Compendium of Legislative Proposals

Simplification and Technical Proposals

Approved by the
Tax Executive Committee

July 1, 2009
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Proposal: Repeal full vesting on partial termination of qualified retirement plans

Present Law

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

Description of Proposal

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

Analysis

The partial termination rules impose significant administrative burdens due to the uncertainty of whether and when a partial termination occurs. Moreover, the benefit to participants of full vesting upon partial termination has diminished over time. The vesting schedule requirements applicable to qualified retirement plans have been greatly accelerated since ERISA was enacted. Section 411(a) originally required either 10-year cliff or 5- to 15-year graded vesting. ERISA, section 1012. The current section 411(a) requirement is 5-year cliff or 3- to 7-year graded vesting.

Conclusion/Recommendation

The requirement under section 411(d)(3) that benefits become fully vested upon a partial termination of a qualified retirement plan should be repealed to reduce employers’ administrative burdens without significantly affecting employees.
Proposal: Harmonize and simplify education incentives

Present Law

Included in the Internal Revenue Code are education incentives that may be categorized in two ways: (1) those that are intended to help taxpayers meet current higher education expenses; and (2) those that encourage taxpayers to save for future higher education expenses. The first group includes strategies that may be divided into three main categories: exclusions from taxable income such as scholarships (section 117) and employer-provided education assistance (section 127); deductions including the student loan interest deduction (section 221) and the tuition and fees deduction (section 222); and credits including the Hope Credit (for tax years 2009 and 2010 referred to as the American Opportunity Tax Credit) and Lifetime Learning Credit (section 25A). The second group, intended for long-term funding, includes educational savings bonds (section 135), qualified tuition programs or QTPs (section 529), and Coverdell Education Savings Accounts or ESAs (section 530).

The various provisions contain numerous and differing eligibility rules as summarized on the accompanying tables.

Description of Proposal

Possible measures for simplifying the tax benefits for higher education include:

1. Replace current tax benefits with a new universal education deduction or credit, \textit{i.e.}, develop one or two education-related deductions or credits to replace the current provisions.

2. Combine the Hope Credit (American Opportunity Tax Credit) and the Lifetime Learning Credit into one. Combining these credits would simplify the tax benefits and remove duplicative provisions relating to higher education expenses. The combined credit should be on a “per student” rather than a “per taxpayer” basis, offering a potentially larger total credit amount available per family.

3. Simplify the definition of “student” by using section 221(d)(3) to define eligible student for all of the provisions.

4. Create a uniform definition of “qualified higher education expenses” (QHEE) for all education-related benefits. Specifically, QHEE should include tuition, books, fees, supplies and equipment, and room and board for all education tax incentives. Because qualified tuition must be reduced by scholarships and like items, the inclusion of room and board as QHEE would make the education tax incentives more broadly available. Further, the definition of room and board should provide that off-
campus housing is allowed to the extent the cost does not exceed the cost for on-campus housing (invoice amount). The board amount for off-campus would be a reasonable amount not to exceed the board amount charged by the educational institution. Also, the terms “special needs services” and “special needs beneficiary” should be clearly defined.

5. Standardize the income ranges required for eligibility.

6. Ease the requirements for student loan interest deduction and coordinate the phase-out amounts with other education incentives.

Analysis

For many taxpayers, analysis and application of the intended incentives are too cumbersome to deal with compared with the benefits received. The GAO estimated that for tax year 2005, 19 percent of eligible tax filers did not claim either a tuition deduction or a tax credit that could have reduced tax liability by an average of $219, probably due to the complexity of the tax provisions. Further, according to GAO research, although the number of taxpayers using the educational tax credits is growing quickly, the complexity of the tax provisions prevent hundreds of thousands of taxpayers from claiming tax preferences to which they are entitled or which would be most advantageous to them. Finally, there is evidence that the regressive nature of the provisions prevent low-income taxpayers from getting the tax benefit that Congress envisioned.

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

For example, eligibility for one of the two education credits depends on numerous factors including the academic year in which the child is in school, the timing of tuition payments, the nature and timing of other eligible expenditures, and the adjusted gross income level of the parents (or possibly the student). Further, in a given year a parent may be entitled to different credits for different children, while in subsequent years credits may be available for one child but not another. Both types of credits are dependent on the income levels of the parents or the child attempting to claim them. Further complicating the statutory scheme, the Code precludes use of the Lifetime or Hope (American Opportunity Tax) Credit if the child also receives tax benefits from an ESA. Although the child can elect out of such benefits, this decision also entails additional analysis.
An additional complicating factor is the phase-out of eligibility based on various AGI levels in six of the nine provisions. This requires taxpayers to make numerous calculations to determine eligibility for the various incentives. Since there are so many individual tests that must be satisfied for each benefit, taxpayers may inadvertently lose the benefits of a particular incentive because they either do not understand the provision or because they pay tuition or other qualifying expenses during the wrong tax year.

