesses with gross receipts of under $5 million per year to use the cash method of tax accounting and NAHB would like to extend this exception to builders and small contractors.

Although NAHB supports the efforts of Congressman Houghton, we believe it does not go far enough to allow builders and small contractors as defined by IRS code section 460 to be included within the scope of service businesses as defined by IRS code section 448 and we would recommend that the legislation be modified to include this equitable and necessary change.

PROTECT AND PRESERVE THE LOW INCOME HOUSING TAX CREDIT PROGRAM

Another issue that has recently become a major problem for NAHB is the unnecessary and harmful recapture of low income housing tax credits by the IRS. As many of you know, the low income housing tax credit program in Internal Revenue Code Section 42 provides a limited amount of tax credits to each state which in turn is sold to investors in the open market and the proceeds of which is used to finance the building and maintenance of low income affordable housing. In order to be awarded the tax credits, developers of affordable housing must endure a very costly underwriting process at three different times. Once the state issues the final amount of tax credits (in the form of an 8609 determination), the developer then sells those credits to investors at a discount to raise the equity necessary to build the project. Unfortunately, the IRS in the last couple of years has begun auditing these affordable housing projects and recalculating the amount of credit and in some cases recapturing a significant amount of those tax credits. This is causing the financing arrangements for some existing low income housing projects to unravel and raising concern in the industry about the financial security of all projects that have been built in the last 10 to 12 years. This approach by the IRS is somewhat akin to a bank recalculating a mortgage to determine whether you meet the right ratios to qualify for a loan after you have bought the house, have moved in and are paying monthly on the debt. This violates notions of fundamental fairness.

The recapture risk by the industry to date has been perceived to be a risk of non-compliance with the Section 42 rules on occupancy eligibility for the most part. Many investors have a staff of compliance monitors as well as contractual reporting requirements for their LIHTC investments in order to compensate for and reduce this type of recapture risk. Many developer/builders, whether for-profit or non-profit, also have increased their on-site and off-site staff that monitor leasing procedures to assure compliance with the complex rules. Syndicators and investors have led the way, in cooperation with state agencies, in promoting additional training and credentialed standards of competency for LIHTC professionals and also in efforts to reduce the risk of recapture from program non-compliance, this we applaud and support.

Developers, syndicators, bond counsel, underwriters' counsel, and investors implicitly have relied on the state agency determination and allocation of the credit amount (the 8609). The industry from lenders to investors, and agencies to developers, has operated on the basis that they could rely on the amount of the credit on the 8609, unless there was non-compliance with program requirements. This new risk from recalculation of a projects eligibility for credits and that the amount of the eligible basis could be reduced and tax credits recaptured was not anticipated. This risk for an existing project can apply back three years from the date of the audit and forward to the end of the 10 year credit period. The states' final determination (the 8609) has been the definitive statement of allocated amount for buyers and sellers of credits. When the IRS is now coming in to redetermine the amount, it undermines the state agency's obligations imposed by Congress.

In its 1989 amendments to the housing credit program, Congress imposed on State agencies the burden of determining the appropriate amount of credit. Congress did not choose the federal pre-approval method (e.g. HUD administration), nor did they rely on the market alone and professional opinions (e.g. tax-exempt bonds) to assure that the developer and investors take the appropriate amount of credit. In our view, for this housing program there should not be, nor previously was there perceived to be, an obligation or "threat" of recalculation of the agency's credit allocation. Part of the "magic" of the LIHTC program is that each State determines what kind of projects and how much federal investment to make in that project.

When the IRS recalculates basis and recaptures tax credits it is second-guessing the state agency. This over regulation is burdensome and will have a severe negative impact on the program.

As with so many tax law issues, the IRS could probably recalculate eligible basis for every project and come up with a different amount than the state agency. This should not be surprising given the complexities of tax law and, the plethora of potentially applicable tax cases, combined with the enormous amount of detail and number of documents that are amassed for any development project. In this program, Congress put the calculation burden on the state agency and the developers of the projects are already incurring the cost of that obligation in the form of fees to the states. This does not need to be duplicated.

