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Tax simplification recommendations submitted to Committee on Ways and Means. U.S. House of Representatives

American Institute of Certified Public Accountants. Federal Taxation Executive Committee; American Institute of Certified Public Accountants. Tax Simplification Committee

AMERICAN INSTITUTE OF CERTIFIED

PUBLIC ACCOUNTANTS

TAX SIMPLIFICATION RECOMMENDATIONS

SUBMITTED TO

COMMITTEE ON WAYS AND MEANS

U.S. HOUSE OF REPRESENTATIVES

APRIL 20, 1990

1455 Pennsylvania Avenue, N.W.
Fourth Floor
Washington, D.C. 20004-1007
(202) 737-6600

INTRODUCTION

The American Institute of Certified Public Accountants (AICPA) is the national, professional organization of certified public accountants (CPA), with over 296,000 members. Many of our members are tax practitioners who work with millions of American businesses and individual taxpayers. As citizens, and as tax practitioners, CPAs are concerned with the growing complexity in the tax law, and the importance of preserving the viability of the voluntary compliance system.

The AICPA applauds Chairman Dan Rostenkowski's announcement on February 7, 1990 that the House Ways and Means Committee would be conducting a "major tax simplification study." In response, the AICPA has developed this comprehensive package of 59 tax simplification recommendations for consideration.

The AICPA Tax Division has, over the past few years, made reducing the level of complexity in the tax law a priority. In October 1988, the AICPA created the Tax Simplification Committee to promote an enhanced awareness of the need to consider simplification in future tax legislation and regulatory activity, and to identify specific areas in existing tax law in need of simplification. The Tax Simplification Committee working with other technical committees of the Tax Division developed the tax simplification recommendations contained in this package. This committee has: Held recent meetings with staffs of the Congressional tax writing committees; written recent articles; and, is developing a "blueprint for tax simplification," which is intended for analysis of the complexity level of legislative and regulatory proposals.

In January 1990, the AICPA sponsored, in conjunction with the American Bar Association, the Invitational Conference on Reduction of Income Tax Complexity. Leading tax practitioners and policymakers presented and discussed detailed policy papers on tax complexity. The conference was a tremendous success. We believe the conference achieved the goal of focusing the attention of those who know the tax system the best on the complexity problem, and, perhaps, renewed the process of review and reform.

In this package, we have tried to limit our recommendations to those that would simplify the tax law, rather than change tax policy. However, we acknowledge that a fine line often divides the two, and in some cases, a line cannot be drawn.

Within this package, this duality occurs primarily among the S corporation simplification recommendations. Several of these would allow corporations to elect S corporation status where they are currently ineligible. We feel compelled to make these recommendations because we believe that removing the impediments to the election of S corporation status is an important simplification goal, because affected taxpayers would be subject to only one income tax system, rather than two, and traps for the unwary would be eliminated.

This is a preliminary package of tax simplification recommendations. Additional projects are currently in process, and we anticipate subsequent submissions to the Ways and Means Committee as it pursues this major tax simplification study.

The AICPA urges Congress, while this study proceeds, to be slow to change the tax law, except for changes carefully designed to simplify provisions of wide application. The tax law will, and should, change with the times. However for the sake of tax administration, professional preparers, and the taxpaying public, consideration of proposed legislative changes should include review of the potential effect of the proposal on the complexity of the tax system. Simplification, efficiency and predictability must be given greater priority in the legislative and regulatory process.

The recommendations presented herein have been developed by the Tax Simplification Committee and approved by the Federal Taxation Executive Committee of the American Institute of Certified Public Accountants. The members of these bodies in 1990, when the report was approved, were:

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American Institute of Certified Public Accountants
1455 Pennsylvania Avenue, N.W.
Washington, DC 20004-1007
(202) 737-6600
Telecopier (202) 638-4512

April 20, 1990

The Honorable Dan Rostenkowski
U.S. House of Representatives
2111 Russell House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

The AICPA applauds your initiative to conduct a "major tax simplification study." Complexity within the tax law is an issue which is of great concern to CPAs.

The enclosed package of tax simplification recommendations is the preliminary result of a major simplification effort being conducted by the AICPA Tax Division. Additional simplification projects are currently in process, and we anticipate subsequent submissions to the Ways and Means Committee as it pursues this study.

We welcome the opportunity to provide this input and to meet the staff of the Ways and Means Committee to discuss and refine these proposals, as well as any other legislative proposals under consideration.

Sincerely,

Arthur S. Hoffman
Chairman, Federal Taxation
Executive Committee

Donald H. Skadden
Vice President - Taxation

Enclosure

AICPA Tax Simplification Recommendation

INTEREST ON UNDERPAYMENTS SHOULD BE BASED ON SIMPLE INTEREST COMPOUNDED ANNUALLY WITH RATES REVISED ANNUALLY

Present Law

Interest on underpayments is set at 3 percent above the short-term federal rate, compounded daily. Interest on overpayments is set at 2 percent above the short-term federal rate, simple interest. The rates are revised quarterly, rounded to the nearest full percent.

Suggested Change

Set interest on underpayments at the effective annual rate, compounded annually. The effective annual rate would be the annual simple interest rate which equals 3 percent above the short-term federal rate compounded daily. Rates on underpayments and overpayments would be revised just once annually, unless interest rates are very unstable. The effective date for the annual interest rate adjustment would be April 16.

Contribution to Simplicity

Because of daily compounding and quarterly rate changes, IRS interest calculations are unverifiable without a computer program. Even then, the IRS and computer program often produce small unreconcilable differences. Calculating the underpayment of estimated tax penalty has become so complicated, that the IRS offers to calculate it for taxpayers and bill them after returns are filed.

This suggested change will make interest calculations simple and verifiable. The April 16 effective date will make it even simpler for individuals.

Other Issues

Pros - This suggested change fulfills the policy goals of a higher interest rate on underpayments and a disincentive for settlement delays through annually compounding a simple interest rate.

Cons - If tax is owed for less than a full year, or if there are rate changes during the year, interest will be slightly higher using an effective annual rate, than a daily compounding rate. Restricting rate changes to once annually will yield different results than the current quarterly changes.

History - Interest on underpayments and overpayments was 6 percent until July 1, 1975. It was then raised to 9 percent, with Code section 6621 requiring Treasury to adjust the rate once every two years to equal bank prime rate. Effective January 1, 1983, a change in rate was required semi-annually, and Code section 6622 was added to require daily compounding of interest on underpayments. Effective January 1, 1987, the change in rate was required quarterly with 2 percent above the short term federal rate on overpayments and 3 percent above the short federal rate on underpayments.

The Tax Equity and Fiscal Responsibility Act of 1982 instituted quarterly interest rate changes because of dramatic monthly fluctuations the U.S. was experiencing at that time. When interest rates are relatively stable, the law should vary the rate less frequently.

The Tax Reform Act of 1986 added an interest rate differential for underpayments and overpayments out of concern that they relate closely to other interest rates in the economy. [However, other interest rates rarely include daily compounding (except as a sales gimmick on low rate savings accounts). So daily compounding and rate differential are two methods of accomplishing the same goal, and the daily compounding (being the more complicated) should be repealed as superfluous.]

ESTIMATED TAX--ALLOW EXCEPTION FOR LAST YEAR'S TAX TO BE USED IF NO TAX WAS PAID

Present Law

The Omnibus Budget Reconciliation Act of 1987 consolidated the corporate estimated tax rules into one section of the Internal Revenue Code, similar to the provision enacted for individuals by the Deficit Reduction Act of 1984. For the taxable years beginning after December 31, 1987, corporations generally are required to make estimated tax payments in an amount equal to the lesser of (1) 90 percent of the tax shown on the return for the taxable year, or (2) 100 percent of the tax shown on the return of the corporation for the preceding taxable year. Corporations are no longer able to avoid a penalty for underpayment of estimated taxes by relying on old "exception two." This exception allowed a corporation to avoid a penalty in the current year if its estimated tax payments were equal to an amount computed based on tax rates applicable to the current year, but otherwise based on the facts shown on the return of the corporation for, and the law applicable to, the preceding tax year. This change effectively prevented corporations from using the lower corporate tax rates enacted in the Tax Reform Act of 1986 without picking up the new broader tax base.

The payment of estimated tax based on 100 percent of the prior year's tax generally is not available to a large corporation, except for the first installment. A large corporation generally is defined as any corporation (or any predecessor corporation) that had taxable income (with certain modifications) of $1,000,000 or more during any of the three taxable years immediately preceding the taxable year involved.

The payment of estimated taxes based on 100 percent of the prior year's tax also is not available to any corporation if the preceding taxable year was not a taxable year of 12 months, or if the return for the preceding taxable year did not show a tax liability.

Suggested Change

Allow corporations (except large corporations for other than the first installment) to not pay estimated tax if no tax was paid the preceding year.

Contribution to Simplicity

The accurate computation of estimated tax payments is difficult for many corporations who paid no tax in the previous year. The payment of 100 percent of the prior year's tax is limited to corporations not meeting the definition of a "large corporation," and to tax returns showing a tax liability in the prior year. Thus, a corporation with only $1 of tax in the preceding year (even if from investment tax credit recapture) can avoid making estimated tax payments while a taxpayer paying no tax the preceding year must make estimated tax payments if it expects to have a tax liability for the current year.

Alternative

An alternative would be to change the rule allowing estimated tax to be paid based on the prior year's liability, by allowing it to be based on the greater of the tax paid in either of the prior two taxable years. If tax was not paid in either year, no estimated tax payments would be required for the current year. Consistent with current law, this would not apply to large corporations except for the first installment.

AICPA Tax Simplification Recommendation

NET OPERATING LOSS AND GENERAL BUSINESS CREDIT CARRYOVER PERIODS SHOULD BE UNLIMITED

Present Law

Net operating losses (NOLs) and general business credits (GBCs) can be carried back 3 years and over 15 years. The last change in the carryover period was made by the Economic Recovery Tax Act of 1981 when the period was increased from 7 years to 15 years generally effective for losses incurred in taxable years beginning after 1975.

Suggested Change

The NOL and GBC carryover periods should be unlimited.

Contributions to Simplicity

Under current law, taxpayers often engage in various tax planning techniques and strategies in order to avoid the expiration of unused NOLs and GBCs. The ability to avoid the loss of NOLs and GBCs has been increased with the enactment of the minimum tax credit (MTC). Taxpayers can now convert expiring NOLs and GBCs into MTCs which have an unlimited carryover period. Providing an unlimited carryover period would eliminate the need to undertake nonbusiness motivated techniques and allow the use of these carryovers in a straight-forward manner rather than indirectly.

Other Issues

The IRS has often argued that carryover periods should not be unlimited because of the difficulty in administration since taxpayers may not keep needed records long enough. However, taxpayers would have the burden of proving the creation and use of an NOL and GBC and therefore would have the obligation to keep such necessary records or lose the benefit. Also, the Tax Reform Act of 1986 enacted an MTC with an unlimited carryover period. This proposal does not apply with respect to financial institutions.

AICPA Tax Simplification Recommendation

CAPITAL LOSS CARRYOVER PERIODS FOR CORPORATIONS SHOULD BE UNLIMITED

Present Law

Capital losses can be carried back 3 years and over 5 years.

Suggested Change

The capital loss carryover periods for corporations should be unlimited.

Contributions to Simplicity

This would eliminate the need for taxpayers to undertake various tax planning techniques and strategies in order to avoid the expiration of unused capital losses.

Other Issues

The IRS has often argued that carryover periods should not be unlimited because of the difficulty in administration since taxpayers may not keep needed records long enough. However, taxpayers would have the burden of proving the creation and use of capital losses and therefore would have the obligation to keep such necessary records or lose the benefit. Also, the Tax Reform Act of 1986 enacted a minimum tax credit with an unlimited carryover period. Under current law the capital loss carryover period for individuals is unlimited.

AICPA Tax Simplification Recommendation

UNIFORM CAPITALIZATION OF INVENTORY COSTS FOR PRODUCED PROPERTY

Present Law

Section 263A enacted in the Tax Reform Act of 1986 provided uniform capitalization rules that apply to the capitalization of costs incurred in the production of property and property acquired for resale. These rules are effective for inventory produced or sold in the first taxable year beginning after 1986 and they expand the categories of costs required to be capitalized rather than expensed as period costs.

Suggested Changes

One-Time Determination: Permit taxpayers who have complied with UNICAP rules to make an election (revocable with the consent of the Commissioner) to continue to use the capitalization rate for future years. This one-time determination could be based on an average capitalization rate determined from a three-year base period. Such an average would insure that the capitalization rate used is not adversely impacted by operational anomalies in a noncomplex way. This election would continue until there is some significant change in the operational make-up of the taxpayer which would alter such an average capitalization rate. This one-time determination would help reduce the compliance burden on the taxpayer without sacrificing the revenue flow to the Treasury.

Add-On Percentage: Allow taxpayers an election (revocable with the consent of the Commissioner) to use a prescribed capitalization rate or, more simply stated, an "add-on" percentage. This percentage would be in lieu of identifying specific costs or making the required calculations annually. This prescribed capitalization rate could be set forth in table format based on SIC grouping. The use of the add-on percentage would be considered as an elected method of inventory accounting and could only be changed subject to the Secretary's approval. The add-on percentage would be more cost effective for the taxpayers to comply with and would be easier for the IRS to audit compliance.

These recommendations should be in the form of an election so that the taxpayer always has the opportunity to utilize the actual amounts or the methodologies under the statutes and regulations. The changes should be available to small businesses who do not have the staff or outside resources to comply with the current statutes and regulations.

Contribution to Simplicity

The expanded and detailed computations and schedules required to comply with UNICAP have created an undue burden on many taxpayers. In many cases, the cost to comply has approached, equaled or exceeded the tax resulting from additional capitalized inventory costs. Such complexity may breed an unwillingness to comply.

These recommendations will enhance compliance with UNICAP, as well as the full absorption rules, by removing some of the burden on taxpayers. Further, the elections should increase compliance and thereby enhance revenue.

Other Issues

Some believe the Department of the Treasury currently has the authority to implement the above proposal through regulations.

