NATIONAL CONFERENCE OF CPA PRACTITIONERS
50 Jericho Tpke, Suite 106
Jericho, NY 11753
(516) 333-8282
FAX: (516) 333-4099
TOLL FREE: (888) 488-5400

CONGRESSIONAL AGENDA
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Prepared By:

NATIONAL CONFERENCE OF CPA PRACTITIONERS (NCCPAP)

TAX POLICY COMMITTEE

Todd D. Newman, CPA
Tax Policy Committee Chair
(845) 276- 2070

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THE ALTERNATIVE MINIMUM TAX (INDIVIDUALS)

BACKGROUND

There is no more urgent priority for a change to be made to the tax law than the repeal of the individual Alternative Minimum Tax (AMT). The AMT was originally enacted in 1969 to address the concerns that persons with substantial economic income were paying minimal Federal income taxes due to the clever use of "tax sheltered" investments. The AMT today is affecting an unintended class of taxpayer, namely the middle class taxpayers, that are not using what we would call "deferral strategies."

The AMT is a tax that eliminates many of your deductions and leaves you paying more, sometimes much more, then you were led to believe you would especially in light of all of the tax cuts of recent years-many of which have been very well publicized.

The AMT is a special tax applicable only if the amount due exceeds the regular income tax. An individual must first calculate the regular tax and then modify the calculation with certain adjustments and add backs and then subtract an exemption amount depending on filing status.

The individual AMT creates a second tax calculation that is a major compliance burden without a significant policy justification. The failure of the AMT to achieve the purpose it was designed for is due to the numerous changes that have been made to the IRC since 1969 that have limited tax shelter deductions and credits which many of the wealthier taxpayers took advantage of for many, many years.

Today this tax affects over two million tax returns and within the next five years about one-third of all taxpayers are likely to be affected. By the year 2010, it is projected that ninety percent of all households with an adjusted gross income in excess of $100,000 will be subject to the AMT.

PROBLEM

The failure of the AMT to achieve its original purpose can be traced to items that are "personal" in nature and not the result of shrewd, sophisticated tax planning. This is the personal exemption, the standard deduction, state and local taxes and miscellaneous itemized deductions. The interaction of the AMT with several recently enacted credits that were intended to benefit families and promote higher education hurts individuals as the AMT reduces benefits conferred by these credits.

For a very long time most people outside of the professional tax preparer community even knew that this so called "second tax calculation" even existed. Even today as more and more middle class individuals are being snared into this trap-they exclaim- "What is an AMT?" when their tax preparer informs them of a much less then anticipated refund or an amount that is due to the IRS when a refund was expected. An individual, who prepares their own return manually and is subject to the AMT but has never heard of it and of course, does not know how to calculate it, will eventually receive a bill for the underpaid tax plus interest and penalties.

While the regular tax rates have dropped repeatedly over the past decade, the AMT tax rates have been largely unchanged and have not been indexed for inflation. As the gap between the regular tax and the AMT rate narrows more people are subject to it.

The AMT is too complex and imposes a large compliance burden. Taxpayer Advocate Nina Olson, in her December 2004 report, stated that the AMT now functions "randomly and no longer with any logical basis in sound tax administration." She believes that the AMT impacts the "wrong" taxpayers. The tax is not indexed for inflation and has an adverse affect on families. The record keeping requirements for two sets of records is burdensome and unfair. Tax simplification can be achieved by an immediate repeal of this tax.

RECOMMENDATION

The tax code should be amended to repeal the individual AMT. It will reduce the complexities associated with the calculations and allow all taxpayers to have their tax calculated fairly and on the same playing field.

Congress is well aware that the alternative minimum tax is affecting a much larger portion of the population than it was intended to.

If a total repeal is not possible because of revenue considerations, the law could be amended to exclude taxpayers with adjusted gross income below a certain threshold from having to calculate any potential AMT liability. Each and every "preference item" should be reviewed to determine whether or not the item really belongs as part of the AMT calculation. All miscellaneous deductions should be deductible for AMT purposes as well. The tax rate brackets and exemption amounts for the AMT should be indexed in the same manner as the regular tax. However, as the regular tax rates fall, more and more taxpayers will be paying the AMT and not the regular income tax.

