

AMERICAN INSTITUTE OF CPAs

**Compendium of Tax Legislative Proposals**

**Simplification and Technical Proposals**

**Approved by the  
Tax Executive Committee**

**October 2021**

**AICPA Compendium of Tax Legislative Proposals**  
**Simplification and Technical Proposals**  
**2021**

## **FOREWORD**

The American Institute of CPAs (AICPA) actively pursues and publishes positions on several legislative proposals. These positions address legislative proposals as well as statutory provisions we have identified as needing modification. These legislative proposals correct technical problems in the Internal Revenue Code (IRC or “Code”) or simplify existing provisions. These proposals generally promote simplicity and fairness and are generally noncontroversial.

This Compendium includes items focused on improving tax administration, making the tax code fairer, and effectively promoting important policy objectives. It is not a comprehensive list of all provisions that Congress should add back or remove from the reformed Code. We intend to continue our efforts in this area and make further recommendations in the future.

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# **General**

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Proposal: Standardize definitions to avoid multiple meanings for the same term

Present Law

There are several terms used throughout the Internal Revenue Code<sup>1</sup> that are defined in multiple ways. For example, the term “small business” is defined using varying parameters that are not consistently used. Some of these provisions, such as section 195, do not use the term “small business,” although the rule includes a preferential treatment to help “small businesses.” The chart below illustrates some of these definitional variations.

<b>Classification/ Provision</b>	<b>Start-up Costs</b>	<b>Current Year Asset Acquisitions</b>	<b>Total Assets</b>	<b>Gross Receipts</b>	<b>Number of Shareholders or Employees</b>	<b>Capital</b>
§1202 gain exclusion for qualified small business stock			Total assets of \$50 million or less			
§1244 ordinary treatment for loss on small business stock						\$1 million or less
§41 research tax credit use against payroll tax				Generally gross receipts under \$5 million and no gross receipts in any tax year preceding the prior 5-year period		

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<sup>1</sup> All references herein to “section” or “§” are to the IRC of 1986, as amended, or the Treasury Regulations promulgated thereunder.

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§45R health insurance credit for small employers					25 or fewer full-time equivalent employees (wage threshold also specified)	
§263A small retailer exception				\$10 million or less		
§448 small business exception				\$25 million or less		
§179 expensing		Less than \$2.5 million of eligible assets				
§195 start-up expenditures increase	Start-up expenditures under \$55,000					
S corporation provisions					100 or fewer shareholders	

Another term with multiple definitions is “modified adjusted gross income.” A few examples of differing definitions for this term are listed below. Note that some of these provisions, such as sections 36B, 1411 and 5000A, were all enacted by the same legislation (Affordable Care Act). Also, some of the provisions, such as section 135 and 530, involve education provisions.

- Section 135, Income from United States savings bonds used to pay higher education tuition and fees – adjusted gross income determined without regard to sections 135, 137, 199, 221, 222, 911, 931 and 933; and after application of sections 86, 469 and 219.
- Section 530 Coverdell education savings accounts - adjusted gross income increased by any amount excluded from gross income under sections 911, 931 or 933. This definition is also used for section 24, Child tax credit.
- Section 36B Refundable credit for coverage under a qualified health plan - “adjusted gross income increased by any amount excluded from gross income under section 911, any amount of interest received or accrued by the taxpayer during the taxable year which is exempt from tax, and an amount equal to the portion of the taxpayer's social security benefits (as defined in section 86(d)) which is not included in gross income under section 86 for the taxable year.”

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- Section 1411 Imposition of tax - adjusted gross income “increased by the excess of the amount excluded from gross income under section 911(a)(1), over the amount of any deductions (taken into account in computing adjusted gross income) or exclusions disallowed under section 911(d)(6) with respect to the amounts described in paragraph (1).”
- Section 5000A Requirement to maintain minimum essential coverage - adjusted gross income increased by any amount excluded from gross income under section 911 and any tax-exempt interest income.

The term “net investment income” has multiple definitions. For example, the definition at section 1411 Imposition of tax, is quite broad including rents and passive activity income, which are not included in the definition of the term used at section 163(d) for the investment interest expense limitation.

**Description of Proposal**

The uniformity of the definition of common terms is necessary. If there is a reason for different definitions, then changing the terminology is essential. For example, if there is a reason to have varying definitions of modified adjusted gross income, using different terms or addressing the adjustment in a different manner is necessary.

**Analysis**

Multiple definitions for the same term add complexity to the tax law. This complexity can increase the chance of errors in compliance and planning. Also, transparency is harmed because taxpayers cannot easily understand how a rule may or may not apply to them.

**Conclusion/Recommendation**

Find existing terms in the Code that have multiple definitions. If there is no reason for different definitions, standardize the definition. Consider if transitional relief is needed along with the change. If there is a reason justifying the different definitions, change the name of one of the terms to avoid confusion. In crafting legislation, consider use of existing terms rather than creating new definitions.

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# **Employee Benefits**

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Proposal: Consolidate and simplify the multiple types of tax-favored retirement plans and the rules governing them and provide transition rules as needed

**Present Law**

The IRC provides for more than a dozen tax-favored employer-sponsored retirement planning vehicles, each subject to different rules pertaining to plan documents, eligibility, contribution limits, tax treatment of contributions and distributions, the availability of loans, portability, nondiscrimination, reporting and disclosure. The following plans are currently representative of the variety that are sponsored by an employer: simplified employee pension (SEP), salary reduction SEP, savings incentive match plan for employees of small employers (SIMPLE), SIMPLE-401(k), profit sharing, money purchase pension, 401(k), 403(b), 457, target benefit, defined benefit, cash balance and the defined benefit / 401(k) combination created in the Pension Protection Act of 2006 (Pub. L. 109-280). Although some consolidation of the rules governing these options were introduced in recent years, further simplification of the confusing array of retirement savings options should take place.

**Description of Proposal**

Possible measures for simplifying the number and complexity of the various types of retirement plan vehicles include the following:

1. Create a uniform employee contributory deferral type plan. Currently there are four employee contributory deferral type plans: 401(k), 457, 403(b), and SIMPLE plans. Having four variations of the same plan type causes confusion for many plan participants and employers.
2. Provide an exception from the top-heavy vesting and minimum contribution requirements of section 416 for certain defined contribution plans. Retirement plans which provide for employee deferrals only and plans which provide for employee deferrals and matching contributions should not be subject to the strict minimum contribution requirements as other top-heavy plans. These financially burdensome and overly complicated requirements cause many small employers to be unable to offer or be forced to terminate 401(k) plans for their employees. Although many small businesses want to offer their employees a retirement plan, they cannot afford to make the required contributions to each employees' account. Furthermore, the vesting requirements are unnecessary as employees are now protected under other provisions.
3. Create a uniform rule regarding the determination of basis in distributions. Depending on the plan type, there are currently different methodologies to determine basis in a distribution. For example, in a Roth individual retirement account (IRA) basis is considered returned first, while in a traditional IRA or Roth 401(k) basis is distributed proportionately with each distribution.