AICPA Tax Simplification Recommendation

DEPRECIATION--PROVIDE FOR USE OF THE OPEN-ENDED ACCOUNT SYSTEM OF DEPRECIATION

Present Law

Under the current accelerated cost recovery system, depreciation is calculated separately for each asset. Also, gain or loss generally is recognized on the disposition of each asset unless another provision provides for nonrecognition. Depreciation must be separately determined for each asset for purposes of determining regular tax, alternative minimum tax, and, for corporations, earnings and profits, and starting in 1990 adjusted current earnings. In addition, in certain states taxpayers must separately determine depreciation for state tax purposes.

Under ACRS, depreciation generally is determined by using the specified method (200 percent declining balance switching to straight-line, 150 percent declining balance switching to straight-line, or straight-line) over the specified recovery period.

Suggested Change

Change the system of determining depreciation under ACRS to an open-ended account system.

Under an open-ended account system of depreciation, there is one account for each recovery period for personal property (e.g., one account for 5-year property and a separate account for 7-year property). For real property, either a separate account is used for depreciating each separate asset or such depreciation can remain under the current system. The open-ended account for each class applies for all property in that recovery period regardless of the year the property is placed in service. (In contrast, under the ADR vintage account system, a separate account was used for each placed-in-service year.) Depreciation is determined by applying a specified percentage to the account balance at the end of the year. [Under modified ACRS, the percentage can be based on the 200 percent or 150 percent declining balance method of the recovery period (e.g., 40 percent for the 5-year class, 28.57 percent for the 7-year class)]. The amount of depreciation taken for the year reduces the balance of the account as of the first day of the succeeding year. First year conventions are accommodated by adding to the account only a portion of the basis in the year the property is placed in service (one-half in the case of the half-year convention), with the remaining portion added the following year.

Under the open-ended account system, gain or loss is not recognized on the disposition of individual assets. Instead, the account is reduced by the proceeds, if any, realized on disposition. The result is that recognition of gains and losses are deferred by reducing depreciation deductions in the year of disposition and subsequent years. Ordinary income is recognized in any year to the extent that the account balance becomes a negative due to dispositions.

Flexibility can be allowed by permitting taxpayers to elect to use a depreciation percentage less than the maximum account (e.g., a percentage equal to one-half of the normal percentage) either on a year-by-year basis or for a period of years. Depreciation for AMT (and ACE) purposes can be determined by setting up similar accounts for each class life. Special rules have been designed to deal with carryover basis transactions, like-kind exchanges and involuntary conversions.

Example:

Assume Taxpayer X has $1000 of new 5-year property placed in service in year 1 and $500 in year 2. Assuming the half-year convention, X's depreciation for each year would be as follows:

	Year 1	Year 2
Beginning Balance	-0-	300
Balance of Prior Additions	-0-	500
New Additions (1/2)	500	250
Proceeds of Dispositions	(0)	(0)
Subtotal	500	1050
Depreciation (40%)	(200)	(420)
Ending Balance	300	630

Contribution of Simplicity

The greatest contribution to simplicity of the open-ended account system is that it greatly reduces the recordkeeping and number of calculations required of taxpayers. Under this system, depreciation calculations can be determined on a recovery period or class life basis, and are not required for each separate asset. The benefits of the ease of computation under the open-ended account system is even greater when taking into account the alternative minimum tax (AMT) and accumulated current earnings (ACE) depreciation requirements. An open-ended account system can be implemented without changing the basic recovery period and method tenets of the accelerated cost recovery system (ACRS).

History of Open-Ended Account System Proposals

1. The open-ended account system is used in Canada and in other countries.

2. It was proposed by the Carter Administration Treasury Department in 1980 as part of its Constant Rate Depreciation proposal.

3. It was approved by Senate Finance Committee in 1980 as part of its Simplified Cost Recovery System (also referred to as the "2-4-7-10" system) proposed by Senator Bentsen.

4. It was approved by House Ways and Means Committee in 1981 as part of its Tax Incentive Bill of 1981.

5. We understand that it was strongly considered by the Reagan Administration Treasury Department in 1981 for ACRS. We also understand that at that time it was formally endorsed by staffs of the Treasury, Joint Tax Committee, Senate Finance Committee, and House Ways and Means Committee.

6. It was proposed by Senators Bentsen and Wallop in 1983 as their proposed "Accounting Cost Recovery Simplification Act of 1983" (S.1758). However, it was not supported by the Treasury on the basis that it was too soon after enactment of ACRS, although the Treasury did state that it recognized that the proposal "would, in many respects, simplify the present system of cost recovery."

7. It was included as part of the Bradley-Gephardt flat tax proposal in 1983.

8. The open-ended account system has been endorsed previously by the AICPA: (1) Letter of June 5, 1981, to the Assistant Secretary of the Treasury for Tax policy, (2) AICPA Statement of Tax Policy No. 7 - Analysis of Capital Cost Recovery Proposal (1980), and (3) AICPA Tax Recommendations to Aid Small Business (April 1980).

AICPA Tax Simplification Recommendation

THE INDEXING OF THE LUXURY AUTOMOBILE LIMITATIONS SHOULD BE LIMITED TO THE TOTAL COST OF THE AUTOMOBILE, NOT TO THE ANNUAL DEPRECIATION LIMITATION

Present Law

Through 1988, depreciation on automobiles was limited to depreciation on an automobile costing $12,800. The annual depreciation rate on $12,800 based on 200 percent declining balance rate over a 5-year recovery period were provided in the Code as $2,560 for the first year, $4,100 for the second year, $2,450 for the third year, $1,475 for succeeding years.

Starting in 1989, the Code provides for indexing the limitations by indexing the annual depreciation limitations. For 1989, the appropriate inflation rate is 2.17 percent which when applied to the annual limitations and rounded to the nearest $100 results in 1989 limitations of $2,660 for the first year, $4,200 for the second year, $2,550 for the third year, $1,475 for succeeding years.

Suggested Change

The indexing of automobiles depreciation limitations should be changed so that the total cost (e.g. $12,800) is indexed instead of the annual depreciation limitations.

Contributions to Simplicity

Through 1988, practitioners could advise clients that automobiles costing over $12,800 would be subject to the luxury automobile depreciation limitations. In 1989, because of the way the indexing is done, it is not possible for practitioners to provide such simple advice. Under the 1989 limitations, an automobile costing over $13,300 is subject to the limitation in the first year, an automobile costing over $13,125 is subject to the limitation in the second year, and an automobile costing over $13,281 is subject to the limitation in the third year. However, since the limitation for years succeeding year three remains at $1,475, depreciation on an automobile costing more than $12,800 will be limited in years after year 3.

These limitations will be very difficult for practitioners to explain to clients. By indexing overall cost of the automobile instead of the annual limitations, it will be easily explained to clients and understood by them that automobiles costing more than $13,100 would be subject to the limitations.

AICPA Tax Simplification Recommendation

REDUCE RECORDKEEPING AND DEPRECIATION RESTRICTIONS FOR NON-AUTOMOTIVE LISTED PROPERTY USED IN CONNECTION WITH A TRADE OR BUSINESS

Present Law

Computers not used exclusively at a regular business establishment, and property generally used for entertainment, recreation, or amusement, require substantiation and potential limits on depreciation deductions.

Suggested Change

Depreciation of non-automotive listed property used in connection with a trade or business would be allowed on 75 percent of cost, straight-line, over seven years. Recordkeeping requirements and reduced depreciation and recapture based on the percentage of non-business use would be repealed. A Section 179 election would not be allowed for listed property.

Treasury would be granted authority to issue legislative regulations defining "in connection with a trade or business," provided they did not require mandatory recordkeeping. The taxpayer must be able to justify the business use of each asset, including accessories (e.g., camera and lenses). Such regulations could be based on corroborating evidence showing required business use or lack of a hobby motive. In limited circumstances, economic justification for purchasing the asset would be acceptable.

Contribution to Simplicity

Unless a person is in a business requiring frequent use of non-automotive listed property, he is generally converting a personal asset into a tax deduction. Substantiation requirements are unverifiable where a reasonable amount of business use can be shown. This suggested change reduces the depreciable cost and lengthens the depreciation deduction in return for reduced recordkeeping. It should be easier to administer and should reduce abuse.

The 75 percent of cost depreciable basis or 7-year life can be modified to ensure revenue neutrality.

AICPA Tax Simplification Recommendation

STANDARDIZE THE ALLOWABLE MILEAGE ALLOWANCE

Present Law

A standard mileage allowance, determined annually, is allowed employees in determining their expenses related to employment (26 cents per mile in 1990). For charitable contribution deduction purposes, a mileage allowance of 12 cents per mile is used. For medical expense deduction and moving expense deduction purposes, a taxpayer may deduct a standard mileage allowance of 9 cents per mile.

Suggested Change

A single rate of 50 percent of the regular standard mileage allowance for business (rounded to the nearest whole cent) should be used for charitable, medical, and moving expenses.

Contribution to Simplicity

Taxpayers would no longer have to remember several different mileage allowances, at least three of which they are very likely to have to use in the same individual tax return.

AICPA Tax Simplification Recommendation

REPEAL REQUIREMENT THAT PRIVATE FOUNDATIONS PUBLISH NOTICE OF AVAILABILITY

Present Law

Section 6104(d) requires that private foundations publish notice of the availability of their annual return for inspection in a newspaper having general circulation in the county in which the principal office of the private foundation is located.

Suggested Change

The publication requirement under section 6104(d) should be repealed. The public inspection requirement for private foundations should be incorporated in section 6104(e) by deleting section 6104(e)(1)(B)(ii).

Contribution to Simplification

The annual newspaper notice is an unnecessary burden on private foundations. The notice is generally buried in the legal classified section, which makes the notice a public record, but hardly publicizes availability. Often, the newspaper does not have general circulation in the required county. Public inspection through section 6104(e), which was enacted in 1987, should better fulfill the rarely asserted inspection right. Taxpayers also have the ability, under section 6104(a), to request copies of private foundation annual returns from the IRS.

AICPA Tax Simplification Recommendation

AMEND PAYROLL DEPOSIT RULES

Present Law

Employers must remit withheld employee income tax and social security taxes by depositing them periodically with a federal reserve bank. Presently, there are eight monthly deposit periods. The appropriate deposit period is determined by aggregating the amount of undeposited payroll taxes. Under the Revenue Reconciliation Act of 1989, if the aggregate amount is $100,000 or more, the deposit must be made either the first, second, or third day thereafter, depending on the year.

Suggested Change

Withheld employee taxes should be deposited within three business days after the date of payment of the payroll, regardless of the aggregate undeposited amount. This provision will be effective for all pay periods starting January 1 after date of enactment. The small payroll exceptions for depositing on the 15th day of the following month and the end of the quarter would be retained.

Contribution to Simplicity

The proposed depository method would eliminate the employer having to aggregate the undeposited taxes due and determining which eighth monthly depository period applies.

The current rules applicable to deposits required to be made on a specific business day following the pay period would apply under the proposed method as modified.

AICPA Tax Simplification Recommendation

ANNUITIES--THE PAYOR, NOT THE RECIPIENT, SHOULD COMPUTE TAXABILITY

Present Law

The tax free portion of amounts received as an annuity is spread evenly over the annuitant's life expectancy. For annuities with a starting date after December 31, 1986, the exclusion of a portion of each annuity payment cannot be continued indefinitely. Once the total of all exclusions taken for payments under the annuity contract equals the investment in the contract, all subsequent payments will be fully taxed. Conversely, if the annuitant dies before the investment in the contract is fully recovered through the annuity exclusion, a deduction is provided in the last tax year in an amount equal to the unrecovered portion of the investment.

The excludable portion of an annuity is the "investment in the contract" divided by the "expected return" under the contract as of the annuity's starting date. Currently, the taxpayer must compute this exclusion ratio for his or her individual return.

Suggested Change

The payor of an annuity, not the recipient, should be required to compute the taxable portion of the annuity payment. The change would be effective only for policies issued prospectively.

Contribution to Simplicity

Presumably, the company which originally sold the annuity is the same company now responsible for making annuity payments. Companies selling annuities should be keeping records of the initial investment in the contract. Those companies are also in a position to best understand the annuity rules and correctly compute the taxable and nontaxable portions of annuities. A significant compliance burden could be removed from the recipients of annuities, while not greatly increasing the burden on the payors.

Other Issues

Pros - All of the information necessary to compute the taxable amount of annuity payments would be available to the payors of the annuity. It would vastly simplify the computation of taxable income for recipients of annuity payments. Compliance would be enhanced.

Cons - A slightly increased compliance burden would be imposed on annuity payors.

AICPA Tax Simplification Recommendation

REPEAL THE FIVE-YEAR LIMITATION ON THE CARRYOVER OF EXCESS CHARITABLE CONTRIBUTIONS

Present Law

Currently, taxpayers are permitted to carryover to five succeeding taxable years unused charitable contributions that have exceeded specified percentages of the taxpayer's contribution base. According to IRC section 170(d), in each of the five subsequent years, current contributions are deducted before carryover amounts. Consequently, if the taxpayer sustains a significant rate of giving to qualified organizations, he or she may never fully benefit from the contributions made in an earlier year. Significant tax planning resources may be expended in determining both the timing and the amount of the taxpayer's contributions.

Suggested Change

Repeal the five-year limitation on the carryover of excess charitable contributions to qualified organizations. In other words, permit the deduction of such contributions in any subsequent year in which applicable limitations related to the taxpayer's contributions base are not exceeded.

Contribution to Simplicity

Currently, significant tax planning may be undertaken to assure that charitable contributions are deducted within five years. Rather than timing contributions to take advantage of available "windows," earlier gift-giving will be encouraged if the focus is no longer on the deduction of expiring contributions carryover.

Other Issues

Qualified organizations would benefit from an acceleration in the timing of charitable gifts.

AICPA Tax Simplification Recommendation

SIMPLIFY MOVING EXPENSE DEDUCTION

Present Law

Section 217 allows a deduction for certain moving expenses incurred in connection with employment if a distance test, a length-of-employment test and a commencement-of-work test are met. The deduction for expenses of house-hunting trips and temporary living (for up to 30 days), and costs of selling, renting or purchasing a home, are limited to an overall amount of $3,000, of which not more than $1,500 may be used for house-hunting trips and temporary quarters. Furthermore, any meal expenses deductible as a moving expense, whether or not reimbursed, are subject to the 20 percent disallowance rule. Similar rules (with increased deductibility limits) apply to foreign moves.