COMMENTS

The National Taxpayer Advocate first recommended repeal of the AMT in her 2001 report to Congress. The AMT rules are unnecessarily complex and result in inconsistent and unintended impact on the taxpayers. The burden on the affected taxpayers is large. Repeal, adjustment, reorganization is desperately needed to restore order to middle class taxpayers.

IRA CONTRIBUTIONS PHASEOUTS AND DISALLOWANCES

BACKGROUND

In 1981, tax legislation established a means for taxpayers to fund retirement accounts for themselves with tax-deductible contributions. This was the beginning of the IRA. In 1986, Congress decided that not everyone should be allowed to fund retirement accounts with tax-deductible contributions and established income levels at which deductible contributions would be "phased out". Since then, legislation has created additional phase-outs and cut offs. In addition, individuals who are active participants in qualified pension or profit sharing plans are not allowed to contribute to an IRA unless their adjusted gross income falls within specific dollar limits.

PROBLEM

Currently, there are different phase-outs depending on the individuals' situation, whether they are married or not, whether they (or a spouse) are a participant in a plan at work or not. In addition, as the average age of Americans' increases, more and more individuals will be filing claims to collect Social Security. Part of the agenda of the current Administration is to do away with Social Security as a retirement plan, or to allow individuals to "privatize" their contributions, along with the matching payment by their respective employers.

RECOMMENDATION

With the exception of the ROTH IRA, we recommend that contributions to Traditional IRA have no restrictions or limitations at all. The original intent of the IRA when it was established was to give taxpayers the incentive to save for their own retirement. Legislation has since then reduced the incentive. Regardless of the type of plan one participates in, at or outside their place of employment, individuals should be encouraged to save for the future as much as possible.

COMMENTS

It should be pointed out that monies placed in a retirement plan of any kind, IRA, 401k, SEP, Keogh, Pension, Profit-Sharing, are being deferred for tax purposes. These monies, along with whatever earnings they generate, will eventually be taxed.

GAIN ON SALE OF RESIDENCE

PROBLEM:

The Taxpayer Relief Act of 1997 completely changed IRS Code Section 121 regarding the tax treatment of gains on the sale of a residence. The rollover provisions of old Code Section 1034 have been repealed in favor of an exclusion of up to $250,000 per taxpayer ($500,000 on a joint tax return). The Committee Reports indicate that the reason for the repeal of Code Section 1034 was that "calculating capital gain from the sale of a principal residence is among the most complex tasks faced by the typical taxpayer." Under current law, a surviving spouse must sell the home in the year of death to take advantage of the full $500,000 exclusion. Thereafter, the surviving spouse can only exclude $250,000. A taxpayer whose spouse died in January has eleven months to sell the home. Conversely, if the spouse died on December 31, the survivor must sell the home instantaneously in order to qualify. This is an inequitable tax policy.

In divorce situations, each spouse can exclude up to $250,000 upon the eventual sale of the home, but only if both spouses retain ownership and a court decree grants one spouse exclusive occupancy. This scenario is not always the most likely result of a divorce negotiation. In many cases, the spouse that retains custody of the children also retains ownership and occupancy of the home. When the children are grown and the house is sold, the exclusion available will only be $250,000. In other words, the custodial spouse is penalized for attempting to provide stability for the children during a very stressful time. This is not equitable.

RECOMMENDATION:

Code Section 121 should be expanded to provide the full $500,000 exclusion in the following two situations:

1. If a surviving spouse sells a home within three years after the year of death and the taxpayers would have qualified on the date of death for the full $500,000 exclusion, then the full exclusion should be available. This provision would provide for the orderly sale of the home rather than cause a rush to make a distress sale in order to qualify for the exclusion. The exclusion should be limited in the event that a step-up in basis was obtained under the estate tax rules. This would avoid a double benefit.

2. If a residence is distributed to one spouse during a divorce proceeding, the spouse that retains the home shall be entitled to a full $500,000 exclusion upon the ultimate sale of the residence. This provision shall apply if the taxpayers would have qualified for the exclusion prior to the divorce.