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4. Create a uniform rule of attribution. Currently, the rules of attribution are governed by various Code sections with subtle differences. The attribution rules are used for different purposes under the Code:
  - a.) Section 267(c) referenced and modified in determining a disqualified person under prohibited transaction rules.
  - b.) Section 318 for determination of highly compensated and key employee status.
  - c.) Section 1563 and Treas. Reg. § 1.414(c)-4 for determining the controlled group and affiliated service group rules of section 414.
5. If the top-heavy rules are not eliminated, create a uniform definition for terms to define owners. Currently, there are different definitions for the terms “highly compensated employee” and “key employee.” A defining factor of a “highly compensated employee” is a 5% owner which is further defined as an individual with a direct or indirect ownership interest of more than 5%. The ownership rules governing a “key employee” consider the 5% ownership rule but also consider persons owning 1% with compensation of \$150,000 or more annually.
6. Provide an exemption from the required minimum distribution (RMD) rules for plan participants with less than \$100,000 in a single retirement account to which the RMD rules apply. Plan participants must begin taking distributions from certain retirement accounts by April 1 of the year following the year they turn age 72 (if the plan participant turns 72 after January 1, 2021 or they are subject to penalties. However, there are no minimum distribution rules governing the timing of distributions related to a Roth IRA. In the case of qualified plans, a less than 5% owner who continues employment may defer taking distributions until his or her subsequent separation from service. Additionally, in the case of a traditional IRA, the participant is entitled to consolidate multiple accounts, subsequently taking a required minimum distribution from a single IRA; however, in a qualified plan the required minimum distribution is taken from each plan individually and consolidation is not permitted.
7. Create uniform rules for early withdrawal penalties. There are currently different rules governing penalties depending on whether the account is an IRA or a qualified plan. An example of this complexity is a distribution for higher education expenses; for an IRA, the distribution avoids the 10% excise tax, except if the distribution is from a qualified plan, it is subject to the excise tax. The same is true for qualified first-time homebuyer distributions and medical insurance premiums.

Analysis

Taxpayers appreciate the opportunity to fund retirement plan accounts and save current tax dollars, the benefits of which are used as a main source of income for many individuals during their retirement years. Employer-sponsored qualified retirement plans are important vehicles with which employers can assist their employees to achieve their retirement goals as taxpayers can

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contribute a larger amount of money to employer sponsored plans than to IRAs or Roth IRAs. While it is not mandatory for employers to offer retirement benefits to their employees, there are incentives such as tax deductions, which are available to employers who contribute to qualified retirement plans on behalf of their employees.

When small businesses grow and explore options for establishing a retirement plan, they encounter numerous alternatives subject to various rules, which can become overwhelming. We think there are too many options available for consideration before a business can decide which plan is appropriate. Some plans are only available to employers with a certain number of employees, whereas other plans require mandatory contributions or create significant administrative burdens. Such administrative burdens include annual return filings, discrimination testing, and an extensive list of notice requirements with associated penalties for failures and delays in distributing such notices to employees.

To determine which plan is right for their business, owners must consider their cash flow, projected profitability, anticipated growth of the work force, and expectations by their employees and co-owners. The choices are overwhelming, and many plans are too complex or expensive for small business owners.

Additionally, the myriad of rules surrounding these plans and the tax treatment of their benefits creates confusion among plan participants. This confusion adds to the factors that keep many plan participants from enrolling in their employer's plan and saving for retirement. With differing contribution limits and tax treatment of distributions, participants become overwhelmed. With our nation's mobile workforce, it is not uncommon for an employee to participate in multiple retirement plans during their working career, and even have multiple concurrent balances. Should these employees happen to work for differing types of employers (e.g., private-sector, not-for-profit and government entity), they are exposed to very different rules governing their benefits. By simplifying the number of available retirement plan options as well as the rules surrounding those options, the decrease in level of confusion to employers will lead to increased levels of plan participation leading to healthier employee retirement savings.

In addition, Federal tax laws and regulations governing retirement plans are overly complex compounding the difficulty for employers who wish to offer retirement plan options to their employees. In order to increase the incentive to employers to set up and maintain retirement plans for their employees, it is imperative that the laws and rules governing retirement plan offerings are as simple and straightforward as possible.

One of the reasons the rules are complex is related to flexibility in employer plan design. There are different sets of rules regulating eligibility, contribution limits, tax treatment of contributions and withdrawals, availability of loans and portability of the numerous plan types. Another reason is to ensure that retirement benefits are available to all employees and not just highly compensated employees.

While retirement plan complexity has long been a topic of discussion, not nearly enough has been done to address the issue.

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**Conclusion/Recommendation**

Consolidate and simplify the multiple types of tax-favored retirement plans and the rules governing them and provide transition rules as needed.

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Proposal: Provide a technical correction to extend minimum funding of retirement plans under Section 201 of the SECURE Act to the later of 8 ½ months or the adoption of the plan

**Present Law**

Section 201 of the SECURE Act amended section 401(b) to allow employers to adopt a stock bonus, pension, profit-sharing, or annuity plan through the filing due date of the sponsoring employer's tax return. Plans that are subject to the minimum funding requirements (ex. defined benefit, money purchase) must be funded by 8½ months of the close of the sponsor's tax year which is generally September 15<sup>th</sup> for calendar year filers.

**Description of Proposal**

Provide a technical correction to extend minimum funding of retirement plans under this provision to the later of 8 ½ months or the adoption of the plan.

**Analysis**

Funding for retirement plans subject to the minimum funding requirements must take place by 8 ½ months of the close of the plan sponsor's tax year, which is generally September 15<sup>th</sup> for calendar year plans. However, employers can create a retirement plan as late as October 15<sup>th</sup> for the prior year. In this situation, the employer will be in non-compliance of the funding requirements which will trigger a 10% excise tax. A technical correction extending minimum funding to the latter of 8½ months or the adoption of the plan would address this issue.

**Conclusion/Recommendation**

Provide a technical correction to extend minimum funding of retirement plans under Section 201 of the SECURE Act to the latter of 8 ½ months or the adoption of the plan.

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Proposal: Eliminate the need to pay an excise tax on a prohibited transaction if the tax is less than \$100

**Present Law**

Section 4975 imposes a 15% tax on a prohibited transaction. The tax is based on the amount involved in the transaction. This tax is paid by filing Form 5330, *Return of Excise Taxes Related to Employee Benefit Plans*, due 7 months after the end of the year.