After the burdensome audit process is concluded, it does not result in any increased benefit for the LIHTC program. Recaptured credits do not increase funds for affordable LIHTC housing. A recapture by the IRS does not return the funds to the states for reallocation and no increased affordable housing results from a recapture. Audits and threats of audits and recaptures will reduce the amount of housing benefit from the already very limited amount of credit available to the states each year.

Most states do not have enough funds to satisfy the outstanding need for affordable housing in their area and the method the IRS is taking regarding the audit process will further impede the flow of capital to this program. The magic of the LIHTC program is that it leverages private money to produce affordable housing that reaches a policy goal set by Congress. Private capital and capital markets, however, are very sensitive to risks and potential risks. Thus, whether IRS audits of credit projects are done frequently or infrequently is irrelevant. When the possible result is the recapture of credits, the capital markets and potential investors may flee the market based on the perception of the extent of the risk.

In addition to a slow down or break in capital flows to LIHTC projects, the prices paid for credits may decline to compensate for the increased risk of recapture and loss of credit to the investor. When the discount paid by investors increases and the price for credits declines, there will be fewer housing units or lesser quality units built for the same revenue offset to the Treasury.

The affordable housing industry would like to continue to make the LIHTC program the best and longest lasting affordable housing program in existence but we need certainty and finality for housing credit allocations. The objective is to protect and preserve the public-private partnership that produces section 42 affordable housing for our communities. The congressional objective is also being achieved which is to provide low income individuals with an affordable place to live and ultimately the public benefits through better neighborhoods and communities.

After discussing this issue with the IRS, it is clear that the only method to provide certainty regarding the allocations provided by the states is to address the problem legislatively. As a result, NAHB would like to work with Congress to develop a legislative proposal that would protect and preserve the public-private partnership that produces section 42 affordable housing.

NAHB has developed a legislative proposal that is intended to eliminate disputes over what is in, or out, of eligible basis for purposes of calculating the credit allocation for an 8609. The objectives of the proposals are to: (1) assure certainty for determining eligible basis and hence credit allocations, (2) protect existing credit allocations and (3) provide finality in credit allocations. The concept behind the legislative language is that a credit allocation is really an equity gap calculation to determine how many credits are necessary for the financial viability of the project. The gap calculation needs to be as formulaic as possible, in order to assure the certainty of the allocation. Allocations should not be at risk of recapture and lost to the affordable housing stock due to disputes over what is or is not in eligible basis.

The legislative language will also preserve the existing credit allocations by preventing the retroactive recalculation of eligible basis on outstanding allocations. Additionally, the legislation will help provide finality for future tax credit allocations because predictability, finality and certainty is what the low income housing development and investment community needs to continue the effective public-private partnerships that has built so many affordable housing projects under Section 42.

NAHB would like Congress to prevent these retroactive recaptures and allow for certainty and finality in credit allocations by the states. Credit allocations need to have finality in order to assure a vibrant, competitive market where investors and developers can rely on an allocation once it is received. Legislative reform in this area is necessary to preserve the LIHTC program and continue to ensure that this program will supply America's affordable housing needs.

INDEPENDENT CONTRACTOR ISSUE

An additional issue that must be addressed is our opposition to Congressman Kleczka and Houghton's bill, H.R. 1525, the "Independent Contractor Clarification Act." NAHB is opposed to this bill for various reasons. First, this bill will turn back the clock 20 years and undermine the current law regarding whether an individual is an independent contractor or an employee. This bill begins with the statutory presumption that an individual is an employee unless the parties can prove otherwise. Current law is neutral and does not, in theory, present a preference either way although, in practice, there is a bias against independent contractors. By creating a statutory preference towards employees, Congress would ignore a national policy that placed the utmost importance and value on independent contractors and the small businesses that utilize their services.