In terms of tax policy, the numerous tax incentives to assist with college expenses are not the only way the federal government provides assistance to college students and their families. Through the Department of Education, the federal government assists low-income individuals through various scholarship and grant programs. We encourage Congress to consider all of these programs together to determine if the desired goals are being met in an effective and efficient manner. The current tax provisions do not always meet the goal of helping low to middle-income families with college expenses. Consideration should be given to where assistance can best be provided through the tax law (such as incentives to save for future college expenses) versus grant and scholarship programs while the student is in college (where assistance is needed at the start of the school year rather than when the tax return is filed). Consideration should also be given to identifying the targeted income group the federal government should be providing financial assistance to for higher education expenses and ensuring that this goal is met whether the aid is distributed through scholarships, grants or tax provisions.

**Conclusion/Recommendation**

Simplification as described in items 1 through 6, above, should decrease the reporting burden on taxpayers, eliminate duplicative provisions, assist the IRS with compliance, lower the cost of administering the tax system, and produce greater efficiency and increased access for taxpayers who need assistance with rising college costs.
### Education Incentives – Exclusions and Deductions

<table>
<thead>
<tr>
<th>Code §</th>
<th>Provision</th>
<th>Summary</th>
<th>Qualified Education Expenses Defined As</th>
<th>AGI Phase-Out</th>
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</thead>
<tbody>
<tr>
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<tr>
<td><strong>Exclusions</strong></td>
<td></td>
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<tr>
<td>117</td>
<td>Exclusion for scholarships</td>
<td>Excludes scholarship from income to the extent it covers qualified education expenses for degree-seeking undergraduate student</td>
<td>Tuition, books, supplies, equipment; but not room and board</td>
<td>None</td>
</tr>
<tr>
<td>127</td>
<td>Exclusion for employer-provided education</td>
<td>Employee excludes from income up to $5,250 of employer-provided qualified education expenses under educational assistance program</td>
<td>Tuition and fees for undergraduate and graduate courses; books, supplies, equipment; but not room and board</td>
<td>None</td>
</tr>
</tbody>
</table>

| **Deductions** | | | | |
| 221    | Student loan interest deduction | For AGI deduction of $2,500 for interest paid on qualifying student loan | Tuition, fees, books, supplies, equipment, room and board, transportation, other necessary expenses | S: $60,000 - $75,000 AGI  
MFJ: $120,000 - $150,000 AGI  
MFS: No deduction |
| 222    | Qualified tuition and fees deduction | For AGI deduction of up to $4,000 | Tuition, fees; but not room and board  
Student-activity fees and expenses for course-related books, supplies, and equipment are included in QHEE only if the fees and expenses must be paid to the institution as a condition of enrollment | S, HOH: If AGI is not more than $65,000, may deduct $4,000; if between $65,000 and $80,000, may deduct $2,000  
MFJ: If AGI is not more than $130,000, may deduct $4,000; if between $130,000 and $160,000, may deduct $2,000  
MFS: No deduction |
### Education Incentives – Credits

<table>
<thead>
<tr>
<th>Code §</th>
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<th>Qualified Education Expenses Defined As</th>
<th>AGI Phase-Out</th>
</tr>
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</table>
| 25A    | **Hope credit** (For tax years 2009 and 2010, the American Opportunity Tax Credit as described in 25A(i)) | Credit of up to $2,500 *per student*: 100% of first $2,000; 25% of next $2,000  
Must be enrolled at least half-time  
40 percent of modified credit is refundable (but not for child subject to section 1(g) Kiddie tax)  
If parent pays the expenses, must be able to claim exemption for student on tax return  
No felony drug conviction  
New regulations explain who gets credit in special circumstances | Tuition, fees, and course materials including books, during first four years of post secondary education; but not room and board  
Courses must be associated with degree program or recognized education credential  
Athletic fees, insurance, activity fees are not eligible unless required as a condition of enrollment and paid directly to the institution | S: $80,000 - $90,000  
MFJ: $160,000 - $180,000  
MFS: No credit |
| 25A    | **Lifetime Learning credit**                                              | Credit of up to $2,000 *per return*: 20% on up to $10,000  
A non-refundable elective credit  
If parent pays the expenses, must be able to claim exemption for student on tax return  
New Regulations explain who gets credit in special circumstances | Tuition and fees including for graduate courses/continuing education; but not room and board  
Available for all post secondary education–not necessarily associated with degree | S: $50,000 - $60,000  
MFJ: $100,000 - $120,000  
MFS: No credit |
## Education Incentives – Planning for College