**Description of the Proposal**

Eliminate the section 4975 excise tax to if the amount of the tax is less than \$100.

**Analysis**

Many taxpayers have very small amounts involved in a prohibited transaction, sometimes resulting in taxes of very minor amounts. For example, assume that an employer inadvertently delayed the deposit of employee salary reduction amounts into a section 401(k) plan for 7 days and that the resulting excise tax was \$5.25.

This small tax liability necessitates the filing of a Form 5330, the cost of which for preparation by a tax preparer and processing by the Internal Revenue Service (IRS or “Service” are in excess of the tax paid. Because this tax is levied on a transaction, annual filing is not required. Thus, it would be most cost efficient to eliminate the need for filing Form 5330 to pay minor amounts of the section 4975(a) excise tax.

These statutory provisions do not seem to provide any opportunity for waiver of the tax administratively.

**Conclusion/Recommendation**

Eliminate the need to pay an excise tax on a prohibited transaction if the tax is less than \$100.

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# **Individual Income Tax**

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Proposal: Harmonize and simplify education-related tax provisions

Present Law

The IRC includes several education incentives that are divided into two general categories:

1. Those incentives that are intended to help taxpayers meet current higher education expenses; and
2. Those incentives that encourage taxpayers to save for future higher education expenses.

The first category includes provisions that are divided into three main subcategories: (1) exclusions from taxable income such as scholarships (section 117), employer-provided education assistance (section 127) and working fringe benefit (section 132); (2) deductions including the student loan interest deduction (section 221) and the tuition and fees deduction (section 222); and (3) credits including the American Opportunity Tax Credit and Lifetime Learning Credit (section 25A). In addition, an exception to the penalty for early distributions from retirement plans (section 72(t)) is allowed for higher education expenses of the taxpayer, spouse or descendants.

The second category, intended to fund future education, includes educational savings bonds (section 135), qualified tuition programs (section 529), and Coverdell Education Savings Accounts (section 530).

Description of Proposal

The AICPA recommends simplification and harmonization of tax benefits for higher education.<sup>2</sup> Specifically, we recommend the following changes for the existing education provisions that provide a benefit to higher education tuition and related expenses:

1. Replace tax incentives (*i.e.*, American Opportunity Tax Credit (formerly Hope Credit), and Lifetime Learning Credit) intended to help taxpayers meet current higher education expenses with one new or revised credit. Combining features of these incentives into one credit would simplify the tax benefits and remove duplicative provisions relating to higher education expenses.
  - a) Apply the credit on a “per student” rather than a “per taxpayer” basis, offering a potentially larger tax benefit per family.
  - b) Make the credit available for any six years of post-secondary education, including graduate-level and professional degree courses. A credit for four years (that includes graduate-level and professional degree programs) is beneficial to many taxpayers, but we suggest increasing the limit to six years.<sup>3</sup>

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<sup>2</sup> The AICPA testimony, “[Senate Finance Committee hearing on Education Tax Incentives and Tax Reform](#),” July 25, 2012.

<sup>3</sup> U.S. Department of Education, National Center for Education Statistics. (May 2021). [Undergraduate Retention and Graduation Rates](#). “That is, by 2019, some 63 percent of students had completed a bachelor’s degree at the same

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- c) Make the credit available only to students meeting the definition of “student” under section 25A(b)(3).
  - d) The tax return reporting requirement should continue including the social security number (SSN) or other taxpayer identification numbers (TIN) of the student associated with the expenses claimed with respect to the credit taken for the tax year. Accordingly, allow tracking of amounts claimed over time by the student’s identification number. These changes may result in improved compliance and enforcement.
  - e) The credit should be 100% refundable and phased-out for high-income taxpayers if Congress deems a phase-out necessary. Make the phase-out limitations consistent with any other education-related incentive.
  - f) Allow a parent to claim the credit on their return as long as the child is a qualifying dependent of the parent.
2. Repeal the student loan interest deduction (section 221) and the tuition and fees deduction (section 222) to relieve taxpayer confusion by reducing the number of provisions. The purpose of this recommendation is to simplify the Code without discussion of the total amount of education incentives for taxpayers.
  3. Repeal educational savings bonds (section 135) and merge Coverdell Education Savings Accounts (section 530) into qualified tuition programs (section 529) by allowing the transfer of savings from Coverdell accounts into section 529 accounts. Further harmonization of education benefits will result with the reduction and combination of these savings tools. Provisions should also allow owners of existing section 135 savings bonds to roll their accounts into a new combined section 529/530 savings plan. These provisions will help taxpayers to properly transition into the merge of the education savings accounts.
  4. Create a uniform definition of “qualified higher education expenses” (QHEE) for all education-related tax provisions. Specifically, QHEE should include tuition, books, fees, supplies and equipment.
  5. If it is determined that phase-outs are necessary, all education-related tax provisions should have the same adjusted gross income (AGI) limitations. By substituting one credit for the several benefits that exist today, the concern for excessively high marginal rates resulting from coordinating phase-out provisions is alleviated. In addition, addressing any remaining concerns is achieved by widening the phase-out range, which would still permit coordination that could simplify matters for taxpayers and improve their understanding of eligibility.

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institution where they started in 2013. The 6-year graduation rate was 62 percent at public institutions, 68 percent at private nonprofit institutions, and 26 percent at private for-profit institutions.”

## **Analysis**

For many taxpayers, analysis and application of the education tax incentives are too cumbersome compared with the benefits received. The GAO analyzed 2009 data for tax returns with information on education expenses and found that about 14% of filers (1.5 million of nearly 11 million eligible taxpayers) failed to claim a credit or deduction for which they were eligible. On average, these filers lost a tax benefit of \$466 (GAO 12560 Report to the Senate Finance Committee). Further, according to GAO research, although the number of taxpayers using the educational tax credits is growing quickly, the complexity of the tax provisions prevents hundreds of thousands of taxpayers from claiming tax benefits to which they are entitled or which are most advantageous to them. Finally, there is evidence that the structure of the provisions prevents low-income taxpayers from getting the tax benefit that Congress envisioned.

Another study performed by the GAO reported<sup>4</sup> that although the economic downturn of previous years may have reduced income available for education savings, “even among those families who considered saving for education a priority, fewer than 1 in 10 had a 529 plan (or “Coverdell”).” Therefore, merging the section 530 Coverdell accounts into the section 529 plan is an effective way to promote wider use of the tax benefit and an efficient method to simplify the education benefits available to taxpayers.