Suggested Change

Moving expenses other than those attributable to the actual move from one home to another and the related transportation of household goods should be subject to one limitation, perhaps the $3,000 amount currently applicable (after the $1,500 limitation is imposed on house-hunting trips and temporary living expenses). There should not be a separate, first-tier, limitation on these expenses. It simply adds to taxpayer confusion and causes taxpayers to recharacterize expenses or search more diligently for receipts related to selling or renting their new or old homes.

Contribution to Simplicity

Taxpayers currently commingle moving expense-related receipts and it is often difficult to sort them into the appropriate categories. Furthermore, they sometimes quit keeping receipts above $1,500 because they have that limitation fixed in their minds and think they are entitled to no further deductions. One overall limitation would significantly simplify the moving expense calculation.

AICPA Tax Simplification Recommendation

SIMPLIFY THE EARNED INCOME CREDIT

Present Law

According to the Internal Revenue Service (IRS), the calculation of earned income credit (EIC) is one of the top five causes for Form 1040 errors annually.

Suggested Change

The EIC can be simplified by reducing exactness and simplifying definitions.

Section 32(c)(1)(A) allows the EIC to certain taxpayers with non-dependent children. This complicates EIC instructions for determining eligibility. If eligibility is restricted to those with dependent children, section 32(c)(1)(A) and (B) can be combined and simplified by including all eligible individuals in one paragraph to read:

> (A) The term "eligible individual" means an individual who, for the taxable year maintains as his home a household in the United States which constitutes for more than one-half of such taxable year the principal place of abode, as a member of such household, of a son, stepson, daughter, or stepdaughter of the taxpayer, or a descendant of a son or daughter of the taxpayer, with respect to whom the taxpayer is entitled to a deduction for the taxable year for such person under section 151.

Section 32(c)(1)(C) is an equity provision denying EIC to individuals claiming a foreign earned income exclusion. For simplification purposes, anyone claiming a foreign earned income exclusion should not be considered for EIC. Section 32(c)(1)(C) should be amended to deny all EIC for taxpayers claiming the exclusion.

Section 32(c)(2) conforms the definition of earned income with other sections of the Code. A simpler method would define earned income as wages appearing on Line 7 of Form 1040 (1988) plus self-employment income from Schedule SE, section A, Line 3. Conformity would be lost, but EIC would be easier to calculate and instructions would be shorter.

Section 32(f) requires that tables have income brackets not greater than $50 each. Form 1040 instructions include two pages of tables with $25 brackets which results in earned income credit intervals of $3. The tables can be reduced to half a page by amending section 32(f) to allow brackets which result in $10 earned income credit intervals.

Section 32(h) requires reduction of EIC for taxpayers subject to alternative minimum tax. This section should be combined with the revised section 32(c)(1)(C) denying EIC to anyone claiming a foreign earned income exclusion.

Instead of a worksheet calculation, the EIC should be calculated on an IRS designed schedule which is attached to the tax return.

Contribution to Simplicity

EIC requires two pages of tables and one full page of written instructions. These changes should reduce the tables to half a page and reduce the instructions to two-thirds page. That should make EIC easier to explain and simpler to calculate.

In addition, these changes should enable the IRS to automatically identify all individuals eligible for EIC and automatically adjust the refund in case they fail to claim it. This is accomplished by simplifying the definition of earned income and denying eligibility to taxpayers without dependent children.

Those entitled to EIC under current law, but not under this proposal are:

(1) Head of household with a nondependent child. (This is often an adult child with a second income for the household.)

(2) Custodial parent who is not entitled to a dependency exemption because he/she released it under section 152(e)(2) or (4). (The custodial parent may choose or negotiate not to release the exemption.)

The tax law already confers the benefit of head of household tax rates on taxpayers with nondependent children. Allowing EIC for these taxpayers hinders the IRS from identifying individuals eligible for EIC and makes the instructions complex. EIC-eligible taxpayers need simplification. This is a more significant consideration than achieving perfect equity.

Other Issues

It should be noted that errors involving the calculation of the earned income credit are in the top five errors in return preparation.

AICPA Tax Simplification Recommendation

ALLOW EMPLOYERS TO CHOOSE AN IRS PROTOTYPE IF THEY WANT A QUALIFIED RETIREMENT PLAN

Present Law

Recent tax laws have liberalized section 408(k), the simplified employee pension (SEP), which allows a maximum of 15 percent of compensation and requires coverage for employees earning at least $300 in three out of five years. However, employers desiring a contribution rate of 25 percent of compensation, or those who could benefit from a regular plan's 1000-hour participation requirement choice of vesting schedules, or those desiring a defined benefit plan, must deal with onerous and expensive compliance requirements.

Rapid tax law changes have required frequent revisions in every qualified plan. This has been especially burdensome for small employers.

Suggested Change

A provision for an employer qualified pension (SEQP) should be enacted. It would:

1. Establish a new IRS prototype plan. It should be as simple to adopt as completing the Form 5305-SEP or 5305A-SEP, used to adopt a simplified employee pension plan. Once adopted, it will automatically be updated for future changes in the law and the employer will be bound by the prototype changes.

2. The plan year would be the employer's fiscal year. The maximum wage base would be $200,000.

3. Allow an annual variable contribution of up to 15 percent of compensation.

4. Allow an election for a fixed contribution of an additional zero to ten percent. Fixed contributions would be commingled with the variable contributions into a single plan. The employer could terminate the fixed contribution election, but he could not re-elect it for five years.

5. Set an eligibility standard not to exceed age 21. Set a participation standard more restrictive than SEP's $300, which does not impose a recordkeeping burden like calculating 1,000 hours (e.g., minimum wage at the beginning of the plan year multiplied by 500).

6. Allow a binding election of 2 years/20 percent, 3 years/100 percent, or faster vesting. The election could be changed upon obtaining IRS approval.

7. A salary reduction option would be permitted, modelled after a SEP.

8. Plan distributions would be made only to an employee's IRA account.

9. Loans would not be permitted. But an employee could request that any vested portion be transferred to his IRA within 30 days of receiving his annual statement.

10. Investments would be restricted to assets allowed to IRA's and which are readily subdivided for distribution.

Defined benefit plans and social security integration would not be features of SEQP. A simplified method should be provided for existing plans to change to a SEQP.

SEQP could be enacted as a new provision, or by expanding SEP provisions.

Contribution of Simplicity

With recent tax reform, an employer's ability to discriminate and tailor retirement plans has been greatly restricted. Frequent tax law changes provide no perceptible improvements for employers other than expensive compliance costs.

In an effort to reduce legal fees, many attorneys are devising prototype and master plans for their clients. Many employers have plans through brokerage houses, insurance companies, and banks. Employers often receive poor advice and wind up with multiple profit sharing and money purchase plans as a result of signing plan documents with competing firms. When an employer changes lawyers or plan providers, his qualified plan is unfamiliar to the new provider. Unless he receives expert (and expensive) advice, his plan will not be properly updated. As a result, a very large percentage of existing plans are technically in violation of paperwork and update requirements of existing law.

SEQP should dramatically reduce costs to administer a qualified retirement plan. It should improve compliance because it will be simpler for employers to understand the rules. Plan updates for tax law changes would be automatic. It would reduce the administration burden on IRS.

AICPA Tax Simplification Recommendation

SHIFT BURDEN OF TRACKING THE BASIS OF INDIVIDUAL RETIREMENT ARRANGEMENTS FROM TAXPAYER TO ACCOUNT TRUSTEES

Present Law

A taxpayer who makes nondeductible contributions to an individual retirement arrangement (IRA) is required to report these contributions on Form 8606. This form must also be filed if IRA distributions are received or nondeductible contributions are made to the IRA(s). In completing this form, the taxpayer arrives at his or her basis in the IRA as of the end of the taxable year. The basis of the taxpayer's IRA(s) must be recompute in each subsequent year in which there are nondeductible IRA contributions or IRA distributions. Currently, under section 408(o), the taxpayer would average the aggregate taxable and nontaxable contributions when determining the taxable portion of distributions.

Suggested Change

The responsibility for the tracking of the basis of IRAs should be reassigned to the account trustee. Information on what portion of the IRA contributions were to be considered nondeductible would be furnished to the trustee by the taxpayer or the Internal Revenue Service at the time the tax return was filed or adjusted. In the absence of timely notice to the contrary, the item will be considered as a deductible contribution. It might be desirable to set up separate IRAs for deductible and nondeductible contributions. Where multiple IRAs exist, the order of the distributions could be specified.

Contribution to Simplicity

This change would result in reducing the administrative burden for a large class of taxpayers who do not normally need to keep track of the tax basis of assets. Account trustees generally have the expertise and data management capabilities to comply accurately with recordkeeping requirements. Parity in the tax treatment of IRAs and pension plans would be enhanced.

Other Issues

Second order effects may include an increase in the tangible costs of administering these arrangements offset by the less tangible savings in the paperwork burden imposed on individual taxpayers. To the extent that taxpayers perceive IRAs to be more costly, this type of savings may decrease. Alternatively, the current recordkeeping required of the individual taxpayer may result in a shift to other forms of savings. This suggestion would change the current averaging rule for IRA distributions.

AICPA Tax Simplification Recommendation

SIMPLIFY THE "PARTIAL DEDUCTION" OF IRA CONTRIBUTIONS

Present Law

Deductions for contributions to individual retirement arrangements (IRAs) are generally permitted in computing adjusted gross income (AGI). However, the deduction is conditioned upon whether the taxpayer or the spouse is covered by an employer-funded retirement plan. If the taxpayer or spouse is deemed to be an active participant in such a plan, the deduction is allowed in full under IRC section 219(g) only if the modified adjusted gross income is $40,000 or less on a joint return (or that of a surviving spouse). The "modified AGI threshold" is $25,000 if the taxpayer files as single or head of household and $0 if the taxpayer is married and filing separately. A partial deduction is calculated if modified AGI is over $40,000 and does not exceed $50,000 on a joint return (between $25,000 and $35,000 on a single return and between $0 and $10,000 on a separate return).

Suggested Change

If the taxpayer or the spouse has had a contribution for his/her benefit made to an employer retirement plan and the taxpayer's(s') modified AGI exceeds the "modified AGI threshold," a partial deduction would be computed with a dollar-for-dollar phaseout of the deduction for each dollar of modified AGI in excess of the threshold. A full deduction up to the allowable amounts (the lesser of $2,000 or $2,250 or earned income or the amount of the actual contribution) would continue to be allowed if the taxpayer's modified AGI is less than the "modified AGI threshold." A full deduction up to the allowable amounts would also be allowed if the taxpayer and spouse, if married, has not had a contribution for his/her benefit made to an employer retirement plan (regardless of whether the taxpayer or spouse is covered by an employer retirement plan or deemed an active participant).

Contribution to Simplicity

Currently, complex calculations are required for a number of middle class taxpayers whose modified AGI falls within the a $10,000 range above the stipulated threshold amounts. The proposed dollar-for-dollar phaseout of the deduction would simplify the computations required in filing a tax return.

Other Considerations

If the dollar-for-dollar phaseout replaces the current $10,000 range, without an upward adjustment to the threshold amounts, two results (or a combination thereof) may occur: (1) the aggregate amount of tax-deductible IRA contributions will be reduced while the corresponding aggregate nondeductible IRA contributions will be increased, which will result in additional tax revenue; and/or (2) there will be a decrease in contributions to this type of savings plan. If Congress wishes to retain the benefit of the average partial deduction under the current system, the thresholds could be increased above $40,000 (or $25,000 or $0). Raising these thresholds would also reduce the number of taxpayers subject to the phaseout calculation.

AICPA Tax Simplification Recommendation

USE ONE SET OF TERMS TO APPLY THE QUALIFICATION, DEDUCTION AND DISTRIBUTION RULES AND CONFORM THE TERMINOLOGY OF THE CODE WITH THE TERMINOLOGY OF TITLE I OF ERISA

Present Law

The Code currently uses two sets of terms to describe qualified retirement plans: pre-ERISA terms and ERISA terms. The pre-ERISA terms are profit-sharing plans, pension plans, and stock bonus plans. The ERISA terms are defined contribution plans and defined benefit plans. Every plan has a pre-ERISA and an ERISA name and a taxpayer must know both names for each plan in order to accurately apply the rules in the Code to a particular plan. For example, most of the ERISA qualifications sections, e.g. section 415, refer to defined contribution and defined benefit plans. Many of the pre-ERISA Code sections, e.g. sections 402 and 404, refer to pension plans, stock bonus plans, and profit-sharing plans.

In general, there are three types of defined contribution plans: profit-sharing plans, stock bonus plans, and money purchase pension plans. TRA 86, however, eliminated the requirement that contributions to a profit-sharing plan must be made from an employer's current or accumulated profits. This eliminates a major difference between profit-sharing plans and other defined contribution plans. The remaining distinctions include the requirement that a money purchase pension plan have fixed annual contributions while a profit-sharing plan may have fixed or discretionary annual contributions. A second distinction exists with respect to when distributions may be made from each of these plans. A third distinction is that the limitation for deductible contributions is generally 15 percent of compensation for a profit-sharing or stock bonus plan and 25 percent of compensation for a money purchase pension plan.

Finally, the primary distinguishing characteristic of a stock bonus plan is that the participants of a stock bonus plan have a right to demand their distribution in employer securities while participants in profit-sharing and money purchase pension plans are not required to have that right.

Suggested Change

The Code should be structured around the ERISA terms - defined contribution and defined benefit plans. The elimination of the "profits" requirement for a profit-sharing plan leaves very little distinction between the types of defined contribution plans from a definitional point of view. It is difficult to see what policy purpose is now served by using two terms in the Code to describe each plan. While distinctions would continue to be permitted between the types of defined contribution plans, for example an employer could still establish a plan calling for either fixed or discretionary contributions or one that mandates distributions in employer stock, those distinctions would be meaningless in applying the qualification, deduction and distribution rules.