| Code § | Provision                        | Summary                                                                                                                                                                                                 | Qualified Education Expenses Defined As                                                                                                                                                                                                 | AGI Phase-Out                  |
|--------|----------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------                                            |                                |
| 135    | Educational Savings Bonds        | Allows for partial or total exclusion of interest income on redemption of qualified U.S. savings bonds used for qualifying purposes                                                                                  | Tuition and fees but not for courses involving sports, games, or hobbies that are not part of degree or certificate granting program; not room and board                                                                 | S: $69,950 and $84,950         |
|        |                                  |                                                                                                                                                                                                         |                                                                                                                                                                                                                                                | MFJ: $104,900 and $134,900     |
|        |                                  |                                                                                                                                                                                                         |                                                                                                                                                                                                                                                | MFS: No exclusion              |
| 529    | Qualified Tuition Plans          | For College Savings Plan, account owner contributes cash to a plan account for a beneficiary and the contribution is invested according to the terms of the plan For Prepaid Tuition Plan, account owner contributes cash to a plan account and the contribution purchases tuition credits or credit hours based on then-current tuition rates Contributions qualify for the annual gift tax exclusion Funds may be withdrawn tax free if used for qualifying purposes at any college | Tuition and fees, books, computers, technology and other expenses for vocational schools, 2-year and 4-year colleges as well as graduate and professional education; room and board if the beneficiary attends school at least half-time; expenses of special needs beneficiary necessary for his/her enrollment at eligible educational institutions | None                            |
| 530    | Coverdell Education Savings Account | Non-deductible contribution of up to $2,000 per year for a beneficiary under age 18. Except for special needs beneficiaries, contributions must end at age 18 and assets must be withdrawn by age 30 Distributions non-taxable to extent funds used for QHEE or qualified elementary and secondary education expenses | Tuition, books, fees, supplies, equipment, tutoring, computer equipment and software, uniforms for both higher education and elementary and secondary education at public, private, and religious schools; room and board for student enrolled at least half-time | S: $95,000 and $110,000         |
|        |                                  |                                                                                                                                                                                                         |                                                                                                                                                                                                                                                | MFJ: $190,000 and $220,000     |
|        |                                  |                                                                                                                                                                                                         |                                                                                                                                                                                                                                                | MFS: $95,000 and $110,000     |
Proposal: Simplify the Kiddie Tax

Present Law

For tax years beginning after May 25, 2007, section 1(g) of the Internal Revenue Code taxes a portion of the unearned income of children under the age of 19 or full-time students under the age of 24 at the parents’ marginal tax rate. Specifically, the provision applies in cases where: (1) the child’s earned income does not exceed one-half of the child’s support; (2) either parent of the child is alive at the close of the year; and (3) the child does not file a joint return for the taxable year.

In the case of parents who are not married, the marginal tax rate of the custodial parent is used to determine the tax liability on net unearned income (that is, in 2008, the amount above $900 plus the greater of $900 or itemized deductions directly connected to producing unearned income). The marginal tax rate of the individual with the greater taxable income is used in the case of parents filing separately. When the provisions of section 1(g) apply to more than one child in the family, each child’s share of the parental tax is apportioned ratably based on the ratio of the child’s net unearned income to the total net unearned income of all children.

Section 1(g)(6) requires the parent to provide his/her TIN number to the child for inclusion on the child’s tax return.

Under certain limited circumstances, parents can elect to include their children’s income on their return. However, the election is not available for parents of a child with any earned income, unearned income in excess of $9000, capital gains, withholding or estimated tax payments.

Description of Proposal

The linkage of a child’s taxable income to his/her parents’ and siblings’ taxable income should be repealed. Income (other than capital gains) subject to Kiddie Tax should be taxed at a separate rate schedule. The child’s capital gains would be taxed at the capital gains rates.

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

Analysis

The Kiddie Tax adds such significant complexity to the computation of tax liability that the IRS has issued Publication 929, a 28-page booklet which provides worksheets that assist the taxpayer, or the return preparer, calculate the child's taxable income and tax liability. There are several challenges related to the Kiddie Tax:
• Difficulty in getting information about the applicable tax rate: Parents may either refuse to provide the tax rate or, if divorced, one parent may refuse to cooperate with the other in providing the information. Without this information, the tax preparer may be forced to calculate the child’s tax unfairly at the highest rate.

• Qualified dividends or capital gain distributions: The IRS requires qualified dividends and capital gain distributions to be allocated between the first $1,800 (in 2008) of unearned income and the portion of the child’s unearned income in excess of $1,800, thus making the computation burdensome.

• Interrelationship with parents’/siblings’ returns: If either the parents or siblings file amended returns, the child must file an amended return. The fact that amended returns have been filed may not be readily known.

• AMT: The Kiddie Tax provision only considers the regular tax of section 1 and not the alternative minimum tax (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 the payment of more tax than if the parent and children’s income are both included in the parent’s AMT calculation.

Removing the linkage to parental and sibling returns 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.

**Conclusion/Recommendation**

In the majority of situations, the additional tax revenue generated by the “Kiddie Tax” appears to be insignificant when compared to the complexity of the calculations. Taxing the net unearned income at a separate rate rather than at a rate linked to that of family members would eliminate a great deal of that complexity and several compliance challenges, while still accomplishing the original intent behind the Kiddie Tax.
Proposal: Remove cell phones and other personal digital assistants (PDAs) from classification as “listed property”

Present Law

Congress created the listed property rules in 1984 to discourage the personal use element of certain property, such as luxury automobiles. Cell phones were added to the definition of listed property in 1989; at that time, the cost of such phones was relatively expensive and the use of such devices in daily business activities was far from the norm.

Description of Proposal

Remove cell phones and other PDAs from listed property classification.

Analysis

Including cell phones as listed property limits the use of accelerated depreciation and expensing of such phones unless the employer and employee substantiate a certain amount of business use of the phone through adequate records. Also, the value of personal use of the phones is treated as wages for employment tax purposes and reported on Form W-2. In order to quantify the personal use, the regulations require detailed records for every business call, including: (1) who was on the call; (2) their relationship to the organization; (3) the business purpose; (4) the date; (5) the time; and (6) the cost of the call.