Secondly, the bill provides a three-prong test to determine employment status that does not simplify the test but only complicates it further. The test consists of three elements: the service recipient must lack control, make their services available to others and have entrepreneurial risk. Neither "control" nor "entrepreneurial risk" is defined in the bill. Although the bill repeals the common law test, the new test would be even more subjective than current law, and would create even greater uncertainty and confusion because the new test lacks clear definition and guidance.

Thirdly, the bill repeals Section 530, a safe harbor provision that allows small businesses and the independent contractors they may engage to rely on "long standing industry practice" as a guide to the appropriate classification of individuals. H.R. 1525 repeals Section 530 and replaces it with a narrower safe harbor, reliance on substantial authority. There have been few favorable IRS rulings over the years that might constitute substantial authority. What makes this repeal so damaging is that it will return us to an era when the IRS had the tools, the authority and power to stifle the entrepreneurial spirit or independent contractors and small businesses and was subject to the mercy of the enforcers.

What NAHB and other small businesses are looking for is clarity and surety regarding the classification of the service provider and protection against retroactive reclassification. A bill S. 344, the "Independent Contractor Simplification and Relief Act of 1999" sponsored by Senator Kit Bond does achieve that goal. Please consider other avenues to address worker classification because H.R. 1525 is not the answer.

NAHB appreciates your attention to issues of concern to our members and look forward to changes in the tax code that include some of the priorities mentioned in this testimony.

NATIONAL CONFERENCE OF CPA PRACTITIONERS
LAKE SUCCESS, NY,
June 7, 1999

A.L. Singleton, Chief of Staff
House Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Singleton:

I am writing in response to your advisory concerning the hearing on the impact of complexity in the tax code.

The National Conference of CPA Practitioners has been in existence since 1979. The organization is comprised solely of CPA firms in public practice. The majority of our members represent small to mid-sized businesses and individual taxpayers. As such, we are in a position to understand the problems that taxpayers have with the complexities of the tax code.

Alternative Minimum Tax

The AMT is perhaps the most difficult item for taxpayers to understand. The perception is that AMT was instituted to thwart the efforts of rich taxpayers to pay little or no tax. Even tax professionals have trouble planning for this onerous tax. It is nearly impossible to prepare a tax projection for a client with a reasonable degree of accuracy.

Many AMT items are passed through on K–1 Forms from partnerships and S corporations. In most cases it is not possible to know what the effect will be until the K–1 is received. Taxpayers can not react on a timely basis.

Code Section 469 was enacted in 1986 to limit the ability of taxpayers to use passive losses to offset other income. There are many other areas of the code that place limitations on deductions. Some examples are medical expense, investment interest expense, gambling losses, the 2% floor for miscellaneous deductions and the 3% overall limit on itemized deductions. It seems that these limitations are already complex and onerous. The AMT further complicates the ability of taxpayers to understand what their actual effective deductions will be.

The rules for employee business expenses, coupled with the AMT, create complexity and discriminatory treatment of some taxpayers. The employee business expenses are reported on Form 2106 and passed through to Schedule A. They are not deductible for AMT purposes, even though there is a valid business purpose for the deduction. Taxpayers that qualify as statutory employees can deduct their expenses on Schedule C without any effect for AMT purposes. Most individuals and many businesses don't understand the statutory employee criteria. Our committee is aware of cases in which the employee qualified as a statutory employee and the employer refused to check the proper box on the W–2 Form. One case involved a large employer. We contacted the home office in Chicago and were informed that the legal department mandates a position whereby nobody is a statutory employee. During a mail in audit, IRS determined that the facts and circumstances indicate that the taxpayer does qualify. If a large employer can't deal with these rules, there is no hope of smaller entities reporting properly. As well, the employee is placed at a tax disadvantage merely because of his status as an employee. This is an unfair tax policy and should be rectified.