EMPLOYEE BUSINESS DEDUCTIONS SUBJECT TO 2% LIMITATION

BACKGROUND

Internal Revenue Code Section 67(a) requires an employee, who incurs ordinary and necessary business expenses in the performance of his/her duties that are not reimbursed by his/her employer, to list those expenses on Form 2106. The total of employee business expenses is transferred to Form 1040 Schedule A and listed as a miscellaneous itemized deduction. Miscellaneous itemized deductions are required to be reduced by two percent of the taxpayer's adjusted gross income. The deduction for these expenses can be further reduced by the phase out of itemized deductions. In many cases these reductions cause the expenses to be eliminated and the employee is denied a deduction for ordinary tax purposes. In addition, employee business deductions are not a permissible expense for AMT purposes.

PROBLEM

"Statutory Employees" and businesses in all forms, i.e., corporations, partnerships, LLC's, LLP's and sole proprietorships, are allowed to deduct all business expenses in full against gross income (subject to limitations such as 50% of meals). The only business expenses not allowed to be deducted in full are those incurred by employees. This is unfair and discriminatory.

RECOMMENDATION

The total of all employee business expenses listed on Form 2106 should be allowed as a deduction before arriving at adjusted gross income and not be listed on Form 1040 Schedule A as a miscellaneous deduction nor be an add back for alternative minimum tax calculations.

COMMENTS

The Joint Committee on Taxation stated in its report dated April 26, 2001 "that present law does not reflect a coherent theory for treating some deductions as above the line and some as itemized deductions." Although above-the-line deductions are frequently thought of as deductions related to the production of income and itemized deductions are frequently thought of as reflecting ability to pay or encouraging certain behavior, not all deductions can be accounted for under these principles. Employee business expenses are related to the production of income yet are allowable only as an itemized deduction, subject to the two-percent floor.

The JCT report recommends that the two-percent floor applicable to miscellaneous itemized deductions should be eliminated. We are in agreement with this recommendation.

TAXATION ON LITIGATION PROCEEDS

PRESENT LAW

There is a well-established principle in the tax law that is known as the assignment of income doctrine. A taxpayer that is entitled to an income stream cannot assign this income stream to another taxpayer and avoid the payment of income taxes. The taxation of contingent attorney fees, however, was an anomaly under the tax law depending on where the taxpayer happened to live. The Circuit Courts split on the simple question of whether or not fees retained by an attorney pursuant to a valid contingent fee agreement is income to the client under the assignment of income doctrine.

The United States Supreme Court in April 2004 agreed, after years of refusal, to hear appeals of two cases. In January 2005 the Court issued its ruling and held that plaintiffs in taxable non-physical injury cases must pay taxes on the full amount of any settlement. The Civil Rights Tax Relief Act, which became law in October 2004, renders the Supreme Court's decision moot with respect to all prospective employment related and certain other settlements.

PROBLEM

The position of the Internal Revenue Service is that the entire amount of the award received by the attorney for the benefit of the client is, in fact, income to the client under the assignment of income doctrine. This is very important in the non-business situation. The position of the Service is that the payment of the legal fees should be handled as a miscellaneous itemized deduction. These deductions are only allowed to the extent that they exceed two percent of adjusted gross income. Because of this, taxpayers do not receive the full benefit of the deduction. Miscellaneous itemized deductions are also subject to another phase out of deductions for higher earning taxpayers and the proceeds themselves add significantly to the adjusted gross income in the year of receipt.

Another serious problem is that these miscellaneous itemized deductions are not deductible for AMT purposes. It is, therefore, possible for the attorney fees and the tax liability to consume the majority of the damage award the taxpayer actually receives. The best example of this is the "alleged settlement" in the case of Paula Jones v. William Jefferson Clinton. Ms. Jones allegedly settled for a payment of $850,000 from Mr. Clinton and had attorney fees of $ 650,000. If she reports the net of $200,000 in income, the tax liability is simply a function of her additional income and expenses and she would keep the net amount of $200,000, less taxes. However, with the AMT kicking in, if she has to report the entire $850,000 as income with no deduction for the attorney fees, her AMT tax will exceed the $200,000 she received. This cannot be considered fair or reasonable.