Today’s technology and business expectations are clearly different from that which existed when cell phones were classified as listed property. Cell phones and other PDAs cost a small fraction of what they did in 1989, and they are often provided at no cost when the buyer agrees to a multiple-year contract. Furthermore, most cell phone/PDA contracts now provide for unlimited minutes for a fixed fee. Further, the use of cell phones and PDAs is expected by businesses as the norm, for connecting to their employees 24/7. The prevalent use of these devices has made them the equivalent of a landline phone, for which detailed recordkeeping has never been required. According to a 2004 NFIB Small Business Poll, 78% of small business owners use a cell phone for business purposes. For further reference see a report from the House Small Business Committee at: http://www.house.gov/smbiz/reports2008/embargoed-small-business-committee-tax-report.pdf

Removing cell phones and other PDAs from classification as listed property would alleviate the need for onerous recordkeeping requirements under the listed property rules in an area that is no longer considered potentially abusive. It also would relieve taxpayers from the onerous recordkeeping requirements and lessen the possibility of penalties being imposed on taxpayers, tax return preparers, and tax exempt organizations.
For further reference, see AICPA testimony presented by Jeffrey R. Hoops, AICPA Tax Executive Committee Chair, before the House Small Business Committee on April 10, 2008, at: http://www.house.gov/smbiz/hearings/hearing-04-10-08-tax/testimony-04-10-08-hoops.pdf.

Conclusion/Recommendation

Cell phones and other personal digital assistants (PDAs) should be removed from classification as “listed property” under Internal Revenue Code section 280F(d)(4)(A)(v), to reflect that the personal use of such items is no longer considered potentially abusive because of changes in technology and business practices since the initial classification in 1989.
Proposal: Standardize the allowable mileage rates for business expense, medical expense, and charitable contribution purposes

Present Law

A standard mileage allowance, generally determined annually, is allowed to employees in determining their expenses related to employment (55 cents per mile beginning January 1, 2009). Further, a standard mileage allowance, also generally determined annually, is allowed to taxpayers for purposes of medical expense and moving expense deductions (24 cents per mile beginning January 1, 2009). When necessary, the IRS has the authority to adjust these rates at any time (as they did in mid-year 2008 to reflect the extraordinary rise in gasoline prices). In contrast, the mileage rate allowed for charitable contribution deduction purposes is set by law at 14 cents a mile. Prior to 1984, the IRS had the authority to set this rate as well.

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

Description of Proposal

Allow two mileage rates: one for business expenses and another for all non-business purposes (charitable, medical and moving expense). The non-business rate should be set at a percentage (at least 50% and as high as 70%) of the business rate, rounded to the nearest half cent. The business rates should be adjusted annually, and possibly semi-annually in certain circumstances. The starting point would be the business rate in effect at the time of enactment.

Analysis

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

The charitable contribution mileage allowance should be set at the same level as the other non-business expense allowances (medical and moving). This single rate should be set at a percentage of the business mileage allowance. All mileage allowance rates should be adjusted on an annual basis, possibly with a mid-year adjustment.
Proposal:  Allow certain attorney fees and court costs as deductions for AGI

Present Law

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

Section 62(a)(20) enacted as part of the American Jobs Creation Act of 2004 (PL 108-357) provides that attorney fees and court costs connected with the following types of actions are deductible for AGI:
- Unlawful discrimination claim (as defined at section 62(e) which lists 18 types of “unlawful discrimination” actions, such as certain violations under the Civil Rights Act of 1991, the National Labor Relations Act, the Fair Labor Standards Act of 1938, the Family and Medical Leave Act of 1993, and several others);
- Claim of violation of subchapter III of chapter 37 of US Code Title 31; and
- Claim under §1862(b)(3)(A) or the Social Security Act.

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

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

Description of Proposal

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

Analysis

The Tax Reform Act of 1986 modified the rules on miscellaneous itemized deductions by making them deductible only to the extent they exceed 2% of the taxpayer’s AGI. The primary
rationale for the change was simplification. The committee report provided the following reasons for change.\(^1\)

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

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

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

The committee also believes that the distinction under present law between employee business expenses (other than reimbursements) that are allowable above-the-line, and such expenses that are allowable only as itemized deductions, is not supportable. The reason for allowing these expenses as deductions (i.e., the fact that they may constitute costs of earning income) and the reasons for imposing a percentage floor apply equally to both types of expenses.

Despite the fact that some types of miscellaneous deductions are incurred to produce gross income, in 1986, Congress sought to limit the deductibility of many of these deductions, including non-business attorney fees associated with litigation and settlement awards. At that time Congress treated all such attorney fees and court costs of producing non-business awards, similarly. However, in 2004, Congress started to treat one type of litigation expenses differently;

\(^{1}\) Tax Reform Act of 1986 (PL 99-514; 10/22/86), House explanation.
and did so again in 2006 with one more type of litigation expense. These changes involving subsets of attorney fees, created an inequity in the tax law regarding the treatment of deductions. Given that all attorney fees and court costs incurred to generate taxable litigation and settlement awards are costs to produce income and that there is little complexity in tracking these specific and often sizable amounts, the principles of equity and fairness warrant treating all attorney fees and court costs the same regardless of the nature of the taxable damages award. Thus, the change made to section 62(a) in 2004 and 2006 should be broadened to include all attorney fees and court costs that relate to taxable awards.