Contribution to Simplicity

This proposal would allow taxpayers to use one set of terms to apply the qualifications, deduction and distribution rules. This proposal would also conform the terminology of the Code to the terminology of Title I of ERISA (the rules administered by the Department of Labor) facilitating the ability of taxpayers to understand both the non-tax and tax consequences of their actions. Specifically, sections 401(a)(27) and 401(a)(23) would be repealed.

AICPA Tax Simplification Recommendation

SEGREGATE LEVERAGED ESOPs FROM THE QUALIFIED PLAN REQUIREMENTS AND TREAT THEM AS A SEPARATE FINANCING VEHICLE

Present Law

Various leveraged ESOP requirements can be found throughout the qualification and other sections of the Code that deal with qualified retirement plans. For example, sections 401(a), 404, 409, 415 and 4975 all deal with leveraged ESOPs as well as with other qualified plans.

Suggested Change

The leveraged ESOP requirements should be removed from the qualified plan rules and collected in a separate subchapter of the Code. The rationale is that, in substance, leveraged ESOPs have tended to be a financing vehicle rather than a retirement vehicle, although they have attributes of both. There are a number of requirements that are unique to leveraged ESOPs which appear throughout the qualified plan rules. Unless someone is intimately familiar with all these rules and their location in the Code, the chance of their overlooking a particular requirement is unnecessarily high. Isolating these rules from the qualified plan rules would eliminate a source of complexity in the qualified plan rules, recognize the unique nature of leveraged ESOPs and collect the related rules in one subchapter.

It is not being proposed that the leveraged ESOP rules be repealed. What is being proposed is that these requirements be collected separately in their own subchapter so that someone need not be an ESOP expert in order to answer a question with respect to them.

Contribution to Simplicity

When dealing with qualified retirement plans, the following sections would no longer need to be considered: sections 401(a)(28), 409, 404(a)(9), 404(k), 415(c)(6), 4975(e)(7) and 4975(d)(3). These sections would be collected in a separate subchapter of the Code.

AICPA Tax Simplification Recommendation

ELIMINATE, TO THE EXTENT POSSIBLE, THE REMAINING STATUTORY DISTINCTIONS BETWEEN SELF-EMPLOYED INDIVIDUALS AND COMMON LAW EMPLOYEES

Present Law

Beginning with the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), distinctions between the qualified plan rules applicable to self-employed individuals and those applicable to common-law employees have slowly been eliminated. This has significantly simplified the law. However, several distinctions remain between the rules applicable to plans covering owner-employees (certain self-employed individuals) and other participants.

Under current law, owner-employees are subject to unique aggregation rules (section 401(d)) and cannot obtain loans from qualified plans under the same terms as other participants.

Other areas which involve a distinction between "owner-employees" or "self-employed individuals" and other participants are sections 401(c)(1), 401(c)(2)(A), 402(e)(4)(A)(ii), 403(a)(3), 404(a)(8), 404(e), 408(k)(7)(A), 415(b)(3), 415(c)(3)(B), 416(i)(3) and 72(m)(6). Still other sections limit contributions to earned income (section 404(a)(8)(C)), preclude the use of contributions made to a qualified plan on behalf of a self-employed individual to purchase life, accident, health or other insurance (sections 408(a)(8)(C) and (e)), prohibit deductible contributions exceeding earned income (section 404(a)(8)(C)), permit disability of a self-employed person to qualify as a triggering event for lump-sum distribution treatment (sections 402(e)(4)(A)(iv) and 72(m)(6)), discuss the rules of annuity taxation (section 403(a)(3)) and define compensation for purposes of the annual additions limitations (sections 415(b)(3) and 415(c)(3)(B)) or the deduction limitations (section 401(c)(2)(A)(v)).

Suggested Change

Those distinctions that remain after TEFRA can be divided into two groups: 1) those designed to treat certain self-employed individuals differently from other plan participants (the owner-employee rules) and 2) those necessary to make sure there is equivalent treatment between self-employed individuals and other participants. Eliminating the first set of distinctions would simplify the law without sacrificing any significant policy goals. It is proposed that the flush language in section 4975(d) that prohibits loans from qualified plans to participants who are owner-employees be repealed. The special aggregation rules of section 401(d) should also be repealed. These changes would eliminate an existing trap for the unwary as well as simplify the Code.

Retention of the second set of distinctions will ensure equivalent treatment between self-employed individuals and other participants.

Contribution to Simplicity

The flush language in section 4975(d) would be repealed. Also repealed would be sections 401(c)(3), 401(c)(5), 401(d) and 401(a)(10)(A). Section 416(i)(3) would be repealed as part of an overall repeal of the top-heavy rules discussed later.

AICPA Tax Simplification Recommendation

SIMPLIFY THE DEFINITION OF A HIGHLY COMPENSATED EMPLOYEE UNDER SECTION 414(q)

Present Law

Under current law, a highly compensated employee is defined as any employee who during the current or preceding year was:

a. a 5 percent owner;
b. received compensation from the employer in excess of $75,000;
c. received compensation from the employer in excess of $50,000 and was in the top-paid group of employees for such year; or
d. was an officer and received compensation greater than 50 percent of the amount in effect under section 415(b)(1)(A) for such year.

A participant who is described in b, c or d above (for the current plan year only), shall not be a highly compensated employee unless he is among the 100 employees paid the greatest compensation during the year.

Suggested Change

One of the key concepts that permeates the entire qualified plan area is the prevention of discrimination in favor of "highly compensated" employees. Under TRA 86, the Code for the first time specifically set forth rules for determining who is in this group. However, the definition is difficult to work with and a clear simple definition would reduce complexity. It is recommended that the Code define the highly compensated group as: 1) 5 percent owners with attribution (as defined in section 318 of the Code) and 2) those earning compensations in excess of $75,000 (indexed for inflation).

In addition, the "highly compensated" group would be determined on the basis of the preceding plan or employer year, not the current and preceding years as under current law.

Contribution to Simplicity

The proposal would simplify plan administration and testing because the highly compensated group would be easy to identify.

PROVIDE A UNIFORM DEFINITION OF COMPENSATION FOR PURPOSES OF THE EMPLOYEE BENEFIT RULES

Present Law

Code sections 414(s), 414(q), 415 and 401(a)(17) all provide different definitions of "compensation." Because of the significance of this concept throughout the employee benefits sections of the Code, it is important to have a simple, uniform definition.

Suggested Change

A uniform definition of compensation should be established to simplify the task of plan sponsors and administrators.

The uniform definition should be tied to taxable compensation with elective contributions under sections 125, 401(k), 408(k), 403(b), 457 and 501(c)(18) added back at the employer's election on a uniform and nondiscriminatory basis. For example, a calendar year plan would simply use W-2 compensation including the specified elective contributions if the employer elects. A fiscal year plan could either determine taxable compensation on the fiscal year basis or use W-2 compensation for the calendar year which ends in the fiscal year. This definition should be used for all purposes of the employee benefit rules.

Contribution to Simplicity

A uniform, simplified standard for compensation would reduce complexity in plan design and administration and eliminate the existing trap for the unwary.

REPEAL THE TOP-HEAVY RULES

Present Law

The top-heavy provisions, enacted as part of TEFRA, provide for accelerated vesting, minimum benefit accrual and a limit of $200,000 on the amount of compensation that can be taken into account under a qualified plan. Congress concluded that in the case of plans under which more than 60 percent of the benefits are focused on key employees, special rules were needed to assure that the rank-and-file employees would receive the benefits that the tax incentives were provided to encourage.

TRA 86 significantly lessened the differences between top-heavy and non-top-heavy plans by capping the amount of compensation taken into account at $200,000 for all qualified plans and also accelerating vesting schedules for all qualified plans. The allowable vesting schedules are:

	Cliff Vesting		Graduated Vesting	
Yrs. of Service	Top-Heavy	Other	Top-Heavy	Other
1	0	0	0	0
2	0	0	20	0
3	100	0	40	20
4		0	60	40
5		100	80	60
6			100	80
7				100

A plan that is top-heavy must also provide a minimum defined benefit for non-key employees equal to 2 percent multiplied by the number of years of service with the employer (up to a maximum of 20 percent) times the individuals' "compensation." A non-key participant's compensation is determined over the period of consecutive years, not in excess of 5, that the participant's compensation was the highest. In a defined contribution plan, a minimum defined contribution amount of 3 percent of compensation, or the amount of the actual percentage contribution made on behalf of key employees, if less, must be made on behalf of non-key employees. Social Security contributions or other legally required contributions cannot be taken into account for purposes of these benefit requirements.

Non-top-heavy plans are not required to provide minimum benefit levels; however, contributions may not be skewed in favor of the highly compensated (section 401(a)(4)) and the Social Security integration rules now require minimum benefit levels for integrated plans.

Suggested Change

The special rules of section 416 should be repealed. While section 416 served a purpose when it was passed, one limitation imposed by section 416 ($200,000 cap on compensation) now applies to all plans and another (faster vesting) is virtually the same for top-heavy and non-top-heavy plans. The other significant difference between top-heavy and non-top-heavy plans involves benefit accrual, and with recent changes in the permitted disparity rules in TRA 86, this difference is significantly less than it was in 1982. the regulations to be issued under section 401(a)(4) could provide further guidance if any perceived gaps exist.

The top-heavy rules also contain their own definition of the employees in whose favor discrimination is prohibited ("key employee"). Following TRA 86, most Code sections affecting discrimination use the term "highly compensated employee." At a minimum, the use of the term "key employee" should be eliminated and the TRA 86 definition of highly compensated employee substituted.

In view of the fact that virtually all plans must include these provisions, and that the incremental benefit of the top-heavy rules has been diminished by subsequent changes in the Code, these provisions could be eliminated with little adverse impact on participants and reduce complexity in the law and plan documents.

Contribution to Simplicity

Repeal of sections 416 and 401(a)(10)(B) and the yearly testing that is required under the provision is recommended.

RECONSIDER SECTION 401(a)(26)

Present Law

Section 401(a)(26) provides that each plan, independently, must cover the lesser of 50 employees or 40 percent of the total employees of an employer (determined on a controlled and aggregated group basis).

Suggested Change

The Section 401(a)(26) minimum participation rules are aimed at preventing multiple plans covering few employees from discriminating against nonhighly compensated employees. Section 410(b) is also aimed at preventing discrimination against nonhighly compensated employees, but may be applied on a group plan basis if such plans are comparable in accordance with Rev. Rul. 81-202, 1981-2 CB 93.

In enacting section 401(a)(26), the legislative history indicates Congressional concern that although plans that are aggregated are required to satisfy comparability requirements with respect to the amount of contributions or benefits, such an arrangement may still discriminate in favor of the prohibited group. Differences in the rates at which benefits are accrued (e.g. presence or absence of past service credit) and the selective use of actuarial assumptions in valuing plan benefits may cause a plan that satisfies the requirement of comparability with respect to the amount of contributions or benefits to favor the highly paid. Similarly, in the case of plans that are comparable with respect to the amount of contributions or benefits, discrimination favoring the highly paid may occur because of disparate funding levels and benefit options that are not taken into account in such a comparability analysis.

Congress was concerned that because of the large number of these arrangements, the inherent complexity of comparability analysis, and the difficulties in discovering all differences in funding levels and benefit options, the IRS lacked sufficient resources to monitor compliance with the nondiscrimination standards by small aggregated plans. Thus, Congressional intent may be summarized as desiring to obtain both nondiscrimination and simplicity. The regulations issued under section 401(a)(26) by all standards are anything but simple.

The Service has stated that it will soon issue a new revenue ruling which will expand upon Rev. Rul. 81-202 and make it more difficult to discriminate using comparability of plans in order to satisfy section 410(b).

Eliminating one-person plans or highly specialized plans that cover small numbers of employees is appealing in reducing the number of plans maintained by a controlled group and in easing the audit burden of the Internal Revenue Service. However, unless the regulations under section 401(a)(26) can be re-drafted in a manner that reflects the straightforward manner of the statute, then section 401(a)(26) should be repealed. If the regulations can be properly drafted, the repeal of section 401(a)(26) may not be necessary.

If the regulations cannot be re-drafted and if section 401(a)(26) is repealed, then any perceived problems with comparable plans should be dealt with directly by amending the rules of Rev. Rul. 81-202. Section 410 should adequately cover the objective of preventing plans from being discriminatory against the nonhighly compensated. If any gaps exist, the forthcoming revenue ruling, final section 410(b) regulations, or additional pronouncements from the Service, could cover them. Alternatively, the percentage tests of section 401(b) could be increased above 70 percent to minimize any abuses. This proposal is one which could result in some incremental discrimination above that allowed by current law, but the reduction in complexity achieved would be substantial.

Contribution to Simplicity

The complexity resulting from section 401(a)(26) and the regulations promulgated thereunder would be eliminated.

ELIMINATE THE ABILITY TO PROVIDE MEDICAL BENEFITS TO RETIREES FROM QUALIFIED PLANS

Present Law

IRC Section 401(h) allows certain medical benefits to be paid to retirees from qualified retirement plans. Under the statute, a pension or annuity plan may provide for the payment of benefits for sickness, accident, hospitalization, and medical expenses of retired employees, their spouses and dependents, but only if the following six requirements are met:

a. the benefits are subordinate to the retirement benefits provided by the plan;
b. a separate account is established and maintained for these benefits;
c. the employer's contributions to the separate account are reasonable and ascertainable;
d. the corpus or income of the separate account cannot be diverted to any purpose other than providing these benefits;
e. if all liabilities to provide these benefits under the plan are satisfied, any amount remaining must, under the terms of the plan, be returned to the employer; and
f. for each key employee, a separate account is established and maintained for these benefits.

"Subordinate" has been defined in the regulations to mean that at all times the aggregate contributions to provide such medical benefits (and any life insurance protection) does not exceed 25 percent of the aggregate contributions, other than contributions to fund past service liability.

Suggested Change

Provided other adequate means are available for pre-funding retiree medical expense, qualified retirement plans should not be allowed to provide medical benefits for retirees. Qualified retirement plans are plans of deferred compensation designed to replace wages upon retirement, not plans designed to replace an employee's entire compensation arrangement. These accounts cause additional complication in plan documents, plan administration, and plan design.