COMMENTS

The contingent fee issue has been litigated in the courts for years. The recent United States Supreme Court decision in Banks v. Commissioner and Banaitis v. Commissioner was anticipated by Congress in its enactment of the Civil Rights

Tax Relief Act and applies only to old (pre October 2004) employment discrimination settlements. In cases not covered by this tax act like defamation and other non-employment related taxable recoveries, the double taxation issue still looms large.

RECOMMENDATION:

NcCPAp recommends that a taxpayer should be taxable only on the portion of any settlement actually received and retained by the taxpayer. Contingent legal fees should be taxable to the attorney only. The changes made by the 2004 Tax Act does not cover all settlement agreements. Until Congress statutorily overrules the Supreme Court's decision, some taxpayers may end up paying more in taxes, as a result of including attorney's fees in income, than they win in a settlement.

TAX PREPARATION AND REPRESENTATION FEES

BACKGROUND

The Internal Revenue Code and associated regulations, rulings, etc. have become extremely complex in recent years. IRS studies show that more taxpayers used the services of a paid preparer for the preparation of their tax returns in the current year than ever before. IRS studies have further shown that a significant number of tax preparers (particularly unlicensed preparers) do not report all of their earnings. Individuals, not operating a business, are not required to issue 1099 Forms in connection with paid professional services. The Tax Reform Act of 1986 altered the treatment of miscellaneous itemized deductions, whereby the total expenses in this category are only deductible to the extent that they exceed 2% of the Adjusted Gross Income (AGI). In addition, the limitation of itemized deductions based on higher levels of income further eliminates this deduction for many other taxpayers.

PROBLEM

Many taxpayers do not derive a tax benefit for the payment of tax preparation (or audit representation) fees, unlike other entities that are permitted a full deduction. The 2% of AGI limitation and the phase out of itemized deductions thus reduces or eliminates the benefit for the middle and upper middle class taxpayer.

RECOMMENDATION:

The deduction for tax preparation and representation fees should be deductible on Page 1 of Form 1040 (in the section for adjustments to income) as an above-the-line deduction. This will generate a direct reduction in AGI and taxpayers will not lose the tax benefit caused by the above referenced limitations. This is a matter of fairness, as all other taxpaying entities receive an undiminished deduction for tax audit representation and tax preparation fees. **NcCPAp** believes that more taxpayers would insist on deducting the fees if they were certain that there would be a tax benefit. As well, the tax preparers would be more likely to sign the return and report the fees that they earn. As a control, the Employer Identification Number (EIN) or Social Security number (or PTIN), if applicable, of the prior year tax preparers would be required on the deduction line (similar to the alimony paid recipient). The IRS should collect enough additional revenue from non-reporting preparers to mitigate the tax revenue lost by allowing these fees.

ITEMIZED MEDICAL EXPENSES

BACKGROUND

Medical expenses are included as an itemized deduction. The current medical expense deduction is the amount that exceeds 7½% of adjusted gross income. For alternative minimum tax (AMT) computations, medical expenses are limited to 10% of AMT adjusted gross income. Also, these expenses are subject to the phase out of itemized deductions.

PROBLEM

Since 1986, only the total amount of medical expenses paid that exceeds 7½% of adjusted gross income is included as itemized deductions. During the past 15 years both adjusted gross income and the standard deduction have increased dramatically. The result of these increases is that taxpayers are receiving less tax deduction benefit than was planned when the original exclusion was established.

RECOMMENDATION

As medical expenses have continually risen, the current tax structure has not maintained the same tax benefit to taxpayers that was initially intended. **NCCPAP** recommends a reduction in or an elimination of the exclusion percentage for medical expenses to be allowed as itemized deductions.

DEDUCTIBILITY OF LONG TERM HEALTH CARE PREMIUMS

BACKGROUND

Long Term Care Insurance (LTCI) helps taxpayers protect their assets and maintain their financial security should they need assisted long-term care at some point in their life. With the escalating costs of nursing homes and other elder care expenses, purchasing LTCI can provide taxpayers with peace of mind in the future. Medicare was conceived to cover the basic medical costs. Medicare does not provide adequate coverage for an extended stay in a nursing home or skilled care facility. Medicaid will provide for long-term health care but only if the taxpayer spends down all of their assets and meets certain financial requirements.