Conclusion/Recommendation

Section 62(a)(20) and (21) should be replaced with one provision to read as follows:

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

Any deduction allowable under this chapter for attorney fees and court costs paid by, or on behalf of, the taxpayer in connection with any award includible in gross income. The preceding sentence shall not apply to any deduction in excess of the amount includible in the taxpayer's gross income for the taxable year on account of such award.
Proposal: Revise the due date of the reporting requirements for foreign bank and financial accounts

Present Law

Treasury Regulations 31 CFR sections 103.24 and 103.27 require that if any U.S. person has a financial interest in or signature or other authority over any foreign financial accounts (including bank, securities or other types of financial accounts in a foreign country) and if the aggregate value of these financial accounts exceeds $10,000 at any time during the calendar year, that person must report that relationship for the calendar year by filing Form TDF 90-22.1 on or before June 30\textsuperscript{th} of the succeeding year.

Description of Proposal

Change the reporting due date from June 30 to October 15.

Analysis

Many, if not most, taxpayers with the financial resources to have offshore investments or business interest are very likely to file for an extension of time to file their income tax returns. Complete filing information from foreign sources is rarely available until mid-summer or later. To conserve time and minimize fees, preparers usually wait until all the required return information is available before beginning work on a return. Thus, the amount and details of offshore accounts are often not known until after June 30\textsuperscript{th}.

Further, few clients understand the full scope of the phrase “foreign financial account” or the concept of indirect (constructive) ownership. Thus, they are unlikely to tell the preparer of the need to file the report by June 30\textsuperscript{th}.

Conclusion/Recommendation

To increase voluntary compliance and reduce the cost of oversight, the due date for the report should be changed to October 15.
Proposal: Allow for abatement of a section 6707A penalty if the taxpayer acts reasonably and in good faith

Present Law
Taxpayers who fail to disclose a reportable transaction are subject to a penalty under section 6707A of the Internal Revenue Code. If the transaction is a listed transaction (or substantially similar to a listed transaction) the penalty is $100,000 for individuals and $200,000 for all other taxpayers. In the case of reportable transactions other than listed transactions, the penalty is $10,000 for individuals and $50,000 for all other taxpayers. The penalty applies even if there is no tax due with respect to the reportable transaction that has not been disclosed. IRS has no discretion to waive the penalty in the case of a listed transaction and has very limited ability to waive the penalty in the case of reportable transactions other than listed transactions. The IRS must report to Congress with respect to any waivers granted. The statute precludes judicial review if IRS decides not to waive the penalty.

Description of Proposal
Amend section 6707A to allow the IRS to abate the penalty if the taxpayer demonstrates that the taxpayer acted reasonably and in good faith, and to allow judicial review of IRS waiver determinations.

Analysis
The current structure of the section 6707A penalty is not consistent with penalty policies articulated by Congress when it amended the Code in 1989 to reform the penalty structure. It is a strict liability penalty. There is no mechanism to allow taxpayers to bring themselves into compliance or incentive for taxpayers to voluntarily come forward. Moreover, we believe the absence of judicial review when the Service has assessed a penalty under section 6707A is a violation of procedural due process and notions of fair tax administration.

Some would argue that the only way to stamp out the use of tax avoidance transactions is to make the section 6707A penalty a strict liability with no availability of judicial review. Our response to this is simply that strict liability penalties may result in some taxpayers not disclosing questionable transactions on a tax return, potentially resulting in such taxpayers playing the “audit lottery.”

As a fundamental principle, the AICPA is opposed to strict liability penalties because such penalties are unduly harsh and do not allow for abatement due to reasonable cause, such as an inadvertent act of the taxpayer. We believe that fairness and effective tax administration require the IRS to retain discretion in assessing and abating penalties.
Conclusion/Recommendation

The statute should be amended to allow the IRS to abate the section 6707A penalty if the taxpayer demonstrates that the taxpayer acted reasonably and in good faith. Further, judicial review of IRS waiver determinations should be allowed.
Proposal: Repeal the section 7122(c)(1) requirement to provide a 20 percent partial payment with a lump-sum offer in compromise

Present Law

Under section 7122(c)(1) of the Internal Revenue Code, if a taxpayer submits a lump-sum offer in compromise (i.e., an offer of payments involving 5 or fewer installments) to compromise a tax debt, the taxpayer is generally required to submit a payment of 20 percent of the offer amount to the Service upon submission of the offer application. Low income taxpayers (persons with incomes below 250 percent of the federal poverty thresholds) are generally exempt from the 20 percent payment requirement.

Description of Proposal

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

Analysis

Resolving outstanding tax liabilities efficiently is necessary for good tax administration and reduction of the tax gap. The IRS should have the opportunity to review offers and determine whether accepting an offer is in the best interest of the government. The IRS should use offers in compromise as one of the many tools to collect the proper amount of tax. However, the 20 percent requirement of current law has discouraged taxpayers from seeking opportunities to settle tax liabilities with the government.