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

For example, eligibility for one of the two education credits depends on numerous factors, including the academic year in which the child is in school, the timing of tuition payments, the nature and timing of other eligible expenditures, and the AGI level of the parents (or possibly the student). Further, in a given year, a parent can have eligibility for different credits for different children, while in subsequent years, credits are available for one child but not another. Both types of credits are dependent on the income levels of the parents or the child attempting to claim them. Further complicating the statutory scheme, the Code precludes use of the Lifetime or American Opportunity Tax Credit if the child also receives tax benefits from education savings accounts. Although the child can elect out of such benefits, this decision also entails additional analysis. Qualifying expenditures used for the credits cannot also be used for the section 72(t) penalty relief.

An additional complicating factor is the phase-out of eligibility based on various AGI levels in six of the nine provisions. This complication requires taxpayers to make numerous calculations to determine eligibility for the various incentives. Since satisfaction of the many individual tests for each benefit is necessary, taxpayers may inadvertently lose the benefits of a particular incentive

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<sup>4</sup> The GAO Report to the Chairman, Committee on Finance, U.S. Senate on “[Higher Education: A Small Percentage of Families Save in 529 Plans](#).”

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because they either do not understand the provision or because they pay tuition or other qualifying expenses during the wrong tax year.

In addition to the complexity described above, there is evidence that erroneous application of education credits contributes to the “Tax Gap.” According to a report issued by the Treasury Inspector General for Tax Administration (TIGTA) in 2015, it appears that education credits of approximately \$5.6 billion (\$2.5 billion in refundable credits and \$3.1 billion in nonrefundable credits) were erroneously allowed.<sup>5</sup> Over 20% of benefits were issued when no Form 1098-T was received by the IRS for an ineligible student or institution.<sup>6</sup>

In terms of tax policy, the numerous tax incentives to assist with college expenses are not the only way the federal government provides assistance to college students and their families. Through the Department of Education, the federal government assists low-income individuals through various scholarship and grant programs. We encourage Congress to consider all of these programs together to determine if the desired goals are being met in an effective and efficient manner. Also, give consideration as to where and how the best assistance is provided through the tax law (such as incentives to save for future college expenses) versus grant and scholarship programs while the student is in college (where assistance is needed at the start of the school year rather than when the tax return is filed). Give consideration to identifying the targeted income group to whom the federal government would provide financial assistance for higher education expenses. When assessing whether this goal is met, aid distributed through scholarships, grants or tax provisions needs consideration. Although the low- to middle-income families are the desired beneficiaries of most education tax provisions, they are also the ones with lower marginal tax rates, which cause them to ultimately benefit the least from the provisions. For example, families with lower tax liability may not receive the benefits of the nonrefundable portion of tax credits and to the extent that any proposed tax deductions are itemized deductions, lower income taxpayers are less likely to receive the benefits because they frequently do not itemize. Finally, a determination is necessary as to which levels of education should yield a tax benefit to taxpayers. All of the education provisions generally cover post-secondary education only. However, the Coverdell Education Savings Account (section 530) also covers elementary and secondary education.

#### Conclusion/Recommendation

Simplification of education-related tax provisions as suggested above allows taxpayers to better understand the rules and can comply with them in a cost-efficient manner. Such simplification would also improve the transparency and visibility of such tax provisions and allow the monitoring of compliance with the provisions. Simplification of the education-related tax provisions would increase the benefits going to the targeted taxpayers, lower the cost of administering the tax system, and reduce the “Tax Gap.”

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<sup>5</sup> Treasury Inspector General for Tax Administration Report 2015-13, Billions of Dollars in Education Credits Continue to Be Claimed for Ineligible Institutions and Students, dated March 27, 2015.

<sup>6</sup> *Id.*

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<b>Education Incentives – Exclusions and Deductions</b>				
<b>Code §</b>	<b>Provision</b>	<b>Summary</b>	<b>Qualified Education Expenses Definition</b>	<b>AGI Phase-Out</b>
<b>Exclusions</b>				
117	Exclusion for scholarships	Excludes scholarships from income to the extent it covers qualified education expenses for degree-seeking undergraduate students	Tuition, books, supplies, and equipment; but not room and board	None
127	Exclusion for employer-provided education	The employee excludes from income up to \$5,250 of employer-provided qualified education expenses under educational assistance program	Tuition and fees for undergraduate and graduate courses; books, supplies, and equipment; but not room and board; not necessarily for work-related courses	None
<b>Deductions</b>				
Reg. 1.1625	Expenses for education	The education must not prepare student for a new job or meet the minimum requirements for a job. Thus, undergraduate education does not qualify. Continuing education courses of a CPA or other licensed professional are examples of qualifying education.	Tuition, fees, materials and possibly some travel and transportation expenses.  Self-employed individuals may deduction on Schedule C if related to the business.	None
221	Student loan interest deduction	For AGI deduction of up to \$2,500 for interest paid on qualifying student loan	Tuition, fees, books, supplies, equipment, room and board, transportation, other necessary expenses	S: \$70,000 - \$85,000 MAGI MFJ: \$140,000 - \$170,000 MAGI MFS: No deduction

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<b>Code §</b>	<b>Provision</b>	<b>Summary</b>	<b>Qualified Education Expenses Definition</b>	<b>AGI Phase-Out</b>
222	The Taxpayer Certainty and Disaster Tax Relief Act of 2020 repealed the tuition and fees deduction for tax years beginning after 2020.)	Income limitations for the lifetime learning credit will be increased to help filers transition to the lifetime learning credit		

<b>Code §</b>	<b>Provision</b>	<b>Summary</b>	<b>Qualified Education Expenses Definition</b>	<b>AGI Phase-Out</b>
25A	American Opportunity Tax Credit	<p>Credit of up to \$2,500 per student: 100% of first \$2,000; 25% of next \$2,000</p> <p>Enrollment of at least halftime is necessary</p> <p>40% of modified credit is refundable (but not for child subject to section 1(g) (Kiddie Tax))</p> <p>If parent pays the expenses, must have authority to claim exemption for the student on tax return</p> <p>No felony drug conviction</p> <p>Regulations explain who gets credit in special circumstances</p>	<p>Tuition, fees, and course materials including books, during first four years of post-secondary education; but not room and board</p> <p>Courses must have association with degree program or recognized education credential</p> <p>Athletic fees, insurance, activity fees are not eligible unless required as a condition of enrollment and paid directly to the institution</p>	<p>S: \$80,000 - \$90,000</p> <p>MFJ: \$160,000 - \$180,000</p> <p>MFS: No credit</p>

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25A	Lifetime Learning Credit	Credit of up to \$2,000 per return: 20% on up to \$10,000  A non-refundable elective credit  If parent pays the expenses, must have authority to claim exemption for the student on tax return  Regulations explain who gets credit in special circumstances	Tuition and fees including for graduate courses/continuing education; but not room and board  Available for all postsecondary education—not necessarily associated with a degree	S: \$59,000 - \$69,000  MFJ: \$118,000 - \$138,000  MFS: No credit
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**Education Incentives – Penalty Relief**