It is not being proposed that employers not be allowed to pre-fund any other of their retiree medical liability. Those who wish to pre-fund this obligation could do so on a tax-preferred basis by utilizing a voluntary employee beneficiary association (VEBA) described in section 501(c)(9). In order for this to be an adequate alternative, however, the VEBA rules need to be amended so that employers can more adequately fund their retiree health obligations, e.g., earnings on funds set aside for retiree health obligations should not be subject to unrelated business income tax.

Contribution to Simplicity

The elimination of sections 401(h) and 415(l) and modification of section 404(e).

ELIMINATE SECTION 1.401-4(c)(2)(ii) CONCERNING RESTRICTION OF BENEFITS WHICH MAY BE PAID TO THE 25 HIGHEST PAID EMPLOYEES

Present Law

Section 1.401-4(c)(2)(ii) requires that the employer contributions which are used for the benefit of any employee who is among the 25 highest paid employees of the employer be restricted if the plan is terminated within 10 years after its establishment of the plan.

Section 415 limits the amounts which may be paid from a defined benefit plan. After TRA 86, the maximum benefit payable under section 415 cannot accrue any faster than ratably over 10 years of plan participation.

Suggested Change

Under section 415, the benefits which may be paid to an employee are limited to no more than $90,000 (indexed) or 100 percent of compensation actuarial reduced for early retirement. In addition, section 415 now sets forth the requirement that the maximum benefit payable may only be accrued ratably over 10 years of plan participation. This prevents a highly compensated employee from receiving a large benefit shortly after a plan has been established. This structure significantly diminishes the possibility of abuse at which section 1.401-4(c) is aimed. In addition, this regulation was adopted before ERISA, which introduced the Pension Benefit Guaranty Corporation and minimum funding rules. Both innovations have also helped to prevent the type of abuse which this regulation was originally enacted to prevent. Finally, the new minimum funding rules under the Omnibus Reconciliation Act of 1987 (OBRA) also help to ensure that plan participants and beneficiaries are protected from the type of abuse at which this regulation is aimed.

Due to the diminished possibility of abuse, section 1.401-4(c) of the regulations should be revoked. This is a situation where significant reduction in complexity could be achieved by eliminating a largely redundant provision.

Contribution to Simplicity

Treasury regulation section 1.401-4(c) should be eliminated and, therefore, plan design would be simplified.

SIMPLIFY THE DISTRIBUTION OF QUALIFIED PRE-RETIREMENT SURVIVOR ANNUITY (QPSA) NOTICES

Present Law

Under current law, certain plans must provide each participant, within a certain period, a written explanation with respect to the qualified pre-retirement survivor annuity option. The period during which the notice must be given is defined in section 417(a)(3)(B)(ii)(I) as the period beginning with the first day of the plan year in which the participant attains age 32 and ending with the close of the plan year preceding the plan year in which the participant attains age 35.

Suggested Change

The QPSA notice should be required to be provided only to individuals within a reasonable period after they become plan participants.

There is little logic in providing this notice only at the current age range, since most employees are sophisticated enough to understand the notice at any age. This provision has simply resulted in an increased compliance burden for plan sponsors without a commensurate return, either in understanding on the part of the participants, or in achieving effective disclosure.

Contribution to Simplicity

This would result in the repeal of section 417(a)(3)(B)(ii)(I).

AICPA Tax Simplification Recommendation

ELIMINATE THE ACTUAL DEFERRAL PERCENTAGE TEST IN CASH OR DEFERRED ARRANGEMENTS

Present Law

Section 401(k)(3) provides that the amounts deferred by highly compensated employees cannot exceed a multiple of the amounts deferred by nonhighly compensated employees. Specifically, the actual deferral percentage of the highly compensated employees cannot be either more than 125 percent of the actual deferral percentage of the nonhighly compensated employees or more than twice the actual deferral percentage of the nonhighly compensated employees with a differential of no more than 2 percentage points.

The Service has issued regulations explaining how to test employee elective deferrals for discrimination. Employer contributions may in some circumstances be used to help satisfy the actual deferral percentage test. In addition, certain matching contributions may also be used to help satisfy the discrimination tests. If the employer cannot afford, or does not wish, to make employer contributions to help satisfy the test and the tests have not been met by plan year end, the employer may recharacterize or distribute the excess deferrals. Penalties leading up to plan disqualification are imposed if the excess 401(k) deferrals are not distributed or recharacterized in a timely fashion. The Service has issued notices and regulations explaining when, and to what extent, deferrals may be distributed or recharacterized.

Suggested Change

The actual deferral percentage test of section 401(k) was enacted at a time when highly compensated employees could elect to defer up to $30,000 annually under a section 401(k) plan. It is aimed at preventing a 401(k) plan from discriminating against lower compensated employees, and operates to supplant section 401(a)(4). The potential for discrimination in a 401(k) plan has been dramatically reduced by the lowering of the elective deferral limitation in TRA 86 to $7,000, (indexed for cost of living). The performance of the actual deferral percentage test is time consuming for a plan of any significant size and many plan sponsors have not accurately tested on a timely basis.

The section 401(k) rules should be amended: 1) to require that all employees with a requisite age and year(s) of service and not in excluded categories under section 410(b) be permitted to make deferrals under an employer's 401(k) plan, and 2) the actual deferral percentage test be repealed.

Contribution to Simplicity

Code section 401(k)(3), section 4979, and the regulations and notices promulgated thereunder would be eliminated. Section 402(g)(1) would be modified to reflect a lower limit and the section 401(g)(5) adjustment for cost-of-living would remain in effect.

AICPA Tax Simplification Recommendation

EXPAND THE COVERAGE RULES FOR SECTION 401(k) PLANS TO INCLUDE EMPLOYEES OF TAX-EXEMPT ORGANIZATIONS AND ELIMINATE THE SEPARATE RULES IN SECTION 403(b)

Present Law

A 401(k) plan is not treated as a qualified 401(k) plan if it is part of a plan maintained by any tax-exempt organization or a state or local government or political subdivision thereof. On the other hand, a separate provision (section 403(b)) applies only to certain tax-exempt and charitable organizations and allows employees of these organizations to participate in arrangements which involve cash or deferred elections.

Suggested Change

It is difficult to understand why tax-exempt organizations are prevented from making salary deferrals available under section 401(k), and yet can make salary deferral elections available in an even more liberal fashion under section 403(b).

In addition, there appears to be no compelling policy justification for requiring employees of tax-exempt organizations to participate in annuity contracts or custodial accounts rather than in the investments available to employees of non-tax-exempt organizations. The repeal of section 403(b) should be considered. In an age where self-directed accounts are very commonly available through any of the large, national brokerage firms or other financial institutions, individual accounts are relatively easy to establish, not very costly, and much more convenient for employees of tax-exempt organizations than when section 403(b) was enacted.

In order to simplify the Code, tax-exempt organization employees should be treated the same as all other employees for salary deferral purposes. Thus, employees of both types of organizations should participate in identical plans, have the same salary deferral amount as a ceiling, and have the same plan investment alternatives available to them. This proposal, when combined with the previous proposal concerning section 401(k) plans, would provide for a uniform set of rules which could easily be administered by plan sponsors and the IRS.

Contribution to Simplicity

This would have effect of repealing section 403(b) and extending the 401(k) plan rules to employees of tax-exempt organizations.

AICPA Tax Simplification Recommendation

ELIMINATE THE ABILITY OF EMPLOYEES TO MAKE AFTER-TAX CONTRIBUTIONS TO QUALIFIED RETIREMENT PLANS

Present Law

If a qualified retirement plan permits, employees may make voluntary after-tax contributions to the plan. For plan years beginning after 1986, these voluntary after-tax contributions count on a dollar-for-dollar basis against the limits of section 415(c). Additionally, a qualified plan that allows after-tax employee contributions is subject to a nondiscrimination test under section 401(m) that is similar to the nondiscrimination test in section 401(k). The nondiscrimination tests of section 401(m) were enacted because of the fear that voluntary after-tax employee contributions are utilized primarily as a tax-deferred savings vehicle for the highly compensated.

Suggested Change

The ability of a qualified plan to accept voluntary after-tax employee contributions should be eliminated and section 401(m) should be repealed. The rationale is one that is motivated solely by a desire for reducing complexity.

Allowing after-tax employee contributions to be made to qualified plans now requires plan administrators to separately account for these amounts annually to ensure that the tests of section 401(m) are met. These amounts must be separately identified when distributed to participants and involve a separate subset of rules in the distribution area to determine what is taxable to a participant and what is a recovery of the participant's basis. These rules are complicated both from a technical and a plan administration perspective.

The elimination of voluntary after-tax contributions would not only reduce complexity in the statute but would also reduce complexity in the administration of qualified plans. Adoption of this proposal would not leave employees without tax-deferred investments because Individual Retirement Accounts (IRAs) on a non-deductible basis under section 408(o) (which were not available until tax years beginning after 1986), tax-deferred annuities, and other investment products such as municipal bonds are offered in this category. Further, the existence and rapid acceptance nationally of pre-tax deferrals in 401(k) plans has made the after-tax contribution a less attractive alternative for employees.

If Congress decides that employees should be allowed to fund larger tax deferred savings accounts for their retirement by using after-tax contributions, the existing rules for IRA after-tax contributions could be amended to increase the allowable level of contribution.

With section 401(m) repealed, matching contributions would be subject to the nondiscrimination principles in section 401(a)(4). The statute could provide that if matching contributions are available at the same rate for all employees, the matching contributions would be deemed to be nondiscriminatory.

Contribution to Simplicity

The following Code sections governing plan qualification can be repealed if voluntary after-tax employee contributions are eliminated: sections 401(a)(19), 401(m), 411(c) and 411(d)(5). In addition to reducing complexity in the qualification area, the elimination of voluntary after-tax employee contributions will reduce complexity in the area of distribution planning and the taxation of distributions. For example, if voluntary after-tax employee contributions are repealed, the portion of section 72 which deals with the recovery of the employee's basis could be eliminated, section 402(a)(5)(B) could be repealed and the second sentence of section 402(a)(1) could be repealed. A transitional rule could be provided to facilitate the distribution of existing voluntary after-tax contributions from qualified plans. For example, participants could be allowed to transfer these amounts, with or without earnings, to an IRA.

AICPA Tax Simplification Recommendation

ELIMINATE THE PERMITTED DISPARITY RULES (SOCIAL SECURITY INTEGRATION RULES) OR RETURN TO A MODIFIED VERSION OF PRE-89 INTEGRATION

Present Law

TRA 86 substantially amended the Social Security integration rules. For example, in an integrated qualified plan, it is no longer possible to deny a participant a benefit accrual or contribution just because the plan is integrated with Social Security.

The new rules permit a certain amount of disparity for defined contribution plans by requiring that the excess contribution percentage (the contribution percentage with respect to compensation above the integration level) may not exceed the base contribution percentage (the contribution percentage with respect to compensation below the integration level) by more than the lesser of:

a. the base contribution percentage; or
b. the greater of

   (1) 5.7 percent; or
   (2) the percentage equal to the section 3111(a) tax rate attributable to old-age insurance.

This is the third set of defined contribution integration rules for plan sponsors within the last six years. Further, the IRS issued Notice 89-70 which supplements the above rules by reducing the permitted disparity for certain plans where the integration level is less than the Social Security wage base.

Similarly, defined benefit plan integration rules require that, for non-offset plans, the excess benefit percentage (computed in the same manner as defined contribution plans except that it is for benefits attributable to employer contributions, not contributions) cannot exceed the base benefit percentage by more than the maximum excess allowance, benefits be based on average compensation, and any optional forms of benefit be provided with respect to compensation below the integration level. The maximum excess allowance is equal to 3/4 percent for benefits attributable to any year of service with the employer, and, for total benefits, is equal to 3/4 percent times years of service up to 35 years. The 3/4 percent is further reduced, pursuant to Notice 89-70 for certain plans where the integration level is less than covered compensation.

The recent regulations and the supplemental notice implementing the TRA 86 rules have been widely criticized as being very complicated.

Suggested Change

The concept of permitted disparity should either be altogether eliminated or substantially simplified. A complete repeal of permitted disparity rules would reduce the complexity of the qualified plan area and would generally provide greater benefits to employees in those plans currently using the permitted disparity rules. Repeal of the disparity rules could, however, lead to termination of existing plans. Therefore, if complete repeal is not desired, the rules should be simplified. For example, the pre-TRA 86 rules could be reinstated with a minimum benefit required for all plan participants.

Contribution to Simplicity

This proposal would repeal sections 401(l), 401(a)(5) and 401(a)(15).

AICPA Tax Simplification Recommendation

SIMPLIFY THE COMBINED PLANS LIMITATIONS OF SECTION 415(e) AND REPEAL SECTION 4980A

Present Law

Where an employee of the same employer is covered by a defined benefit and a defined contribution plan, section 415(e) imposes a limitation that prevents an employee from accruing the maximum benefits otherwise allowable under both the defined contribution and the defined benefit plan. Section 415(e) requires a calculation of a defined benefit fraction and a defined contribution fraction the sum of which may not exceed 1. These fractions are based on the benefits allowed by law. In some cases, these calculations require yearly monitoring. In other cases, the section 415(e) result is not know until an employee terminates employment or retires.

Section 4980A, enacted by TRA 86, places a 15 percent excise tax on certain distributions that exceed $150,000 a year or lump-sum distributions that exceed $750,000 a year. These rules diminish the value of large accumulations within qualified plans even though the section 415(e) limit may have been followed in the past.

Suggested Change

Employees who are benefited by a defined benefit and defined contribution plan of the same employer should be subject to either section 415(e) or section 4980A but not both.

If section 415(e) is to be retained, then section 4980A should be repealed. If section 415(e) is retained, it should be revised to be based on a plan design approach rather than on an actual accrued benefit approach. For example, if 100 percent of the defined benefit plan limit is being accrued for an individual, then only 25 percent of the maximum defined contribution limit would be provided for an individual under a defined contribution plan. (These percentages are used for illustrative purposes only.) This would eliminate the need for the annual cumulative calculation that is required under current law.

If, however, section 4980A is maintained in the law, then section 415(e) should be repealed and the maximum benefit should be allowed to accrue in both defined benefit and defined contribution plans.