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

Although proponents of the 20 percent partial payment amount under section 7122(c)(1) believe the partial payment amount is effective in eliminating the submission of frivolous offers, it appears that the real effect of the 20 percent requirement is to discourage the submission of a large number of legitimate offers.
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Conclusion/Recommendation

Repeal of section 7122(c)(1) will provide taxpayers with an effective option for addressing a federal tax liability, particularly during the current period of economic downturn.
Proposal: Amend section 118 to apply to partnerships

Present Law

Section 118 of the Internal Revenue Code currently permits an exclusion from gross income for contributions to the capital of a corporation. When the contributor is an existing shareholder, the shareholder’s basis is increased by the amount of the contribution and the corporation’s basis in the contributed property equals, under section 362(a), the shareholder’s carryover basis plus gain recognized by the contributing shareholder on the transfer, if any. When the contributor is a non-shareholder, the basis to the corporation of the contributed property is, under section 362(c), zero if the property is other than money; if the contribution consists of money, the basis of any property purchased with that money during the 12 months following the contribution is reduced pro rata.

The legislative history to section 118 indicates that the exclusion was enacted to address situations where a contribution is made by a governmental unit, chamber of commerce, or other association of individuals who do not have any proprietary interest in the corporation. The legislative history notes that when such a contribution is made the contributor often expects to derive indirect benefits. As such, the contribution cannot be considered a gift. On the other hand, any indirect benefits derived by the contributor may be so intangible that the contribution should not be considered a payment for future services or goods. Thus, Congress granted the exclusion from gross income for contributions to capital.\(^2\) The exclusion provided in section 118 effectively codified several Supreme Court decisions including *William H. Edwards v. The Cuba Railroad Company*,\(^3\) *The Detroit Edison Company v. Commissioner*,\(^4\) and *Brown Shoe Company, Inc. v. Commissioner*.\(^5\)

Section 118 does not apply to contributions to capital of a partnership. The IRS, in Coordinated Issue Paper LMSB4-1008-051 issued on November 18, 2008, has confirmed its position that neither statutory nor case law applies to exclude contributions to the capital of a partnership from the gross income of a partnership. Some practitioners, however, believe that substantial authority still exists under case law for a partnership to exclude contributions from a non-partner to its capital.

Description of Proposal

Section 118 should be amended to provide that the exclusion from gross income for contributions to capital applies with respect to contributions made to corporations and to partnerships.


\(^3\) 268 US 628 (1925).

\(^4\) 319 US 98 (1943).

partnerships. The legislative history should make clear that there is no inference with respect to the treatment of non-partner contributions to capital of a partnership under current law.

Under this proposal, no legislative change should be necessary to the basis rules regarding contributions made by a partner; the partner’s outside basis will increase and the partnership’s basis in the contributed property will equal the partner’s carryover basis plus gain recognized by the contributing partner on the transfer, if any.

However, a legislative change will be necessary to the basis rules regarding contributions made by a non-partner. Specifically, section 723 should be changed so that basis to the partnership of the contributed property will be zero if the property is other than money; and if the contribution consists of money, then the basis of any property purchased with that money during the 12 months following the contribution is reduced pro rata. The distributee partner should recognize gain under the principles of sections 737 and 704(c) upon distribution of “section 118 property” that was contributed by a non-partner.

### Analysis

Partnerships are utilized in today’s business world much like corporations were in 1954 when the rule in section 118 was codified. As long as similar basis rules are enacted under subchapter K (along with rules to prevent abuse upon distribution to partners of section 118 property contributed by non-partners), there is no theoretical reason section 118 should not apply to partnerships.

The section 118 exclusion for non-partner contributions to capital of partnerships is needed to prevent corporations from being given an unfair advantage with respect to the receipt of increasingly popular government incentives. For example, if a municipality is willing to provide monetary incentives to construction companies to build in its jurisdiction, corporations and partnerships should be able to treat these incentive payments similarly in developing their competitive bids for the projects.

### Conclusion/Recommendation

As a matter of fairness, the section 118 exclusion from gross income for contributions to capital should apply to both corporations and partnerships. Appropriate basis and anti-abuse rules related to this change also should be adopted.
Proposal: Allow spouses (and divorced spouses) to transfer partnership suspended losses to one another

Present Law

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

Description of Proposal

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

Analysis

Spouses and former spouses who transfer partnership interests between themselves find that they are in the same position that husband and wife shareholders of an S corporation were in prior to the addition of section 1366(d)(2)(B). That is, after the transfer, they find that suspended losses of the transferor are now trapped, forever unusable. This common-sense change being proposed may make the divorce process a little bit easier on all parties in the case of divorcing spouses, and the marriage bond a little bit stronger in the case of married couples transferring interests to one another.