Code §	Provision	Summary	Qualified Education Expenses Definition	AGI Phase-Out
72(t)(2)(E); 72(t)(7)	Distributions from Individual Retirement Plans for Higher Education Expenses	Distributions for higher education of taxpayer, spouse, or descendent are excluded from penalty when expenses paid in same tax year	Tuition, fees, books, supplies, equipment, room and board	None

**Education Incentives – Planning for College**

Code §	Provision	Summary	Qualified Education Expenses Definition	AGI Phase-Out
135	Educational Savings Bonds	Allows for partial or total exclusion of interest income on redemption of qualified U.S. savings bonds used for qualifying purposes	Tuition and fees but not for courses involving sports, games, or hobbies that are not part of degree or certificate granting program; not room and board	S: \$82,350 - \$97,350 MFJ: \$123,550 - \$153,550 MFS: No exclusion

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529	Qualified Tuition Plans	<p>For College Savings Plan, account owner contributes cash to a plan account for a beneficiary and the contribution is invested according to the terms of the plan</p> <p>For Prepaid Tuition Plan, account owner contributes cash to a plan account and the contribution purchases tuition credits or credit hours based on then-current tuition rates</p> <p>Contributions qualify for the annual gift tax exclusion</p> <p>Earnings are not taxed and can withdrawal funds tax-free if used for qualifying purposes</p>	<p>Tuition and fees, books, computers, technology and other expenses for vocational schools, 2-year and 4-year colleges, qualified apprenticeship programs as well as graduate and professional education; room and board if the beneficiary attends school at least half-time; expenses of special needs beneficiary necessary for his/her enrollment at eligible educational institutions</p> <p>Up to \$10,000 per year for private school elementary education</p> <p>\$10,000 per beneficiary and sibling for student loan forgiveness</p>	None
530	Coverdell Education Savings Account	<p>Non-deductible contribution of up to \$2,000 per year for a beneficiary under age 18. Except for special needs beneficiaries, contributions must end at age 18 and must withdraw assets by age 30</p> <p>Distributions non-taxable to extent funds used for QHEE or qualified elementary and secondary education expenses</p>	<p>Tuition, books, fees, supplies, equipment, tutoring, computer equipment and software, uniforms for both higher education and elementary and secondary education at public, private, and religious schools; room and board for student enrolled at least half-time</p>	<p>S: \$95,000 and \$110,000  MFJ: \$190,000 and \$220,000  MFS: \$95,000 and \$110,000</p>

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Proposal: Harmonize standard mileage rates for business, medical, armed forces moving expense, and charitable contribution purposes

**Present Law**

An optional standard mileage allowance, generally determined annually, is used to calculate the deductible costs of operating an automobile for business, medical, and moving, and charitable deduction purposes.

For 2021 these rates are:<sup>7</sup>

- \$.56 per mile driven for business use, down 1.5 cents from the rate for 2020,
- \$.16 per mile driven for medical, or moving purposes for qualified active-duty members of the Armed Forces, down 1 cent from the rate for 2020, and
- \$.14 per mile driven in service of charitable organizations, the rate is set by statute and remains unchanged from 2020.

When necessary, the IRS has the authority to adjust the business, medical, and moving rates (as it did in mid-year 2011 to reflect the extraordinary rise in gasoline prices). In contrast, the standard mileage rate for charitable contribution deduction purposes is statutorily set at \$0.14 a mile.<sup>8</sup> Prior to 1984, the IRS had the authority to set this rate as well.

Several time Congress has attempted to change the way the standard mileage deduction is calculated for charitable purposes.

Specifically:

- In 110<sup>th</sup> Congress:
  - a. Legislation (H.R. 6854 and S. 3246) was introduced in the 110<sup>th</sup> Congress to allow the IRS to once again set the charitable contribution deduction mileage rate and standardize it at the same amount as that allowed for medical and moving expenses.
  - b. Separate legislation (S. 3429) also was introduced to set the charitable deduction mileage rate at 70% of the business mileage rate.
- In the 113<sup>th</sup> Congress:
  - a. H.R. 1212 was introduced to set the charitable contribution mileage deduction rate at the same amount as that allowed for business expenses.

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<sup>7</sup> IR-2020-279, December 22, 2020.

<sup>8</sup> Section 170(i).

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**Description of Proposal**

Statutorily require the IRS to set and regularly adjust two mileage rates: one for business expenses and another for non-business purposes (*i.e.*, charitable, medical, and moving expenses). The IRS should set the non-business rate at a percentage of the business rate, rounded to the nearest half cent. These rates could be annually and possibly semi-annually adjusted in certain circumstances based on the change in the business standard mileage rate. Using the business rate in effect commencing for the next calendar year at the time of enactment as the starting point is recommended.

Modify section 170(i) to state that a standard mileage rate, as established and regularly adjusted by the IRS, is allowed for charitable contribution usages. Removal of the current language regarding \$0.14 per mile is recommended.

**Analysis**

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

**Conclusion/Recommendation**

Congress should allow the IRS once again to set the charitable contribution deduction mileage rate, standardized to the same amount as that allowed for other non-business purposes (medical and moving expenses). Setting this single rate at a percentage of the business mileage allowance is advised. Adjustment of all mileage allowance rates on an annual basis, possibly with a mid-year adjustment, is needed.

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Proposal: Standardize the medical lodging deduction limitation with the allowable business per diem rates

**Present Law**

Under section 213(d)(2), the amounts paid for certain lodging away from home that is treated as medical care is not indexed for inflation and does not differentiate among high and low-cost lodging localities. A taxpayer is limited to a deduction of \$50 per night for lodging if he/she is traveling alone even though few lodging or hotel establishments across the country are available at this rate per night. Additionally, since the rate is \$50 per person, the amount rises to \$100 per night if the taxpayer travels with a companion. Even with a companion rate, this \$100 remains less than the expected cost for medical patients to find reasonable and conveniently located lodging near an urban medical facility.

**Description of Proposal**

Remove the strikethrough language from section 213(d)(2) as follows:

(2) Amounts paid for certain lodging away from home treated as paid for medical care.—

Amounts paid for lodging (not lavish or extravagant under the circumstances) while away from home primarily for and essential to medical care referred to in paragraph (1)(A) shall be treated as amounts paid for medical care if—

(A) The medical care referred to in paragraph (1)(A) is provided by a physician in a licensed hospital (or in a medical care facility which is related to, or the equivalent of, a licensed hospital), and

(B) There is no significant element of personal pleasure, recreation, or vacation in the travel away from home.