We believe that the better course of action is to repeal section 4980A.

Contribution to Simplicity

The simplification achieved is the repeal of either section 415(e) or section 4980A.

SIMPLIFY THE COVERAGE RULES BY REPEALING THE SECOND PART OF THE AVERAGE BENEFITS TEST

Present Law

Section 410(b) provides two ratio tests and an average benefits test; one of these three tests must be satisfied by a plan if it is to satisfy the coverage tests and qualify under section 401(a). The average benefits test is a two part test: 1) a fair-cross-section test comparable to pre-TRA 86 rules, and 2) the average benefit test which provides that the average benefit for nonhighly compensated employees must be at least 70 percent of the average benefit for highly compensated employees. A benefit percentage must be calculated for each employee and all benefit percentages within the two groups then averaged. The benefit percentage is the employer-provided benefit divided by compensation.

Regulations explaining average benefits have not been issued. Temporary regulations have been issued that provide percentage safe harbors, based on coverage, for the fair-cross-section test part of this test.

Prior to TRA 86, there were two ratio tests and a fair-cross-section test, but the fair-cross-section test did not have an average benefits test. Guidance on the fair-cross-section test was found primarily in revenue rulings. The fair-cross-section was a subjective test with no safe harbors.

Suggested Change

The average benefits test should be repealed. Section 410(b) is designed to test coverage and not benefit accrual. There are other sections of the Code that deal with nondiscrimination in benefit accrual and that concept should not be tested with coverage. This approach adds complexity and substantially overlaps with other requirements of the law such as 401(a)(4).

An alternative approach would be to confirm the section 401(a)(4) test to the section 401(b) test by statute so employees would have a uniform set of values to apply.

Contribution to Simplicity

The simplification achieved is the repeal of the average benefits test found in section 410(b)(2)(A)(ii).

AICPA Tax Simplification Recommendation

APPLY SECTION 404(a)(1) ONLY TO DEFINED BENEFIT PLANS

Present Law

Section 404(a)(1) currently limits the amount deductible for contributions to pension plans. Pension plans include defined benefit plans and money purchase pension plans, a form of defined contribution plan.

Suggested Change

Given the earlier proposal to classify all plans as either defined benefit or defined contributions plans, section 404(a)(1) would only apply to defined benefit pension plans.

Contribution to Simplicity

The reduction in complexity achieved would be the consistent treatment of money purchase pension plans throughout the Code.

AICPA Tax Simplification Recommendation

APPLY SECTION 404(a)(3) TO ALL DEFINED CONTRIBUTION PLANS

Present Law

Section 404(a)(3) limits the amount deductible for contributions to profit-sharing plans and stock bonus plans.

Suggested Change

Section 404(a)(3) should limit the deduction for all types of defined contribution plans instead of for just profit-sharing and stock bonus plans. After this change, the deduction limit for money purchase plans would be found in section 404(a)(3). A further simplification is the coordination between the 15 percent deductibility limit in 404(a)(3) and the 25 percent contribution limit in section 415(c). The section 415(c) and section 404(a)(3) limits would be the same, for example, 25 percent of compensation.

Contribution to Simplicity

Again, one set of terms would be used consistently throughout the Code. This proposal would also eliminate the necessity of maintaining two plans, a money purchase pension plan and a profit-sharing plan to achieve the maximum level of contribution allowable under law for defined contribution plans, while retaining maximum flexibility.

REPEAL FIVE YEAR AVERAGING FOR DISTRIBUTIONS FROM QUALIFIED RETIREMENT PLANS

Present Law

An individual can receive his or her entire balance from a qualified plan in one year and elect five-year averaging. Five-year averaging in certain situations lowers the tax that would otherwise be paid if the entire distribution were to be included into income in one year.

Suggested Change

The proposal is that five-year averaging be repealed. Lump-sum distributions would be included in income in the year received and taxed as ordinary income unless rolled over into an IRA.

Congress has become increasingly concerned that retirement plan balances are being used to fund expenditures unrelated to retirement, e.g. venture capital. Studies indicate that lump-sum distributions are often depleted by the time an employee reaches retirement age. Repeal of favorable tax treatment is intended to encourage using retirement funds to pay for living expenses upon retirement. This would also simplify decision making for plan participants at retirement by eliminating one of the current taxation alternatives.

It is not recommended that lump-sum distributions from plans be prohibited because of the administrative convenience of paying an employee's balance, especially smaller sums, upon termination of employment. What would be eliminated would be preferential tax treatment if the distribution were not rolled over into another qualified plan or IRA.

Contribution to Simplicity

Repeal of five-year averaging would eliminate the following Code sections: 402(e)(1), (2), (3), 402(e)(4)(B), (C), (D), (G), (H), (M) and (O).

AICPA Tax Simplification Recommendation

ALLOW THE ROLLOVER OF ANY DISTRIBUTION FROM A QUALIFIED PLAN, OTHER THAN REQUIRED MINIMUM DISTRIBUTIONS

Present Law

Section 402(a)(5)(D) allows for the rollover of partial distributions into IRAs. To qualify as a partial distribution, the distribution must be at least 50 percent of the account balance of the participant and must be payable because of death, separation from service or disability. This provision was enacted as part of the Deficit Reduction Act of 1984 (DEFRA). Prior to DEFRA, only total distributions could be rolled over. Congress enacted this provision so that rollovers could still be allowed even though a participant inadvertently received less than the total plan balance. It is not clear why a 50 percent threshold was chosen, particularly since current law allows any portion of an otherwise "qualifying" distribution to be rolled over even if it is less than 50 percent of the distribution.

Suggested Change

Any distribution from a qualified plan should be eligible to be rolled over into an IRA except for distributions pursuant to section 401(a)(9). This would simplify distribution planning and encourage retention of funds originally contributed to retirement plans for retirement. It would also eliminate the disparity between the amount required to be distributed to be eligible for a rollover and, at the option of the recipient, the lesser amount which is permitted to be rolled over.

Contribution to Simplicity

Section 402(a)(5)(D) would be repealed and the definition of a qualified total distribution would no longer be necessary.

AICPA Tax Simplification Recommendation

SIMPLIFY THE MINIMUM DISTRIBUTION RULES OF SECTION 401(a)(9)

Present Law

Section 401(a)(9) provides for the systematic distribution of qualified plan and IRA benefits over an individual's and beneficiary's life expectancy beginning at age 70 1/2.

Suggested Change

The minimum distribution rules are aimed at preventing plan participants from using qualified retirement plans as estate planning devices. With the repeal of the estate tax exclusion in DEFRA for qualified plan interests, a strong argument can be made for the repeal of section 401(a)(9). However, even after DEFRA, participants could still receive a significant tax advantage by deferring the receipt of their benefits to a date in the distant future.

Two changes can be made to simplify section 401(a)(9) without compromising the purpose of the provision. First, at death, distributions could be required to be paid over the life expectancy of the beneficiary beginning at the decedent's death. There would be no distinction between situations where an individual dies before or after his required beginning date. There would also be no distinction between types of beneficiaries as there is under current law. Second, the calculation of life expectancy should not be recalculated. The only method of determining life expectancy would be reducing the initial calculated life expectancy by one each year. Both of these suggestions are intended to streamline section 401(a)(9) without altering the underlying concept. Finally, consideration should be given to reducing the number of participants to whom this rule applies by limiting its application to participants with accrued benefits in excess of a certain level.

Contribution to Simplicity

Section 401(a)(9)(B) would be condensed from four rules for distributions upon death to one rule. The regulations would be simplified concerning the calculation of life expectancy.

AICPA Tax Simplification Recommendation

SIMPLIFY HARDSHIP WITHDRAWALS FROM 401(k) PLANS

Present Law

Under current law, hardship withdrawals based on need can be made from cash or deferred arrangements under section 401(k). However, such distributions are subject to a 10 percent additional income tax under section 72(t) if the distribution is made prior to age 50 1/2, with some exceptions.

Suggested Change

The rules governing hardship distributions from qualified plans could be substantially simplified by specifying certain situations in the statute which would be considered a hardship for distribution purposes, e.g., purchase of a principal residence, education, or medical expense. In addition, no suspension from plan participation would be imposed on account of a hardship withdrawal.

An alternative to simplification would be elimination of hardship withdrawals. Elimination of hardship withdrawals, however, might discourage nonhighly compensated employees from participating in section 401(k) plans.

Contribution to Simplicity

The complicated plan amendments required as a result of the proposed and final regulations on hardship withdrawals in 401(k) plans which were issued on August 8, 1988 would no longer be needed and the role of plan administrators in administering affected 401(k) plans both now and in future years would be simplified.

AICPA Tax Simplification Recommendation

BETTER DEFINE THE TERMINOLOGY USED IN SECTIONS 414(m) AND 414(n) AND REPEAL SECTION 414(o)

Present Law

Section 414(m) provides rules which treat all employees of members of affiliated service groups as employed by a single employer for certain qualified retirement plan purposes. In general, there are two sets of rules in section 414(m): affiliated service group rules and management group rules.

Section 414(n) provides similar rules concerning certain leased employee arrangements.

Section 414(o) provides a broad grant of regulatory authority for the IRS to deal with business arrangements which would allow for circumvention of the qualified plan requirements.

Suggested Change

The section 414(m) affiliated service group definitions under the Code and the regulations are extremely complex. If Congress wishes to prevent the perceived abuse at which section 414(m)(2) was aimed, it appears that much of the complexity would have to remain. However, it would be helpful if some of the terms used in the Code were more clearly defined. The use of too many qualitative terms causes plan sponsors and their advisors to spend extra time and effort in attempting to interpret them.

First, the definition under section 414(m)(2)(A)(ii) could be changed to state that "if more than 25 percent of the services performed by the A organization are for the first service organization" instead of using the amorphous term of "regularly performed." Also, de minimis ownership should be ignored under section 414(m)(2)(A)(i), e.g. ownership of less than 1 percent. Under the B organization definition, the phrase "significant portion" should be defined as 25 percent or more.

With respect to section 414(m)(5), the "principal business" should be defined in the Code as the business constituting 50 percent of gross revenues. In addition, firm management functions should be defined as executive type functions rather than permitting the regulations to expand that definition to include professional services. Simply rendering professional services for another organization should not cause the individual providing the service to be aggregated with the recipient organization on that basis alone.

Section 414(n) is a fairly straightforward Code provision aimed at abusive situations where employers do not employ their own employees, but rather lease employees from a third organization. This provision should be clarified so that it does not cover independent contractors where there is no third party leasing organization involved. Also, it would be helpful if the reference to section 144(a)(3) under section 414(n)(6) were eliminated as it makes analysis under this Code provision extremely difficult.

Finally, section 414(o) should be eliminated entirely as it has made it virtually impossible for a sole proprietor and other small businesses to determine eligibility for pension plan contributions when it is involved in any way with any other entity. For example, an employee who is a 5 percent owner of a company and who also works for another company must determine whether the two companies are recipients under sections 1.414(n)-1(b)2 and (b)(6), which in turn, requires an analysis under sections 414(b), (c) (m), and (o) and also under section 144(a)(3), and with respect to any organization under sections 414(b), (m), and (o) and section 144(a)(3) requires an analysis of whether there is aggregation under sections 267, 707(b) or members of controlled groups as defined in section 1563 substituting 50 percent for 80 percent. This analysis is beyond the ability of most sole proprietors (and many practitioners), and would probably cost more in advisor's fees than what many sole proprietors would gain by taking the pension plan deduction.

Contribution to Simplicity

Making the statute more specific will assist plan sponsors and their advisors in interpreting and applying these provisions.

AICPA Tax Simplification Recommendation

UNIFIED CREDIT AND GENERATION SKIPPING TRANSFER EXEMPTION PORTABILITY BETWEEN SPOUSES

Present Law

The $600,000 unified credit equivalent exemption amount and the $1,000,000 generation skipping transfer (GST) exemption amount can be wasted under current law when the first spouse to die owns property with a value smaller than the equivalent exemption or GST exemption amount respectively. Potential benefits are also lost when the entire estate is bequeathed to the surviving spouse.

The benefits from the credit can be salvaged where the first spouse to die holds property in an amount less than the unused exemption amount by a hedging gift from the wealthier spouse. However, this gift may raise concerns depending on the family situation, unless a QTIP trust is used with an appropriate election by the donor under section 2325(f).

Will (or administrative trust) drafting to avoid loss of the section 2010 credit benefit from overuse of the marital deduction generally entails a by-pass (credit shelter) trust bequest to the decedent's children. Loss of the benefit from the GST exemption amount when the wealthier spouse dies first can be avoided by a drafting scheme entailing two marital trusts and one trust funded with $1,000,000 value of assets at death. In addition, hedging interspousal gifts can be made from the wealthier spouse to the other spouse so as to increase the value of the donee's estate to $1,000,000. Thus, portability between the spouses of the unified credit equivalent exemption and the GST exemption amounts can be achieved by skillful drafting and hedging gifts. However, both involve complications for fully advised spouses. Unadvised spouses can pay unnecessary taxes when the exemptions are wasted.

Suggested Change

The unused unified credit equivalent exemption and GST exemption amounts should be passed to and be usable by the surviving spouse. Thus if the decedent bequeaths his entire estate to the surviving spouse, the marital deduction would eliminate the taxable estate for the decedent and the surviving spouse would be entitled to a $1,200,000 unified credit equivalent exemption amount. Lifetime hedging gifts would be unnecessary. The surviving spouse would be entitled to a $2,000,000 GST exemption where the entire estate is bequeathed to the surviving spouse.

Contribution to Simplicity

Simplicity would be achieved by avoiding lifetime hedging gifts between spouses that would not be desired for non-tax reasons. A children's trust would not be established under a will unless there was a non-tax reason for deflecting part of the decedent's estate from the surviving spouse to the children (or other third parties). Only one marital trust would be required where the decedent makes direct skip bequests to grandchildren.

