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TAX POLICY COMMITTEE

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BACKGROUND

The alternative minimum tax (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 end result is then multiplied by the AMT rate of 26% or 28%. There are different exemption amounts depending on filing status but that is not the focus of this problem.

There is no more urgent priority for a change to be made to the tax law then the repeal of the individual AMT. The AMT was originally enacted in 1969 to address the concerns that persons with substantial economic income were paying minimal federal income taxes thanks to the clever use of "tax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 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 because of 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.

After the passage of the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Job Creation and Worker Assistance Act of 2002, middle class taxpayers were scheduled to receive certain tax benefits and incentives. Those benefits and incentives were lost because of the provisions of the AMT. According to the Treasury Department it is estimated that one-third of all taxpayers will be subject to the AMT in the year 2010. An additional alarming statistic is that almost 50 percent of all taxpayers currently subject to the AMT will have all of their EGTRRA benefits completely offset by 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 will hurt individuals as the AMT reduces benefits conferred by these credits.

The AMT is too complex and imposes a large compliance burden. Tax simplification can be achieved by an immediate repeal of this tax. If repeal cannot be achieved due to the revenue reduction that would accompany repeal then in the alternative we would suggest several scenarios.

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.

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 to 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 Joint Committee on Taxation in its report dated April 26, 2001 also recommended repeal of the individual (and corporate) AMT. According to the Congressional Joint Committee on Taxation, it is their belief that the individual AMT no longer serves the purpose for which it was originally intended. NCCPAP agrees with this belief.

Additionally, it is important to note that the National Taxpayer Advocate, Nina Olsen, in her report to Congress on December 31, 2001 stated, "The individual AMT no longer serves the purpose for which it was originally enacted. The present structure of the individual AMT expands the scope of its provisions to taxpayers who should not be drawn into the complex concepts, calculations and recordkeeping required of AMT taxpayers".

IRA CONTRIBUTIONS PHASEOUTS

BACKGROUND

In 1981, tax legislation established a means for taxpayers to fund retirement accounts for themselves with tax-deductible contributions. This began the IRA. In the Tax Reform Act of 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 that time, legislation has created additional phase outs and cut offs.

PROBLEM

Currently, there are different phase out income levels for: single taxpayers covered by retirement plans at work, couples where one or both spouses are covered by retirement plans at work, single taxpayers for ROTH IRA contributions and couples for ROTH IRA contributions. These AGI phase outs have increased only moderately in the past year. A single taxpayer, for example, who is employed by a company that contributes a small amount to a retirement plan on his behalf, is barred from contributing to a tax deductible IRA account if his AGI exceeds $ 50,000.

RECOMMENDATION

The original intent when IRA's were established was to provide incentive (and savings vehicles) for taxpayers to save for their own retirement. It seems that legislation since then has reduced the incentive. If the intent is for taxpayers to save for their retirement, we recommend the elimination of all income limits for deductible contributions and for ROTH IRA contributions. If limits must be maintained, we recommend uniform limits for tax simplification and the income limits should be indexed for inflation.

COMMENTS

The Joint Committee on Taxation staff recommends in its report dated April 26, 2001 that the income limits on eligibility to make deductible IRA contributions, ROTH IRA contributions, and conversions of traditional IRAs to ROTH IRAs should be eliminated. Further, the joint committee staff recommended that the ability to make nondeductible contributions to traditional IRAs should be eliminated.

GAIN ON SALE OF RESIDENCE

PROBLEM:

The Taxpayer Relief Act of 1997 completely changed 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 Couple 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 Couple 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 2% 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 states 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, is an anomaly under the tax law depending on where you happen to live. The circuit courts have 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.

Many lawsuits are filed in this country whereby the lawyer only recovers a fee if successful. The lawyer will receive a percentage of the eventual recovery. If the lawsuit results in taxable income to the successful party there is a significant difference in the taxes to be paid depending on which circuit the taxpayer resides in.

