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TAX POLICY COMMITTEE

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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 The AMT was originally enacted in 1969 to address the concerns that persons with substantial economic income were paying minimal Federal income taxes due to the clever use of "tax sheltered"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 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.

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.

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 could be lost because of the provisions of the AMT. In 2005, it is projected that 65% of married couples with an AGI between $75,000 and $100,000 and two or more children will be affected by the AMT. This is up from one percent in 2003. By 2010, it is projected that the AMT will affect over 32 million taxpayers. The majority of these people will have incomes under $100,000 and more then 36% of taxpayers with incomes between $50,000 and $75,000 will be affected.

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.

The AMT is too complex and imposes a large compliance burden. Taxpayer Advocate Nina Olson, in her December 2003 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.

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

BACKGROUND

In 1981, tax legislation established a means for taxpayers to fund retirement accounts for themselves with tax-deductible contributions. Thus 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.

RECOMMENDATION

The original intent when IRA's were established was to provide an 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 recommended 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.

IRA CONTRIBUTION DISALLOWANCE

BACKGROUND

An individual who is an active participant in a qualified pension or profit sharing plan cannot make tax-deductible contributions to an IRA account unless the taxpayer's adjusted gross income falls within the specific dollar limits.

PROBLEM

There are individuals who, through previous employment, made contributions to a retirement plan. Now, years after they have left that employment they are still "in a retirement plan" because of contractual obligations whereby contributions are made to a retirement plan from royalties earned.

RECOMMENDATION

Providing that the current place of employment does not offer a retirement plan, we recommend that the limitations on IRA contributions due to exceeding MAGI be eliminated.

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, is an anomaly under the tax law depending on where the taxpayer happens 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 Circuit Courts. The Tax Court has ruled that the recovery is fully taxable and the attorney fees are a deduction below the line.

Circuit Courts in the Second, Third, Fourth, Seventh, Ninth, Tenth and Federal Circuit Court of Appeals have sided with the IRS. Courts in the Second, Fifth, Sixth and Eleventh Circuits have sided with the taxpayer. There has been a split amongst the Judges of the Second Circuit of Appeals depending on residence (Vermont v. New York) of the taxpayer. The United States Supreme Court in April 2004 agreed, after years of refusal, to hear appeals of two cases, one from the Sixth Circuit and one from the Ninth Circuit. Though the cases will be heard this November, we urge Congress to continue to consider this issue.

RECOMMENDATION:

NcCPAp recommends that a taxpayer 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, 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 began for a single taxpayer at $41,000 and was completely phased out when AGI reached $51,000. For a joint filer, the phase out started at $83,000 and the credit was 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 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 2004 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.