~~The amount taken into account under the preceding sentence shall not exceed \$50 for each night for each individual.~~

Additionally, simplify the lodging deduction calculation by linking the allowance for medical care lodging deduction with the annually adjusted business per diem rates.<sup>9</sup> Analysis

Eliminating the \$50 limitation and allowing the use of business expense per diem lodging rates would help taxpayers secure affordable lodging near a place suited to facilitate the necessary care, treatment, and healing of the patient. Removing the sentence shown above will also promote administrative efficiency because it is arguably unlikely that travel associated with medical

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<sup>9</sup> This proposal is consistent with the AICPA's proposal to: "Standardize the allowable mileage rates for business expense, medical expense, moving expense and charitable contribution purposes." We recommend the use of business per diem rates for the medical lodging deduction limitation in order to further harmonize and synchronize the non-business rates and limitations used throughout the Code with standard business expense rates.

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treatments are often an occasion for frivolous expenditures on lodging. There is no need to repeatedly adjust deduction amounts in the future as inflation occurs and prices rise nor keep multiple sets of figures that adapt to price levels across various cities. Linking the lodging rate allowance to regularly published business per diem amounts that are generally adjusted annually is a simple approach that promotes both fairness and equity.

Additionally, we recommend keeping the language: “not lavish or extravagant” in order to protect valuable government resources. Such language discourages any possible, yet unlikely, abuse of the Code while providing taxpayers some relief from the costly expenses of medical care.

**Conclusion/Recommendation**

Congress should eliminate the \$50 limitation in section 213(d)(2), as shown above, and standardize the lodging allowance for medical care with the allowable per diem rates for business expense.

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Proposal: Allow certain attorney fees and court costs as deductions for adjusted gross income

**Present Law**

In computing AGI, individuals are allowed to treat costs related to certain types of litigation or award recoveries as deductible for AGI. Attorney fees for other types of non-business litigation, if deductible, are generally treated as expenses for the production of income under section 212 of the IRC. Before the legislation commonly known as the Tax Cuts and Jobs Act (TCJA), these expenses were treated as miscellaneous itemized deductions subject to the 2% of AGI limitation of section 67 and the overall limitation of section 68 on itemized deductions. Under TCJA, section 67 miscellaneous itemized deductions are not deductible for tax years beginning after December 31, 2017 and before January 1, 2026. In addition, miscellaneous itemized deductions are not deductible in computing AMT.<sup>10</sup> Thus, despite the fact that legal fees are incurred and gross income is derived from the litigation or action, taxpayers are not treated similarly with respect to the tax treatment of their legal fees.

Section 62(a)(20) enacted as part of the American Jobs Creation Act of 2004 (P.L. 108-357) provides that attorney fees and court costs connected with the following types of actions are deductible for AGI:

- Unlawful discrimination claim (as defined at section 62(e) which lists 18 types of “unlawful discrimination” actions, such as certain violations under the Civil Rights Act of 1991, the National Labor Relations Act, the Fair Labor Standards Act of 1938, the Family and Medical Leave Act of 1993 and several others);
- Claim of violation of subchapter III of chapter 37 of U.S. Code Title 31; and
- Claim under section 1862(b)(3)(A) of the Social Security Act.

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

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

**Description of Proposal**

Replace section 62(a)(20) and (21) with one provision to read as follows:

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

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<sup>10</sup> The AICPA supports repeal of the alternative minimum tax (AMT). AICPA Testimony, “[Hearing on Small Businesses and Tax Reform](#),” March 03, 2011; and AICPA comments, “[Tax Reform Act of 2014](#),” January 12, 2015.

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Any deduction allowable under this chapter for attorney fees and court costs paid by, or on behalf of, the taxpayer in connection with any award includible in gross income, with appropriate adjustments for amounts previously deducted. The preceding sentence shall not apply to any deduction in excess of the amount includible in the taxpayer's gross income for the taxable year on account of such award.

### Analysis

The Tax Reform Act of 1986 modified the rules on miscellaneous itemized deductions by making them deductible only to the extent they exceed 2% of the taxpayer's AGI. The primary rationale for the change was simplification. The committee report provided the following reasons for change:<sup>11</sup>

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

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

Accordingly, the committee believes that the imposition of a 1% floor on miscellaneous itemized deductions constitutes a desirable simplification of the tax law. This floor will relieve taxpayers of the burden of recordkeeping, unless they expect to incur expenditures in excess of the percentage floor. Also, the floor will relieve the IRS of the burden of auditing deductions for such expenditures when not significant in aggregate amount.

The committee also believes that the distinction under present law between employee business expenses (other than reimbursements) that are allowable above-the-line, and such expenses that are allowable only as itemized deductions, is not

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<sup>11</sup> Tax Reform Act of 1986 (P.L. 99-514; 10/22/86), House explanation.

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supportable. The reason for allowing these expenses as deductions (i.e., the fact that they may constitute costs of earning income) and the reasons for imposing a percentage floor apply equally to both types of expenses.

Despite the fact that some types of miscellaneous deductions are incurred to produce gross income, in 1986, Congress sought to limit the deductibility of many of these deductions, including non-business attorney fees associated with litigation and settlement awards. At that time, Congress treated all such attorney fees and court costs of producing non-business awards, similarly. However, in 2004, Congress started to treat one type of litigation expenses differently, and again in 2006 with one more type of litigation expense. These changes involving subsets of attorney fees, created an inequity in the tax law regarding the treatment of deductions. This inequity has been expanded by the TCJA where instead of limitations on the deduction of attorney fees creating a disparity, the non-deductibility of non-business attorney fees except in certain types of litigation creates an entirely different treatment.

Given that all attorney fees and court costs incurred to generate taxable litigation and settlement awards are costs to produce income and that there is little complexity in tracking these specific and often sizable amounts, the principles of equity and fairness warrant treating all attorney fees and court costs the same regardless of the nature of the taxable damages award. Thus, the change made to section 62(a) in 2004 and 2006 should broaden to include all attorney fees and court costs that relate to taxable awards.

#### Conclusion/Recommendation

Replace section 62(a)(20) and (21) with one provision to read as follows:

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

Any deduction allowable under this chapter for attorney fees and court costs paid by, or on behalf of, the taxpayer in connection with any award includible in gross income, with appropriate adjustments for amounts previously deducted. The preceding sentence shall not apply to any deduction in excess of the amount includible in the taxpayer's gross income for the taxable year on account of such award.