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 and has resulted in split decisions amongst the circuits. The tax court has ruled that the recovery is fully taxable and the attorney fees are a deduction below the line.

TAXATION ON LITIGATION PROCEEDS (page 2)

This view is also shared by the Third, Fourth, Seventh, Ninth, Tenth and Federal Circuit Court of Appeals. The Court of Appeals for the Second, Fifth, Sixth and Eleventh Circuits have sided with the taxpayer. The United States Supreme Court has denied certiorari twice in this matter.

RECOMMENDATION:

The individual should be taxable only on the portion of any settlement actually received. Contingent legal fees should be taxable to the attorney. This will alleviate the inequitable application of the AMT to these settlement amounts and the way deductions are disallowed for AMT purposes. Equally as important is how the miscellaneous itemized deduction format under the regular tax law unfairly impacts the taxpayer.

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, because of 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.

EDUCATION CREDIT INCOME PHASE OUTS- HEAD OF HOUSEHOLD

BACKGROUND

The Taxpayer Relief Act of 1997 established education incentives in the form of tax credits for qualified tuition and related expenses to eligible post-secondary educational institutions. These credits were aimed at benefiting low and middle-income individuals. Income limitations were established for single taxpayers with the phase out beginning at $40,000 of Modified Adjusted Gross Income and ending at $50,000 of Modified Adjusted Gross Income. For married taxpayers filing jointly these phase out levels had been doubled. In 2003, the phase out of the credit begins for a single taxpayer at $41,000 and are completely phased out when AGI reaches $51,000. For a joint filer, the phase out starts at $83,000 and the credit is completely phased out at $103,000.

PROBLEM

The Act did not differentiate between a single taxpayer and a single taxpayer with dependent children (Head of Household). The cost of living is significantly different when an individual must pay expenses for additional family members and yet they are subject to the same phase out limits as the single taxpayer.

RECOMMENDATION

Internal Revenue Code Section 25A (Limitation Based on Modified Adjusted Gross Income (d)(2)(A)(ii)), should be expanded to permit taxpayers claiming Head of Household status, a higher income phase out than a single taxpayer in order to allow more single parents to claim tuition credits.

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 exceed 7½% of adjusted gross income are 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 you protect your assets and maintain your financial security should you need assisted long term care at some point in your life. With the escalating costs of nursing homes and other elder care expenses, planning now can provide you 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 you meet certain financial requirements.

PROBLEM

Currently the cost of these policies range up to almost $6,000 per year. The premium paid will be determined by the level of benefits that you choose. You may be able to deduct all or a part of the premiums that you pay for yourself, your spouse or a dependent based upon the covered individuals age. The deduction for 2003 ranges from a low of $250 per year for an individual under 40 years of age to a maximum of $3,130 for an individual older then 71 years of age. This deduction is currently added to your other medical expenses and is then further limited to the amount that exceeds 7.5 % of your adjusted gross income. Therefore, the total expenditure for LTCI premiums faces two limitations before any possible tax savings is realized.

RECOMMENDATION

Our 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.

UNIFORMITY OF PENSION PLAN RULES

BACKGROUND

Certain pension legislation, in actual practice appears to be discriminatory and not consistently applied to pension plan participants, owners and stockholders. In an attempt to eliminate discriminatory practices to fund retirement plans, Congress passed certain legislation, which continues to result in discrepancies and inconsistencies.

PROBLEM

As in many areas of tax legislation, the effort to correct existing legislation in a piece meal approach results in confusing rules that are not easily understood by the average taxpayer. Another result is rules that are inconsistent and viewed as discriminatory. For example, an active owner of a business may be required to take a minimum distribution from a retirement plan at a certain age while an active employee of the same age is not required to take a minimum distribution.

RECOMMENDATION

Recent pension legislation has taken steps in the right direction encouraging savings for retirement and increasing allowable amounts to be contributed to pension plans on a tax deductible basis. In addition, while a method has been established to be used uniformly in pension distributions we believe that the pension area should be re-examined with the view of creating rules that result in uniformity and consistency.