I recently had to prepare a projection for a client who had eligible Section 1202 transactions. This provision was enacted to encourage investment in small businesses. The effective tax rate on Section 1202 transactions is nominally 14% (50% of the gain taxed at 28%). Because 21% of the gain is added back for AMT, most taxpayers will not pay the 14% rate. The effective rate including the AMT is 19.88%, which was enacted to keep the rate no more than the ordinary 20% capital gain rate. My projection software does not handle the AMT on Section 1202 transactions automatically and the analysis required to make the proper adjustments is onerous. Accordingly, my initial estimate of how much money to set aside for the income tax on his sale was understated. In fact, the AMT for this taxpayer was approximately $130,000. For practical purposes, the people who make these investments would need to sell their holdings over many years if they wish to avoid the AMT. As well, the 21% AMT adjustment will expose other income to AMT that ordinarily would not be. This make the effective rate on the Section 1202 transaction 28%, which is not consistent with the intentions of the statute.

I presented the Section 1202 topic as part of a tax update seminar. Over 500 of our members attended the seminar and most of them did not understand the nuances of the AMT on Section 1202 transactions. If one presumes that the CPAs attending seminars are well versed in taxation, there is little hope of unlicensed tax practitioners being able to work with these rules. One would doubt that any lay person could understand them.

Independent Contractor Rules

This issue has been on our legislative agenda for years. The difficulty of working with the 20 common law tests is well documented. The Microsoft case should be a clear indication that ordinary taxpayers can not work with the existing rules. The potential ramifications of a worker classification error are Draconian. If Congress is unable to devise a logical approach, taxpayers should be given liberal relief in correcting errors. We understand the need for IRS to capture the taxes that many independent contractors do not report. In our experience, the honest taxpayer that made a good faith attempt to comply is most likely to be hurt. The true non-compliant taxpayer is likely to be out of the tax system completely.

We have reviewed several previous bills that were intended to modify the independent contractor rules. Every bill attempts to place statutory definitions on the concepts of (a) control, (b) profit motive, and (c) availability to other entities. While these concepts may be easier to comply with than the common law tests, they still leave significant room for interpretation. Taxpayers need clear and concise criteria that can be assessed without the assistance of a tax lawyer. It is likely that, as taxpayers find ways to bend new rules, additional legislation will be required to close the loopholes. Before long, the new rules will be as complex and burdensome as the old ones.

Congress has always been concerned that employers will coerce employees to elect independent contractor status. This is a concern has merit, but the tax code can not solve every social problem. At this time an employer may pass IRS scrutiny and lose an audit with the Federal or State Department of Labor. We believe that independ-

ent contractor status should require a written agreement between the service provider and the service recipient. Perhaps a model agreement could be developed by statute. If the statutory language were adopted, there would be a presumption that the arrangement is valid. The IRS should only have the ability to interfere if undue influence can be proven.

We are concerned about conflicts between Federal and State laws. We believe that most states mandate workers compensation coverage for sub-contractors that don't have their own coverage. Any new Federal legislation should address this area. It should be mandated that the service recipient is not required to cover the service provider for workers compensation if the provider is an independent contractor for Federal purposes.

Phase Out Tables

Since 1986 Congress has become enamored with phase out tables. An example of this concept is the phase out of passive losses for rental real estate losses for income ranges from $100,000 to $150,000. We now have phase out tables for IRA contributions, Roth IRAs, education savings bonds, education IRAs, education credits, itemized deductions, personal deductions, student loan interest, etc., etc. At our seminars the standing joke is that you need a table to keep track of the tables. Practitioners who work with the tax code continuously can't remember all of these tables. When a practitioner attempts to explain these to a client they usually just give up. The fact is taxpayers just can't deal with it. Clients may call with a simple question, such as "should I fund my IRS as early as possible?" The practitioner now responds that it depends on the gross income because of the phase out ranges. Taxpayers can't plan under this scenario. Some of the decisions must be made prior to December 31, however they can't determine whether they qualify until the year is over. Taxpayers that receive K–1 Forms might not know their AGI until October 15 of the following year because of extensions. This is unfair and unmanageable.