PROBLEM

Currently the cost of some LTCI policies ranges up to almost $6,000 per year. The level of benefits chosen determines the premium to be paid. Taxpayers may be able to deduct all or a part of the premiums paid for themselves, their spouse or a dependent based upon the covered individuals age. The deduction for LTCI for 2005 ranges from a low of $260 per year for an individual under 40 years of age to a maximum of $3,250 for an individual over the age of 70. This limited deduction is then added to other medical expenses and is then further limited to the amount that exceeds 7.5 % of adjusted gross income. After these two limitations, the deduction may be limited by the phase-out of itemized deductions. Therefore, the total expenditure for LTCI premiums faces three levels of limitation before any possible tax savings is realized.

RECOMMENDATION

NCCPAP's proposal is to allow a full deduction for all expenditures for LTCI premiums as an above-the-line deduction similar to the self-employed health insurance deduction. This change would give individuals the incentive to purchase this insurance. With the availability of this tax deduction, we believe that this will eliminate a lot of the need for "tax planning" to avoid long term health care costs in the future which results in transfers of assets amongst family members solely to qualify the ailing individual for some type of government assistance.

While there would be some short-term loss of tax revenues, we believe that in the long term, revenues of the US Government would increase due to the reduction in the need for Medicaid benefits. The amount of tax dollars saved will exceed the short-term tax loss over the next few years as the "baby boomers" reach an age where assisted living facilities become necessary.

OFFICE IN HOME- S CORPORATION SHAREHOLDERS

PRESENT LAW:

IRS Code Section 280A(a) states generally that "***in the case of a taxpayer who is an individual or an S corporation, no deduction otherwise allowable under this chapter shall be allowed with respect to the use of a dwelling unit which is used by the taxpayer during the taxable year as a residence.***"

Section 280A(c) provides for certain exceptions (deductions are allowed) when a portion of the dwelling unit "***is exclusively used on a regular basis - ... as a place of business which is used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of his trade or business***" [280A(c)(1)(B)] Accordingly, allocated expenses are deductible when one of the three exceptions provided under Section 280A(c) are met.

Section 280A(c)(3) provides an additional exception (deductions are allowed) to the extent that the deductions ***"are attributable to the rental of the dwelling unit or portion thereof***".

Section 280A(c)(6) provides an exception to the exceptions, to wit "***deductions shall not apply to any item which is attributable to the rental of the dwelling unit (or any portion thereof) by the taxpayer to his employer during any period in which the taxpayer uses the dwelling unit (or portion) in performing services as an employee of the employer.***"

The Committee Reports on P.L. 99-514 (Tax Reform Act of 1986) indicate that this law was structured in reaction to the Feldman Case 84 T.C. 1 (1985). The Committee Report states that: "***allowing employees to use lease arrangements with employers as a method of circumventing the restrictions on home office deductions might encourage some taxpayers to arrange sham transactions whereby a portion of salary is paid in the form of rent. Moreover, it is questionable whether lease transactions between an employer and employee are generally negotiated at arm's length, ...Accordingly, the committee believes that no home office deductions should be allowable ... if the employee rents a portion of his or her home to the employer.***"

PROBLEM:

Some taxpayers have become the unwitting victims of Section 280A merely by their choice of entity which, in many cases, was made without knowledge or consideration of Section 280A. Specifically, a taxpayer, for example a chiropractor, forms a corporation for his practice and makes an election to be taxed under Subchapter S. The practice operates in a portion of the home that is clearly used regularly and exclusively for business purposes. In fact, significant modifications have been made to the residence to accommodate the practice. While the tax code [Section 1372(a)] treats taxpayers that own more than 2% of

the stock of an S Corporation as self-employed for fringe benefit purposes, no such language is provided with regard to the use of a home office. Accordingly, S corporation shareholders are caught between various Code Sections. The individual cannot claim home office deductions on Form 8829 because there is no Schedule C associated with the tax return; therefore no qualified business use exists. However, if the corporation pays the owner rent for the use of the property, the individual can't claim deduction on Schedule E against the rent income due to the limitations provided under Section 280A.