Conclusion/Recommendation

Suspended losses should be made available to either spouse regardless of who actually owns the partnership interest. This recommendation furthers the tax policy goal of simplicity.
Proposal: Allow S Corporations to have nonresident aliens as shareholders and potential current beneficiaries of electing small business trusts

Present Law

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

Description of Proposal

Allow nonresident aliens to be shareholders of an S corporation and require the S corporation to withhold and pay a withholding tax for its nonresident alien shareholders. Also permit nonresident aliens to become PCBs of an ESBT.

Analysis

Nonresident aliens should be allowed as shareholders and as potential current beneficiaries of electing small business trusts. Nonresident aliens are able to contribute capital to and participate in the benefits and obligations of an S corporation indirectly in instances where the S corporation is aware that such result can be obtained and is willing and able to pay a professional to restructure the operations of the S corporation through partnerships; the operating partnerships, in turn, permit nonresident aliens to hold ownership interests and thus nonresident aliens indirectly receive passthrough items from the S corporation’s operations. If nonresident aliens were permitted to be direct owners of S corporations, they would be subject to withholding just as nonresident alien partners are, thus protecting against revenue loss at the individual level. Such direct ownership benefits should not be available only to the sophisticated taxpayer. The smaller, struggling S corporations, particularly those in border states, should also be free to raise capital from these individuals.

With regard to nonresident aliens as PCBs of an ESBT, because the trust pays tax at the highest rates, there is no policy reason for restrictions on the types of allowable ESBT potential current beneficiaries.
Conclusion/Recommendation

Section 1361(b) should be amended to allow a nonresident alien to be an eligible shareholder of an S corporation. In conformity with that change, section 1446 should be amended to require the S corporation to withhold and pay a withholding tax on effectively connected income allocable to the corporation’s nonresident alien shareholders. A nonresident alien should also be a permitted potential current beneficiary of an electing small business trust.
Proposal: Allow estates and trusts to deduct all administrative costs

Present Law

Internal Revenue Code section 67(a), enacted in 1986, imposes a 2-percent floor on miscellaneous itemized deductions for individuals. Section 67(e), however, provides an exception to the 2-percent floor for certain administrative costs of estates and trusts, which are generally taxed like individuals. The exception applies to costs that are “paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate.”

The exception for estates and trusts in section 67(e) is ambiguous and consequently has spawned four costly judicial battles over its meaning. On January 16, 2008 the U.S. Supreme Court attempted to resolve the split in Knight v. Commissioner and held that the “proper reading” of section 67(e) is to allow a full deduction for costs that a hypothetical individual with the same property would not “commonly incur.” In order to determine whether an individual would commonly incur the cost, the Court held that for each expense the trustee incurs, the trustee must “predict” whether a hypothetical person with the same property as the trust would have incurred the cost.

Unfortunately this interpretation imposes enormous uncertainty, complexity, recordkeeping, and enforcement burdens on both the trustee and the government. In short, it raises more questions than it answers.

Prior to the Supreme Court’s opinion in Knight, the IRS had issued proposed regulations incorporating its litigating position that trustees must unbundle their trustee fees, deducting in full only those costs that individuals are incapable of incurring and subjecting costs that individuals are capable of incurring to the 2-percent floor. But in Knight, the Supreme Court held that subjecting to the 2-percent floor costs that individuals are incapable of incurring “flies in the face of the statute.” Therefore, the IRS must substantially rewrite the proposed regulations or withdraw them.

After the Supreme Court’s holding in Knight, the IRS began working on regulations that would be consistent with the Court’s interpretation. But regulations have not yet been issued. In February 2008 and again in May 2008 the AICPA sent written comments to the IRS asking it to clarify in forthcoming regulations the meaning of “commonly” as used by the Supreme Court in Knight. The AICPA also provided 15 examples of situations where “commonly” needs to be clarified.

The AICPA, the American Bankers Association, and several large trust companies, banks, accounting firms, law firms, and individuals sent written comments to the IRS urging it to abandon its unbundling requirement, citing its enormous cost and complexity. In addition, commentators stressed that unbundling was contrary to the legislative and
judicial history of the statute and may not even be feasible for several reasons. Namely, trustees do not charge by the hour. Their fees are generally based on the value of assets under management and often negotiated based on account size, relationships, and other considerations. Trustee fees cover many costs, including general overhead, reviewing legal issues, custody of assets, accountings, tax and accounting services, and numerous other cost factors that vary by account and change from year to year, if not day to day. However, the IRS has expressed concerns that without a requirement to unbundle, trustees will artificially “gross up” their trustee fees, allowing them to claim more deductions than the statute purportedly allows.

Description of Proposal

The legislative proposal would delete the disputed phrase from IRC section 67(e), allowing estates and trusts to claim a full deduction for all costs legitimately incurred in connection with their administration. As amended, the statute would provide as follows:

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

Analysis

The AICPA supports this measure for the following reasons:

1. **The present statute is overly complex.** The present statute is overly complex and burdensome. In order to claim a full deduction for trust administration expenses, the trustee must predict whether an ordinary individual with the same property would have incurred the same cost or a portion thereof. And if the trustee determines that the cost is not fully deductible, page 21 of the Form 1041 instructions requires an algebraic formula to determine the amount of the deduction.