Other Issues

The proposal will involve some loss of revenue, assuming that not all married persons are fully advised as to the techniques for avoiding loss of the unified credit equivalent exemption benefit or GST exemption benefit in the estate of the first spouse to die. The portability (survivability) of the unused unified credit equivalent exemption and GST exemption amounts also furthers the Congressional purpose of neutrality between spouses in common law property states with spouses in community property states. Spouses in community property jurisdictions are more likely to hold property in approximately equal amounts so that credit and exemption benefit loss is less likely.

AICPA Tax Simplification Recommendation

REPEAL THE GENERATION-SKIPPING TRANSFER TAX ON TAXABLE DISTRIBUTIONS AND TAXABLE TERMINATIONS

Present Law

The Tax Reform Act of 1986 repealed retroactively the generation-skipping transfer (GST) tax enacted in 1976 and replaced it with a substantially revised version (Chapter 13 of the Internal Revenue Code of 1986). The new tax, like the old tax, applies to "taxable distributions" (distributions of trust property to generation skipping beneficiaries) and "taxable terminations" (expirations of trust interests resulting in all remaining interests being held by generation skipping beneficiaries). Unlike the old tax, the new tax also applies to "direct skips" (outright transfers or transfers to a trust on behalf of generation skipping beneficiaries). "Generation skipping beneficiaries" are grandchildren or other third generation (or younger) beneficiaries.

Suggested Change

Repeal the GST tax on taxable distributions and taxable terminations, while retaining the tax on direct skips. This will simplify administration while still helping to achieve the overall goals of the generation skipping transfer tax. The majority of large intergenerational transfers will continue to be subject to the GST.

Contributions to Simplicity

One of the principal administrative problems under the prior law GST tax resulted from the requirement that trustees obtain estate and gift tax information with respect to the "deemed transferor" of property to calculate the amount of tax payable. Procedures to provide this information were never established by the IRS, preventing the effective implementation of the tax.

Under the new law, GST tax is imposed on taxable distributions and taxable terminations on a "tax-inclusive basis" (the tax base must generally be grossed up for gift or estate tax, as applicable). The IRS will therefore need to establish procedures to provide transfer tax information to trustees. This will raise the same administrative difficulties that existed under prior law, potentially rendering the tax unadministrable.

AICPA Tax Simplification Recommendation

RECAST THE QTIP ELECTION AS A PRESUMPTIVE ELECTION

Present Law

Generally, transfers of terminable interest (e.g., life estates) do not qualify for the marital deduction for estate and gift tax purposes. An election is available, however, to qualify "qualified terminable interest property," or "QTIP", for the marital deduction. (QTIP is property where the spouse is entitled to all income from the property for life, payable at least annually). See IRC sec. 2056 (b)(7). A similar provision applies for gift tax purposes. See IRC sec. 2523 (f). The election must be made by the executor of the decedent's estate or the donor, as applicable, and is irrevocable.

TAMRA of 1988 modified these rules to provide for a deemed QTIP election in the case of an annuity where only the surviving spouse has the right to receive payments before his or her death. In this case, the executor or the donor's spouse (in the case of a gift) must elect out of the marital deduction, if so desired. See IRC sec. 2056 (b)(7) and sec. 2523 (f)(6)(b).

Suggested Change

Amend IRC sec. 2056 (b)(7) and 2523 (f) to provide that a gift or bequest of QTIP to the donor's or decedent's spouse automatically qualifies for the marital deduction, unless the donor or the decedent's executor elects out from the QTIP treatment. The risk of entrapment under this presumptive election approach is slight since QTIP qualification requires that substantial predeath planning steps be implemented.

Contributions to Simplicity

The IRS has generally required strict compliance with the QTIP election requirements, including detailed identification of the QTIP property. In some cases, taxpayers have been unable to utilize the QTIP election due to inadvertent or unavoidable omissions in fulfilling these requirements. This has occurred even in cases where the decedent or donor expressly intended for the QTIP election to be made.

In addition, the requirement for an affirmative election of marital deduction treatment for most QTIPs, and an election out for certain annuities is confusing to taxpayers.

AICPA Tax Simplification Recommendation

CHANGE THE SECTION 691(c) DEDUCTION TO AN ESTATE TAX ADJUSTMENT

Present Law

Income earned or accrued by an individual before death, but not properly includible in the individual's taxable income prior to death, under his method of accounting, is referred to as income in respect of a decedent (IRD). The taxation of IRD is intended to parallel the federal income and estate tax consequences that would have resulted had the decedent received payment of income prior to death. For estate tax purposes an item of IRD is includible in the decedent's gross estate, and for income tax purposes if it is includible in the gross income of the recipient. In addition, section 691(c) allows the recipient of IRD to claim an income tax deduction equal to the estate tax attributable to the inclusion of the net amount of the IRD in the decedent's gross estate.

Deductions in respect of a decedent (DRD) consist of certain expenses that accrued during the individual's lifetime, but were not properly deductible by the individual in a taxable year prior to death. For estate tax purposes an item of DRD is deductible on the decedent's estate tax return, and for income tax purposes it is also deductible to the estate or person obligated to make the payment. However, no corresponding adjustments similar to section 691(c) for IRD items is required to limit the double deduction for DRD items except in those cases where the DRD must be netted against IRD.

This approach creates two inequities. The first is that the double deduction generated by DRD items provides an undue benefit for estates with only items of DRD. The second inequity is that the section 691(c) deduction only provides a benefit in the case of beneficiaries who itemize their deductions.

Suggested Change

To promote simplification and establish consistency in the treatment of items of IRD and DRD, as well as to parallel the federal income and estate tax consequences that would have resulted had payment been received prior to death, the adjustment allowed under section 691(c) should be modified in the following manner:

1) In the case of IRD items included in the gross estate, section 691(c) should be amended to exclude from the estate an amount equal to the income tax liability the decedent would have paid had he received the payment prior to death. The recipient of the IRD would then include the item in gross income and receive no deduction for estate tax paid on the IRD.

2) In the case of DRD items paid by the estate or a beneficiary, section 691(c) should reduce the deduction available to the estate for estate tax purposes in an amount equal to the income tax savings the decedent would have realized had the individual paid the expense prior to death. The person obligated to pay the expense would then deduct the expense in the year of payment.

Contribution to Simplicity

Treatment of IRD and DRD in this manner would promote simplification of the rules applicable to such items by allowing the necessary adjustments to be made on the estate tax return by the executor. He has access to the information required to make these computations (decedent's income tax returns). The recipient who typically lacks any understanding of the current section 691(c) adjustment would no longer be directly affected. This treatment would also establish consistency between the treatment of IRD and DRD. Finally, this treatment would more closely parallel the federal income and estate tax treatment that would have resulted had the individual actually received the IRD item or paid the DRD item before death.

AICPA Tax Simplification Recommendation

TRUSTS AS SHAREHOLDERS

Present Law

Trusts may only own stock in an S corporation if the trust is: (1) a grantor trust owned by a U.S. citizen or resident, (2) a trust described in (1) where the trust's owner has died (but only for a 60 day period beginning on the date of death, unless the entire corpus is included in the decedent's estate, where the stock may be held in trust for two years), (3) a trust that received the stock pursuant to the terms of a will (but only for a sixty day period), (4) a voting trust, and (5) a "Qualified Subchapter S Trust," known as a QSST.

In order for a trust to qualify for QSST status the trust must have the following characteristics: (1) during the life of the current income beneficiary, there may be only one income beneficiary, (2) any corpus distributed during the life of the current income beneficiary may be distributed only to such beneficiary, (3) the income interest of the current income beneficiary shall terminate upon the earlier of the death of the beneficiary or the termination of the trust, (4) upon the termination of the trust during the life of the current income beneficiary, and (5) all of the trust accounting income shall be distributed (or shall be required to be distributed) currently to one individual who is a citizen or resident of the U.S.

In addition, in order for a trust to be a QSST, the beneficiary must elect QSST status within two and one-half months from the date that the stock is transferred to the trust.

Suggested Change

A new type of trust should be permitted as an S corporation shareholder. The trust, rather than the beneficiaries, shall be treated as the corporate shareholder, except that the beneficiaries shall be counted for purposes of the maximum number of shareholders test, and all beneficiaries who receive distributions must be qualified S corporation shareholders as if they owned the stock directly. S corporation pass-through income or deductions would be taxed either to the trust or to the beneficiaries under the current trust income taxation rules contained in Subchapter J. Special rules would be required for beneficiaries of eligible S corporation trusts to limit the number of ownership tiers.

Contribution to Simplicity

The current S corporation trust rules provide limited opportunities for trusts to be S corporation shareholders, and contain a complex set of rules for those trusts that do qualify as eligible shareholders. The addition of another eligible trust that has no special qualifications would allow most trusts to own S corporation stock, thereby eliminating the necessity to specially design trusts to meet the eligibility rules currently in place. Such a trust does not appear to present tax avoidance opportunities under the current tax rate structure applicable to estates and nongrantor trusts.

Alternative

A more simple solution to remove the complexities associated with trusts as S corporation shareholders would be to allow all trusts as S shareholders, provided that all beneficiaries would be eligible shareholders as if they had owned the stock directly. This approach would virtually eliminate the complexities in current law.

AICPA Tax Simplification Recommendation

PERMIT NONRESIDENT ALIENS AS SHAREHOLDERS, SUBJECT TO ADEQUATE WITHHOLDING

Present Law

Section 1361(b)(1)(C) (and the flush language of section 1361(c)(2)(A)(i)) provides that a "small business corporation," which is otherwise eligible to elect S corporation status, may not have a nonresident alien as a shareholder.

Suggested Change

Permit nonresident aliens as shareholders in S corporations, subject to adequate withholding provisions.

Contribution to Simplicity

Permitting nonresident aliens as shareholders in S corporations would contribute to simplicity in two ways. First, it would eliminate a significant tax impediment to conducting business operations in the S corporation form of entity relative to the partnership form. Unlike S corporations, partnerships are allowed to have nonresident aliens as partners and these partners are subject to withholding at the partnership level under section 1446 on their distributive shares of income effectively connected with the conduct of a U.S. trade or business by the partnership. This statutory withholding requirement could also be extended to nonresident alien shareholders of an S corporation. Second, termination of S corporation status automatically occurs when there is a transfer of stock ownership to a nonresident alien, even if such transfer is inadvertent. Although there is a statutory relief provision to restore the corporation's S election, it requires procedural action by the taxpayer and the Service. Allowing nonresident aliens as shareholders would eliminate the time and costs associated with filing for such relief.

Other Issues

A related issue concerns the effect of this suggested change on tax treaties between the U.S. and its trading partners. In general, nexus for the taxation of entities under tax treaties is based on the residency of the entities, regardless of their legal form. Once this residency has been determined under the applicable treaty provisions, the treaty establishes the taxing jurisdiction and the tax treatment of the entity and its owners. Since permitting nonresident aliens as shareholders in an S corporation does not alter the determination of residency under treaties for either the entity or its owners, the suggested change should not adversely affect existing tax treaties or the principles of taxation therein.

AICPA Tax Simplification Recommendation

C CORPORATION OWNERSHIP OF S CORPORATION STOCK

Present Law

S corporation rules exclude regular C corporations from owning stock in an S corporation. As soon as a C corporation becomes a shareholder, S corporation status is terminated. Corporations with C corporation shareholders are not eligible to make an S election until the C corporation shareholder terminates its S corporation interest.

Suggested Change

C corporations should be permitted to own any percentage of stock in an S corporation.

Contribution to Simplicity

Allowing C corporations to be eligible S corporation shareholders will afford the S corporation with operating feasibility. Because the C corporation is a taxpaying entity (and not a pass through entity), its ownership of S corporation stock does not present any peculiar problems regarding the 35-shareholder limitation or the ability to tax S corporation income at the shareholder level. When a C corporation owns 80 percent or more of an S corporation, the S status of the subsidiary would substitute for any consolidation of that corporation under the consolidated return rules. For ownership of less than 80 percent, the S corporation would function, in effect, to expand the benefits available under the consolidated return rules.

Alternative

In addition to allowing C corporations to hold stock in S corporations, consideration should be given to permitting S corporations to hold any percentage of stock in other corporations. (See Recommendation entitled "S Corporations as Members of Affiliated Groups"). However, this alternative proposal would necessitate the scrutiny of ownership tiering of multiple flow-through entities.

AICPA Tax Simplification Recommendation

S CORPORATIONS AS MEMBERS OF AFFILIATED GROUPS

Present Law

An S corporation may not be a member of an affiliated group. Affiliated groups are defined as one or more chains of corporations connected through ownership of eighty percent or more in stock or value of other corporations in the chain. For S corporation eligibility purposes, the exceptions provided in IRC section 1504(b) will not apply in determining the presence of an affiliated group.

Subchapter S contains a limited exception for inactive subsidiaries that allows an S corporation to own 80 percent or more of the stock in a subsidiary, provided that the subsidiary has not begun business at any time on or before the close of the S corporation's taxable year, and the subsidiary does not have gross income for such period.

Suggested Change

S corporations should be permitted to own any percentage of stock in a C corporation. However, the S corporation and members of its chain will not be eligible to file consolidated tax returns. In cases of wholly owned subsidiaries, these subsidiaries will be eligible to elect S status. C corporations would not be permitted to own S corporation stock under this change.

Contribution to Simplicity

The complexity of the affiliated group rules acts as a disincentive to electing S status, and expansion of the affiliated group rules presents no apparent opportunity for tax avoidance that may not be addressed through regulations. In addition, the current affiliated group rules create a substantial amount of confusion to corporations that wish to elect S status, but own subsidiaries that were formerly active, thus disqualifying them from the inactive subsidiary exception.

Alternative

If the above recommendation is not enacted, at a minimum, the current law regarding inactive subsidiaries of S corporations should be clarified to permit active corporations to become completely inactive, in terms of both operations and ownership of assets, prior to affiliation with S corporations. As a result, S corporations should be able to own 80 percent or more of the stock or value of the subsidiary, provided the subsidiary is inactive at all times during the period for which the S election is to be effective, regardless of prior activity of the subsidiary before its ownership by the parent S corporation. In addition, the law should clarify that when a subsidiary disposes of all its assets and becomes inactive, a de facto liquidation has occurred.