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Proposal: Equalize the tax treatment for health insurance deductions for employees and self-employed individuals

**Present Law**

The Self-Employment Contributions Act (SECA) imposes tax on the net earnings from self-employment. The tax is composed of two parts: old-age, survivors and disability insurance (OASDI) tax and hospital insurance (HI) tax. Section 162(l)(4) provides that self-employed individuals are not allowed to deduct their health insurance costs from net earnings from self-employment (within the meaning of section 1402) in determining tax under section 1401(a) and section 1401(b) for old-age, survivors and disability insurance and hospital insurance, respectively. However, pursuant to section 3121(a)(2), health insurance costs are excluded from an employee's wages in determining tax under section 3101(a) and 3101(b) for OASDI and HI taxes.

**Description of Proposal**

Equalize the tax treatment with respect to the deduction for health insurance costs in determining income subject to OASDI and HI taxes as was allowed temporarily under the Small Business Jobs Act of 2010.

**Analysis**

Deductions allowable in determining a particular tax should remain consistent among taxpayers subject to such tax. Employees subject to OASDI and HI taxes are allowed a deduction for health insurance costs in determining their net income subject to these taxes while self-employed individuals subject to these same taxes are not allowed a deduction in determining their net income subject to these taxes.

**Conclusion/Recommendation**

We recommend that deductions allowed in determining income subject to OASDI and HI taxes remain consistent amongst taxpayers regardless of whether they are employees or self-employed individuals.

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Proposal: Simplify the provisions for calculating the tax on unearned income of a child

**Present Law**

Section 1(g) of the IRC taxes a portion of the unearned income of a child at the parent's marginal tax rate (Kiddie Tax). A child is defined as any child who is (1) under the age of 18; (2) age 18 at the end of the year and who did not have earned income that was more than half of the child's support; or, (3) a full-time student under the age of 24 who did not have earned income that was more than half of the child's support. Specifically, the provision applies in cases where (1) the child's unearned income was more than \$2,200; (2) the child is required to file a tax return; (3) either parent of the child is alive at the close of the year; and (4) the child does not file a joint return for the taxable year.

The marginal tax rate of the individual with the greater taxable income is used in the case of parents filing separately. In the case of parents who are not married, the marginal tax rate of the custodial parent is used to determine the tax liability on net unearned income. Net unearned income is the amount of unearned income above \$1,100 plus the greater of \$1,100 or itemized deductions directly connected to producing unearned income (for 2020). When the provisions of section 1(g) apply to more than one child in the family, each child's share of the parental tax is apportioned ratably based on the ratio of the child's net unearned income to the total net unearned income of all children.

Section 1(g)(6) requires the parent to provide his/her taxpayer identification number to the child for inclusion on the child's tax return. Parents can elect to include their children's interest and dividend income (including capital gain distributions) on their tax return. However, the election is not available for parents of a child if such child has any earned income, unearned income of \$11,000 or more (for 2020), unearned income other than interest, dividends and capital gain distributions, withholding, or estimated tax payments.

**Description of Proposal**

We recommend the repeal of the provisions linking a child's taxable income to his/her parents' and siblings' taxable income. Investment income (other than qualified dividends and capital gains) subject to this tax should use the income tax rates for estates and trusts. Income from qualified dividends and capital gains should use the capital gains rates applicable for estates and trusts with one change; the 0% rate for capital gains should not apply to children's unearned investment income. Unearned income that is not investment income under the definition used in section 1411(c)(1)(A) should be taxed at the same tax rate as earned income of the child. Non-investment unearned income would include income such as taxable Social Security benefits, taxable scholarships, Gold Star Family DOD benefits, Alaska Permanent Fund dividends, and Native American tribal distributions.

Further, an elimination of the election to include a child's income on the parent's return should take place to facilitate the complete de-coupling of the link between the computation of the child's tax liability and the parent's tax liability.

## Analysis

The Kiddie Tax adds significant complexity to the computation of a child's tax liability. As a result of this complexity, the IRS issued Publication 929, a 29-page booklet that provides worksheets to assist the taxpayer, or return preparer, with calculating the child's taxable income and tax liability. In addition to the complex calculations, several challenges arise in complying with the rules of the statute:

- Difficulty in getting information about the applicable tax rate: Parents may either refuse to provide the tax rate or, if divorced, one parent may refuse to cooperate with the other in providing the information. Without this information, the tax preparer is forced to calculate the child's tax unfairly at the highest rate.
- Qualified dividends or capital gain distributions: The IRS requires qualified dividends and capital gain distributions to allocate between the first \$2,200 (in 2020) of unearned income and the portion of the child's unearned income in excess of \$2,200, thus making the computation burdensome.
- Interrelationship with parents'/siblings' returns: If either the parents or siblings file amended returns, the child must file an amended return. The fact that amended returns have been filed is not readily known information.
- Alternative minimum tax (AMT): The Kiddie Tax provision only considers the regular tax of section 1 and not the AMT of section 55. Therefore, the way the current rules are written, if a parent must pay AMT, the child's income is still taxed at the parent's regular marginal tax rate, while the parent is taxed at the AMT rate without taking into account the child's income or the child's regular tax liability. The result when AMT applies to the parent is the taxation of the child's income at a rate higher than the rate that applies to the parent.

Removing the linkage to parental and sibling returns would allow a child's return to stand on its own. Complications due to missing information on one return, matrimonial issues and unintended AMT problems are likely eliminated.

Updating the definition of unearned income subject to this tax would eliminate the unintended consequences of prior reform that disadvantaged Gold Star families and others. Additionally, taxing income attributable to the child such as taxable portions of Social Security, DOD benefits, scholarships, fellowship grants, and other grants at the child's tax rate creates a more equitable tax system where the income of the taxpayer is taxed at the taxpayer's tax rate except for investment income which is tied to property instead of the individual.

## Conclusion/Recommendation

The AICPA recommends the repeal of the provisions linking a child's taxable income to his/her parents' and siblings' taxable income. Investment income (other than qualified dividends and capital gains) subject to this tax should use the income tax rates for estates and trusts. Income

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from qualified dividends and capital gains should use the capital gains rates applicable for estates and trusts with one change; the 0% rate for capital gains should not apply to children's unearned investment income. Further, the election to include a child's income on the parent's return should be eliminated to facilitate the complete de-coupling of the link between the computation of the child's tax liability and the parent's tax liability.

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Proposal: Simplify the tax treatment of Roth individual retirement account contributions

**Present Law**

The term “Roth IRA” means an individual retirement plan as defined in section 7701(a)(37). This vehicle was added to the Code in 1997 to encourage taxpayers to save for their own retirement without a tax benefit. For taxable income purposes, no deduction is allowed under IRC section 219 for a contribution to a Roth IRA. Also, contributions to a Roth IRA are affected by modified adjusted gross income as computed for Roth IRA purposes and the modified adjusted gross income limitation reduces the contribution amount to zero for many taxpayers.