2. **The proposed change would eliminate uncertainty, inconsistencies, errors, and penalties that will result from the requirement to predict what individuals commonly do.** Because section 67(e) requires the extraordinarily difficult task of predicting whether individuals would commonly incur a particular expense that the trust or estate incurred, it will result in uncertainty, inconsistent treatment from trust to trust, errors of judgment, and penalties imposed by the IRS on both the trustee and tax preparers.
3. The present statute requires extensive recordkeeping. The Supreme Court’s interpretation of the present statute is contrary to Congress’s original intent to simplify recordkeeping and prevent individuals from deducting essentially personal expenses such as safe deposit box fees, investment magazines, and home office expenses. As interpreted, the rule is more onerous for estates and trusts than for individuals, for whom the statute was originally intended.

4. The present statute is out of date. The present statute was enacted in 1986, before the enactment of the Prudent Investor Act (1994) by nearly all states. This Act raised the investment standard from the “prudent man” to the more demanding “prudent investor” rule for 4 million trusts nationwide. To comply with this new standard, many trustees require professional advice. As currently written, the statute may subject deductions for costs incurred to comply with this Act to the 2-percent floor.

5. The present statute penalizes compliance with mandatory fiduciary duties. The present statute penalizes trustees in carrying out their fiduciary duties. Trustees are required to perform certain duties under the Prudent Investor Act or delegate them. But if they delegate them, they may be denied a full deduction for the cost. On the other hand, if they forgo professional advice in order to obtain tax deductions, they risk breaching their fiduciary duties. Such tension should not exist between the Prudent Investor Act and the Internal Revenue Code.

6. Trusts are already heavily taxed. Trusts already pay a hefty tax due to very compressed rate brackets that reach 35 percent after only $10,450 of taxable income compared to $349,700 for single individuals in 2008. Thus, there is no incentive for individuals to place money in trust to avoid the 2-percent floor. Nor do people create estates (i.e., die) to avoid income taxes.

7. Over 96 percent of trusts are small. According to IRS Statistics of Income for 2006 trust returns by AGI, over 96 percent of all trusts are small, reporting less than $100,000 of gross income. This is nearly the same threshold income level that many sections of the Internal Revenue Code use to distinguish between high and low income taxpayers for purposes of special tax relief, including the allowance for personal exemptions, the deduction for regular and Roth IRA contributions, the deduction for interest on education loans, the adoption credit, the child tax credit, and many more.

8. Compliance and enforcement costs of the present law outweigh the tax collected. If left unchanged, trusts and estates will be forced to try to comply with the Supreme Court’s interpretation of the present statute, and the IRS will be responsible for auditing their compliance. Smaller trusts and estates may just subject all administration expenses to the 2-percent floor in order to avoid further expenses of tracking and justifying a different answer. Larger trusts and estates will likely incur
the additional expenses to achieve a more advantageous result. The cost of compliance on the part of both the taxpayers and the IRS likely will be significant in light of the little additional revenue that may result. Our tax system should not tolerate such inconsistent treatment based solely on the cost to comply.

9. The proposed change is simple. This bill would simply delete the ambiguous phrase in section 67(e)(1), *i.e.*, “and would not have been incurred if the property were not held in such trust or estate.” After amendment, the statute would allow a full deduction for all costs “incurred in connection with the administration of the trust or estate.” It would be simple and consistent with the definition of adjusted gross income in section 165(h)(4)(C).

10. Trustees are already heavily scrutinized. Unlike individuals, fiduciaries are heavily scrutinized in contrast to individuals who are free to spend as they please. Fiduciaries must be in compliance with the Uniform Trust Code and the Uniform Prudent Investor Act. Bank fiduciaries are even more heavily regulated. Among other things, these Acts mandate loyalty to and impartiality among the beneficiaries, diversification, cost containment, and the consideration of eight other circumstances unique to the trust. It is not necessary or desirable to further scrutinize trustees’ behavior by allowing full deductions for only certain kinds of expenses incurred to carry out these duties.

11. The proposed change would provide a single unified definition of “adjusted gross income” (AGI) for an estate or trust. There are currently two different definitions of AGI for an estate or trust – one in section 67(e), which limits miscellaneous itemized deductions to those in excess of 2-percent of AGI and another in section 165(h)(4)(C), which limits personal casualty losses to those in excess of 10-percent of AGI. Both sections, however, allow a deduction for fiduciary administration costs in arriving at AGI. Section 67(e) defines such costs as those “paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate.” On the other hand, section 165(h)(4)(C) simply defines them as “costs paid or incurred in connection with the administration of the estate or trust.” The latter meaning has never been disputed, unlike section 67(e)(1), which has been hotly debated for 16 years and remains uncertain even after the Supreme Court’s holding in *Knight*.

It is unlikely that any individuals or groups will oppose this legislation.

**Conclusion/Recommendation**

Section 67(e) should be amended by deleting the phrase “and would not have been incurred if the property were not held in such trust or estate.” This one change would vastly simplify the law and make it clear that executors and trustees may fully deduct all
legitimate costs incurred to carry out their mandatory fiduciary duties. The current law that reduces certain of these costs by 2-percent of the estate or trust’s adjusted gross income (the 2-percent floor) is ambiguous, costly to administer, and obsolete.