One of our members has discussed this issue with a Revenue Agent on audit. He was told to have the corporation make proportionate payments for mortgage, real estate taxes, utilities, maintenance, etc. with a separate corporate check and that the corporation can deduct those payments. We believe that this advice is contrary to the Tax Code for several reasons. Interest deductions are not allowed for payments on a loan for which the entity is not obligated. Principal payments are never deductible. The associated depreciation expense is not available because the corporation does not have an ownership interest in the property and 280A thwarts that treatment in its opening paragraph if the corporation did have an ownership interest. Furthermore, we believe that the payments made by the corporation directly would be properly classified as a distribution or compensation to the shareholder under the Tax Code.

Had the entity been formed as a single owner LLC instead, the business would be reported on Schedule C and all of the allowable home office deductions under Section 280A would be available. Section 280A was enacted prior to the existence of the LLC under state business laws. In many cases, corporations were formed prior to the availability of the LLC as a choice of entity or prior to the "check the box" regulations that delineate the proper treatment of a single owner LLC. Furthermore, the dissolution of the S Corporation and immediate reformation as an LLC would have a number of adverse tax consequences.

Accordingly, taxpayers in situations similar to this are denied fair and equitable treatment under the Tax Code.

RECOMMENDATION:

Section 280A should be revisited. In general, we believe that 280A should be coordinated with the rules under Section 1372 for S corporation shareholders. Adverse consequences also exist when a taxpayer rents a portion of the residence to a closely held C Corporation due to Section 280A(c)(6). A fair and equitable result could be achieved by requiring any rental to the employer to be made at fair market value. IRS has already used the reasonable compensation rules successfully to stop taxpayers from converting compensation into Sub S dividends. We understand the need of IRS to collect a proper amount of FICA, Medicare, Unemployment and Withholding taxes. This need, however, should not obviate the need to provide fair and equitable tax administration to all taxpayers.

DEDUCTIBILITY OF MEDICAL INSURANCE

BACKGROUND

Medical insurance has been deductible as an itemized deduction, combined with other medical expenses, subject to a 7 1/2 per cent of Adjusted Gross Income floor. A self-employed taxpayer is allowed to deduct one hundred percent (100%) of medical insurance as an adjustment for adjusted gross income subject to self-employed income. Employers have generally paid a large portion of medical insurance premiums as a tax-free fringe benefit with the employee paying the balance with taxable dollars subject to deduction under the limitations stated above. For the calculation of alternative minimum tax the floor percentage is increased to 10% of adjusted gross income.

PROBLEM

The cost of medical insurance has been steadily increasing. Accordingly, employees have been required to share a larger portion of the premium costs with their employers,

RECOMMENDATION

All taxpayers should be allowed a deduction for adjusted gross income for the premiums paid for medical insurance paid with taxable dollars on page one of the Form 1040. This is a matter of equitable treatment of like expenses for all taxpayers. Additionally, this will allow an ever increasing, necessary expenditure to be deductible for both regular and alternative minimum tax.

COMMENTS

This change will be an incentive for taxpayers not previously covered by medical insurance to now be covered and help reduce the burden on public health coverage.

DEDUCTIBILITY OF GAMBLING LOSSES

BACKGROUND

Gambling losses have been deductible to the extent of gambling winnings as a miscellaneous itemized deduction not subject to the 2% limitation.

PROBLEM

Since taxpayers are required to report gross gambling winnings as income in arriving at Adjusted Gross Income (AGI) and AGI is the basis for calculating both exemption and itemized deduction phase-out, taxpayers may not truly get an offset of gambling losses to gambling winnings.

RECOMMENDATION

All taxpayers should be allowed a deduction for adjusted gross income in the amount of gambling losses not to exceed winnings on page one of the 1040. This will reinstate the intent of the Internal Revenue Code to allow an offset of winnings with losses to arrive at the true net winnings. This deduction predates the Tax Reform Act of 1986, which instituted the itemized deduction phase-out.