The reason for phase out ranges in the law is understandable, but the rules need to be codified. We believe that Congress should develop a set of phase out ranges that will apply to each filing status (single, married joint, etc.). These tables should be used for every area of the code that requires a phase out. In many cases it would make sense to use the prior year adjusted gross income to make the calculation. An example is the conversion of an IRA to a Roth IRA. Conversions are only allowed if AGI is less than $100,000, but the conversion must be made by December 31. While the law does provide a remedy to correct invalid conversions, the complexity involved to correct the conversion creates an additional burden on taxpayers. Taxpayers are losing confidence in our tax system because they can't understand the rules.

I wish to thank you for the opportunity to submit our comments. Our committee welcomes any future opportunity to be involved in the process of seeking a more fair and equitable tax code. We applaud your efforts.

Respectfully submitted,

STEVEN GREENBERG, CPA
Chair, Tax Policy Committee

Statement of LaBrenda Garrett-Nelson and Robert J. Leonard; on behalf of Washington Counsel, P.C., Attorneys-at-Law

Washington Counsel, P.C. is a law firm based in the District of Columbia that represents a variety of clients on tax legislative and policy issues.

INTRODUCTION

As Chairman Houghton stated in his announcement of today's hearing, "simplification of the most complex provisions of the code may help to reduce significantly the burden on individual taxpayers and small businesses." In this regard, the provisions that make up the U.S. international tax regime certainly rank among the most complex provisions in the Code. This statement sets forth a proposal to reduce complexity in this area by repealing the little used regime for export trade corporations ("ETCs"), enacted in 1962 to provide a special export incentive in the form of deferral of U.S. tax on export trade income. The rationale for the proposed repeal is that the special regime for ETCs was, effectively, repealed by the 1986 enactment of the passive foreign investment company ("PFIC") rules. At the same time, the proposal would provide appropriate (and prospective) transition relief for ETCs that were caught in a bind created by enactment of the PFIC regime.

I. The Overlap Between the ETC Regime and the PFIC Rules Effectively Nullified the ETC Rules For Many Corporations

Although the PFIC rules were originally targeted at foreign mutual funds, the Congress has recognized that the scope of the PFIC statute was too broad. Thus, for example, the Taxpayer Relief Act of 1997 eliminated the overlap between the PFIC rules and the subpart F regime for controlled foreign corporations. Similarly, in the 1996 Small Business Jobs Protection Act, the Congress enacted a technical correction to clarify that an ETC is excluded from the definition of a PFIC.

The 1996 technical correction came too late, however, for ETCs that took the reasonable step of making "protective" distributions during the ten-year period between the creation of the uncertainty caused by enactment of the PFIC regime and the passage of the 1996 technical correction. Although U.S. tax on distributed earnings would have been deferred but for the ETC/PFIC overlap, these ETCs were, effectively, required to make distributions to protect against the accumulation of large potential tax liabilities under the PFIC rules. Thus, the PFIC rules, in effect, repealed the ETC regime.

II. Congressional Precedents for Providing Transition Relief for ETCs

The proposal would simplify the foreign provisions of the tax code by repealing the ETC regime. When the Congress enacted the Domestic International Sales Company ("DISC") rules in 1971, and again when those rules were replaced with the Foreign Sales Corporation ("FSC") rules in 1984, existing ETCs were authorized to remain in operation. Moreover, ETCs that chose to terminate pursuant to the 1984 enactment of the FSC regime were permitted to repatriate their undistributed export trade income as nontaxable PTI.

The Proposal also provides a mechanism for providing prospective relief to ETCs that were caught in the bind created by the PFIC rules. Consistent with the transition rule made available in the 1984 FSC legislation, the proposal would grant prospective relief to ETCs that made protective distributions after the 1986 enactment of the PFIC rules. Essentially, future (actual or deemed) distributions would be treated as derived from PTI, to the extent that pre-enactment distributions of export trade income were included in a U.S. shareholder's gross income as a dividend. Note that the proposed transition relief would provide only "rough justice," because taxes have already been paid but the proposed relief will occur over time.

CONCLUSION

Repeal of the ETC provisions would greatly simplify the international tax provisions of the Code, but such a repeal should be accompanied by relief for ETCs that were caught in the bind created by the PFIC rules.

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