AICPA Tax Simplification Recommendation

INEFFECTIVE S ELECTION -- ALLOW CORRECTION FOR INADVERTENT INELIGIBILITY AT THE TIME OF ELECTION

Present Law

The Subchapter S Revision Act of 1982 (P.L. 97-354) enacted the governing rules for election, revocation, and termination of S corporations in section 1362. This section provides that a corporation electing S status must meet the tests of eligibility in section 1361(b), both on the date of its election and on the first day of the taxable year for which the election is to be effective.

Suggested Change

Permit the Internal Revenue Service to allow a corporation to cure inadvertent ineligibility under section 1361(b), by timely correcting the flaw after discovery thereof.

Statutory authority currently exists in section 1362(f) for correcting inadvertent terminations after S corporation status has been perfected. Inadvertency concerning eligibility of qualification should be just as forgivable at the time of election as at the time of subsequent occurrence.

The Senate Finance Committee Report for section 1362(f) enacted by the Subchapter S Revision Act of 1982 states in part:

> If the Internal Revenue Service determines that a corporation's subchapter S election is inadvertently terminated, the Service can waive the effect of the event for any period if the corporation timely corrects the event and if the corporation and the shareholders agree to be treated as if the election had been in effect for such period.
>
> The committee intends that the Internal Revenue Service be reasonable in granting waivers, so that corporations whose subchapter S eligibility requirements have been inadvertently violated do not suffer the tax consequences of a termination if no tax avoidance would result from the continued subchapter S treatment.

Proposed regulations section 1.1362-5 provides the guidelines for determining inadvertency as well as the mechanics for correcting the eligibility deficiency.

An inadvertent eligibility provision similar to the inadvertent termination provision should be administratable without unusual problems.

Contribution to Simplicity

Taxpayers who elect S status in good faith, believing they meet the eligibility requirements of section 1361(b), can suffer severe tax consequences and incur substantial administrative costs upon discovery subsequent to the election date that they have an ineffective election. This suggested change will allow the Service to waive the effect of such a termination and thus eliminate uncertainty and unnecessary cost.

AICPA Tax Simplification Recommendation

EXTENSION OF TIME TO MAKE S CORPORATION ELECTION

Present Law

The Internal Revenue Service has stated that it does not have the authority to grant an extension of the time prescribed by section 1362 for filing an election to be treated as an S corporation. (Rev. Rul. 60-183, 1960-1 C.B. 625).

Suggested Change

A statutory change should be enacted to give the IRS the authority to grant an extension of time for filing the election to be an S corporation. This relief is available under Regs. sec. 1.9100-1 to taxpayers who submit a late election to file a consolidated return. Similar relief should be available, at the IRS' discretion, for an S corporation election that is filed late due to reasonable cause.

Contribution to Simplicity

The suggested change would remove an impediment to the making of an S corporation election.

AICPA Tax Simplification Recommendation

TERMINATION OF S CORPORATION STATUS BECAUSE OF EXCESSIVE PASSIVE INCOME

Present Law

Section 1363(d)(3) provides that an S election terminates whenever a corporation has subchapter C earnings and profits at the close of each of three consecutive taxable years during which the election is in effect and has gross receipts for each of such taxable years more than 25 percent of which are passive investment income.

Suggested Change

Section 1362(d)(3)(A) should be repealed. An S election should not terminate because of the presence of excessive passive investment income.

Contribution to Simplicity

Section 1362(d)(3)(A) represents unnecessary complexity in the Internal Revenue Code. Section 1375 imposes a corporate level tax when an S corporation has C corporation earnings and profits on excess passive investment income. This results in both a corporate level tax and shareholder level tax on passive investment income generated not just by retained C corporation earnings but also retained S corporation earnings. This provides a sufficient penalty on S corporations retaining C corporation earnings and profits. Furthermore, the application of section 1362(d)(3)(A) is generally in situations where the retention of C corporation earnings and profits was inadvertent. Section 1362(f) provides a waiver of the automatic termination in this case. Demonstrating the inadvertence requires time and expense on the part of both the taxpayer and the Service. Repeal of section 1362(d)(3)(A) would eliminate this needless expense and would simplify the Code.

AICPA Tax Simplification Recommendation

RECOMMENDATION RELATING TO THE LIFO RECAPTURE RULE

Present Law

The Omnibus Budget Reconciliation Act of 1987 (P.L. 100-203) added new section 1363(d) which provides in general that if a C corporation used the LIFO inventory method (as authorized by section 472) for the last taxable year prior to the effective date of its S corporation election, it must include in income the LIFO recapture amount for the last C corporation taxable year. The LIFO recapture amount is defined as the excess of the inventory amount under the first-in first-out method (FIFO) over the inventory amount under the LIFO method. Any increase in tax due to LIFO recapture is payable in four equal installments.

Suggested Change

Code section 1363(d) should be repealed, thereby eliminating the LIFO recapture rule.

Contribution to Simplicity

Repeal of the LIFO recapture rule would eliminate a substantial impediment to the making of the S election by affected corporations and would promote simplicity by removing a complex provision in the code requiring complex calculations. The LIFO recapture rule is an impediment to the making of the S election in that it forces affected corporations to pay tax on income for which an economic benefit has not yet been realized. Furthermore, it unfairly targets specific industries for which the accounting for inventories on the LIFO method is the common practice. Especially affected adversely are wholesalers, distributors and retailers, many of which are small family owned businesses. The rule requires calculations of the inventory amount using both the LIFO and FIFO methods and results in a basis adjustment to the inventory for tax purposes that may not be recognized for financial reporting purposes under generally accepted accounting principles (GAAP). This results in complex recordkeeping requirements to account for these differences between tax and financial reporting. Furthermore, since a corporation that pays the LIFO recapture tax will be an S corporation at the time of payment, complex rules must be prescribed to account for the effect of the payment of the tax on the accumulated adjustments account and the stock basis for the shareholders. This complexity would be eliminated by the repeal of section 1363(d).

AICPA Tax Simplification Recommendation

ADJUST EARNINGS AND PROFITS RATHER THAN TAX SHAREHOLDERS FOR BUILT-IN GAINS

Present Law

Section 1366(a) requires that each shareholder of an S corporation include in taxable income the shareholder's pro rata share of the corporation's built-in gains reduced by the tax paid by the corporation on such built-in gains (section 1366(f)(2)). The shareholder is taxed on such S corporation income whether or not it is actually distributed to the shareholder by the corporation. Section 1371(c)(1) provides that generally no adjustment shall be made to the earnings and profits of an S corporation except for redemptions, liquidations, reorganizations or dividend distribution transactions.

Suggested Change

Recognized gains (and losses) which had economically accrued during C corporation status years would not pass through to shareholders but instead such items would increase (or decrease) corporate earnings and profits potentially taxed to shareholders when distributed under section 1368(c). The corporate level tax on such net gains would reduce earnings and profits. Because these built-in gains and losses would not be passed through to the shareholders' returns, they would neither affect the Accumulated Adjustments Account (AAA) nor the shareholders' basis in the corporation. Thus, actual distributions in excess of the smaller AAA (i.e., not increased by net built-in gains) would be out of earnings and profits taxable as dividends to the shareholders. Recognized gains (and losses) economically accrued after the effective date of an S election would continue to be exempt from the section 1374 tax and to pass through to the shareholders with appropriate adjustment to the AAA and shareholders' bases.

Contribution to Simplicity

The major impediment to an S election under present law is the complexity, uncertainty and inequity (as compared to C status) imposed by the section 1374 built-in gains tax. Unlike shareholders of a C corporation, S corporation shareholders are <u>immediately</u> taxed on recognized but undistributed built-in gains less the corporate level tax thereon. Shareholders are reluctant to consent to an S election which will result in double taxation of undistributed recognized built-in gains often difficult to quantify at the time of the election. There should be no difference in the timing of the double taxation of gains recognized before the S election becomes effective and gains economically accrued in the C corporation but not actually recognized until an S status year.

AICPA Tax Simplification Recommendation

FISCAL YEAR ELECTIONS FOR S CORPORATIONS AND PARTNERSHIPS

Present Law

For tax purposes, S corporations and partnerships must generally report on a calendar year basis. However, fiscal year reporting is allowed if the S corporation or partnership has a natural business or ownership tax year. In addition, an S corporation or partnership may elect under section 444 a fiscal year that results in a three month or less deferral of income. This election results in no deferral of tax, because the S corporation must make deposits, known as required payments, to the government to approximate the tax the owners would have paid had the entity reported on a calendar year basis.

Suggested Change

S corporations and partnerships shall be permitted to adopt or change to any fiscal year under section 444, provided the entity makes required payments for the deferral period that results from the fiscal year election.

Contribution to Simplicity

The required payment mechanisms under section 444 are intended to neutralize any tax benefit achieved by the tax deferral resulting from fiscal year tax reporting. There is no apparent reason to restrict fiscal year elections to tax years that will result in deferral of income for three months or less.

AICPA Tax Simplification Recommendation

FRINGE BENEFITS

Present Law

Section 1372 provides that for Federal income tax purposes the S corporation shall be treated as a partnership and any covered shareholder of the corporation shall be treated as a partner. S corporations are thus discriminated against in comparison with C corporations as a tax form of business organization.

Suggested Change

Section 1372 should be repealed. The owners of S corporations (and of partnerships) should be on equal footing with the owners of C corporations.

Contribution to Simplicity

The suggested change would remove an impediment to the making of an S corporation election by many closely held C corporations. It would also obviate the necessity to determine whether S corporation shareholders are receiving fringe benefits as (i) third parties (in situations which would be covered by section 707(a)), (ii) owners who receive the benefit as compensation not determined by profits (in situations which would be covered by section 707(c)), or (iii) owners who receive the benefit as a distribution (in situations which would be covered by section 731).

AICPA Tax Simplification Recommendation

AMOUNT AT RISK -- PROVIDE FOR CARRYOVER OF DISALLOWED LOSSES AND DEDUCTIONS UNDER SECTION 465 TO POST-TERMINATION TRANSITION PERIODS

Present Law

The at risk limitations of section 465 do not provide for a carryover of disallowed losses and deductions to post-termination transition periods.

Suggested Change

Allow a carryover of disallowed losses and deductions to post-termination transition periods under section 465, thereby complementing a similar rule under section 1366(d)(3).

Contribution to Simplicity

If an S corporation election is terminated, section 1366(d)(3) provides that losses and deductions existing at the date of termination that have been suspended under the basis limitations of section 1366 are allowed as deductions at the shareholder level during a post-termination transition period to the extent of the shareholder's basis in his or her stock. This gives shareholders the opportunity to deduct losses and deductions suspended under that section for a limited period after the termination, which would otherwise be denied due to the S corporation's conversion to C corporation status, if they invest additional capital in the corporation. Because the section 465 at risk rules do not provide comparable treatment for losses and deductions suspended under that section, an inconsistency exists between these two statutory provisions even if shareholders were to invest additional capital in the corporation during the post-termination transition period. The suggested change would clarify that losses and deductions suspended at the shareholder level under the section 465 at risk limitations could be utilized during the post-termination transition periods similar to losses and deductions suspended under the section 1366 basis limitations.

AICPA Tax Simplification Recommendation

ACCUMULATED ADJUSTMENT ACCOUNT DISTRIBUTIONS

Present Law

The Accumulated Adjustment Account (AAA) is a corporate level account, representing income that has been taxed to S corporation shareholders in prior years, but has not been withdrawn through distributions or redemptions. To the extent an S corporation has a balance in AAA, distributions may be made tax-free to shareholders during any S year or during the post-termination transition period.

Section 1368(e) by reference to section 1367(a) contains a set of ordering rules requiring that AAA be adjusted first for profit and loss for the year, and then for distributions during the year. To the extent that these distributions are less than or equal to the AAA balance at the beginning of the year adjusted for the year's income or loss, the distributions will be tax-free. To the extent that distributions exceed that amount they may be a dividend, return of capital or a capital gain to the shareholder.

This ordering rule essentially requires that any S corporation which plans to distribute a year's income to shareholders must determine its profit and loss for the year on the last day of the year. If distributions are made after year-end based upon a later determination of income or loss for the year, these distributions must be compared with profit or loss for that succeeding year, and could potentially result in a taxable dividend or capital gain to the shareholder, even though they would have been tax-free had they been made by year-end.

Suggested Change

In order to allow time to make a determination of income for the year, S corporations which make distributions within two and one-half months after year-end shall be permitted to treat those distributions as made prior to year-end. (Note: prior to the SSRA of 1982, section 1375 of Subchapter S contained such a two and one-half month rule for distributions of undistributed taxable income.)

Contribution to Simplicity

While the concept of a corporate level accumulated adjustment account used to measure retained S corporation earnings is sound, problems and complications exist in current law that unfairly penalize S corporations that are unable to both determine corporate income and make distributions by year-end. This extended distribution period would permit an orderly book closing to determine the year's earnings available for distribution.

AICPA Tax Simplification Recommendation

EARNINGS AND PROFITS ARISING OUT OF PRE-1983 SUBCHAPTER S YEARS

Present Law

It is possible for an S corporation to have earnings and profits (E&P) from taxable years in which the corporation was a Subchapter S corporation under pre-1983 law ("S-E&P"). S-E&P could have arisen by virtue of permanent differences between taxable income and E&P on income and deduction items arising prior to 1983. S-E&P could also arise by reason of pre-1983 timing differences between taxable income and E&P items which were made permanent for years after 1982 by virtue of the "no operating adjustments" rule of section 1371(c)(1). The acquisition in a tax free reorganization of a corporation that had S-E&P could also bestow S-E&P on the acquiring S corporation.

Suggested Change

S-E&P from continuous S years prior to and including the effective date of the Subchapter S Revision Act of 1982 should be eliminated. The prior taxability of distributions should not be changed, but E&P should be reduced (even below zero) by the suggested elimination.

Contribution to Simplicity

The principal impact of the proposal would be to eliminate the inequity in which an S corporation can have E&P from pre-1983 passthrough years in which it was a Subchapter S corporation. There may be complexity in determining the necessary reduction of E&P, but this complexity will be offset in part by not having to be concerned with S-E&P and in part by the equity in the suggested change.

Alternative

If it is not acceptable to eliminate the S-E&P of all S corporations (including those with a prior C history), at a minimum, S-E&P should be eliminated for those S corporations with no prior C history.