If taxpayers are eligible to participate in a workplace retirement account such as a 401(k) or 403(b), they are subject to limitations for deducting the IRA contributions. However, the IRS allows anyone to make an election for nondeductible contributions to a traditional IRA account if the taxpayers are subject to the workplace limitations. These nondeductible IRA contributions are tax-deferred and the contributions are treated as basis when IRA distributions are taken. Therefore, tax is only paid on the growth of the nondeductible IRA contributions. For example, for taxpayers who make a \$5,000 nondeductible IRA contribution that grows to a value of \$50,000, the withdrawal of \$1,000 may only result in a taxable amount of \$900 because 10% (\$5,000/\$50,000) is a return of the nondeductible basis.

Prior to 2010, a traditional IRA account could not be converted to a Roth IRA account if modified adjusted gross income exceeded \$100,000 or if the taxpayer’s filing status was married filing separately. These limitations were removed as part of the Tax Increase Prevention and Reconciliation Act of 2005.

**Description of Proposal**

We propose the removal of the adjusted gross income limitation for Roth contributions. By removing this limitation, all taxpayers would have the ability to make a direct contribution to a Roth IRA account.

**Analysis**

As noted above, taxpayers may convert from a traditional IRA account to a Roth IRA account without regard to their level of income. Congress took deliberate action to allow this procedure by changing the law to allow conversions without regard to income level.

Although Congress took action to allow conversions without regard to income level, Congress did not remove the income limitations with respect to contributing directly to a Roth IRA account. Thus, even though Congress has provided an opportunity through the conversion process for all taxpayers to ultimately have a Roth IRA account without regard to income level, taxpayers with income above the specified thresholds must first make a nondeductible contribution to a traditional IRA account (where no income limitations apply) and then convert it to a Roth IRA account. Our proposal would eliminate this step by allowing taxpayers to contribute directly to a Roth IRA account without regard to income level. This proposal could result in some loss of revenue to the

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Treasury, due to the fact that taxpayers who convert from a traditional IRA account to a Roth IRA account recognize income upon the conversion equal in amount to the difference between the account balance and basis in the account. Specifically, if contributions are made directly to a Roth IRA account, there is no conversion income to recognize. However, this effect is mitigated by the fact that under current law, the amount of income recognized upon the conversion is in many cases relatively low. This is the case when a taxpayer with no traditional IRA accounts other than a nondeductible traditional IRA account converts to a Roth IRA account shortly after the nondeductible traditional IRA account is established. In that case, there is little to no growth in the account between the time it is established and the time it is converted, resulting in little to no income recognized upon the conversion. The nondeductible contribution followed by a Roth conversation is called a “backdoor Roth contribution” because it allows a higher income taxpayer to make a Roth contribution.<sup>12</sup>

The nondeductible IRA contribution (or allowable Roth contribution) is currently limited to \$6,000 with an additional \$1,000 for those over 50. The amount is relatively small when compared to the desired outcome of increasing private retirement savings.

Conclusion/Recommendation

We propose eliminating the adjusted gross income limitation for Roth contributions, which would remove the need for higher income taxpayers to use a two-step process in funding these accounts.

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<sup>12</sup> The “backdoor Roth” was acknowledged as allowable in the Conference Report to the Tax Cuts and Jobs Act.

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# **Tax Administration**

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Proposal: Allow a reasonable cause exception to the section 6707A and 6662A penalties for all reportable transactions, and provide for judicial review where such relief is denied

**Present Law**

Taxpayers who fail to disclose a reportable transaction are subject to a penalty under section 6707A of the IRC. For penalties assessed after 2006, the amount of the penalty is 75% of the decrease in tax shown on the return as a result of the transaction (or the decrease that would have been the result if the transaction had been respected for federal tax purposes). If the transaction is a listed transaction (or substantially similar to a listed transaction), the maximum penalty is \$100,000 for individuals and \$200,000 for all other taxpayers. In the case of reportable transactions other than listed transactions, the maximum penalty is \$10,000 for individuals and \$50,000 for all other taxpayers. The minimum penalty is \$5,000 for individuals and \$10,000 for all other taxpayers.

The section 6707A penalty applies even if there is no tax due with respect to the reportable transaction that has not been disclosed. There is no reasonable cause exception to the penalty. The Commissioner may, however, rescind all or a portion of the penalty, but only in the case of transactions other than listed transactions, where rescinding the penalty would promote effective tax administration, and only after the taxpayer submits a lengthy and burdensome application. In the case of listed transactions, the IRS has no discretion to rescind the penalty. The statute precludes judicial review where the Commission decides not to rescind the penalty.

Under section 6662A, taxpayers who have understatements attributable to certain reportable transactions are subject to a penalty of 20% (if the transaction was disclosed) and 30% (if the transaction was not disclosed) of the amount of the understatement. A more stringent reasonable cause exception for a penalty under section 6662A is provided in section 6664, but only where the transaction is adequately disclosed, there is substantial authority for the treatment, and the taxpayer had a reasonable belief that the treatment was more likely than not the proper treatment. In the case of a listed transaction, reasonable cause is not available, similar to the penalty under section 6707A.

**Description of Proposals**

Amend section 6707A to provide that no penalty is imposed if it is shown that there was reasonable cause for the failure to disclose and that the taxpayer acted in good faith, for all types of reportable transactions. Allow judicial review if the reasonable cause exception is denied.

Amend section 6664 to provide that no penalty is imposed under section 6662A where there was reasonable cause for the understatement and the taxpayer acted in good faith, for all types of reportable transactions, irrespective of whether the transaction was adequately disclosed, and irrespective of the level of assurance of the treatment.

**Analysis**

The current structure of the penalties under sections 6707A and 6662A is not consistent with penalty policies articulated by Congress when the Code was amended in 1989 to reform the penalty

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structure. In the case of a penalty under section 6707A, no reasonable cause exception is provided, and rescission is available in very limited circumstances and only through a lengthy and burdensome application process. In the case of listed transactions, the penalty is a strict liability penalty with no review or appeal procedures. For penalties under section 6662A, the more stringent reasonable cause provisions are not consistent with the reasonable cause provisions throughout the Code, and no reasonable cause exception is available in the case of a listed transaction.

The strict liability nature of sections 6707A and 6662A and absence of judicial review of any penalty assessed under section 6707A is a violation of procedural due process and notions of fair tax administration.

As a fundamental principle, the AICPA is opposed to strict liability penalties because such penalties are unduly harsh and do not allow for abatement due to reasonable cause, such as an inadvertent act of the taxpayer or circumstances beyond the taxpayer's control. Fairness and effective tax administration require the IRS to retain discretion in assessing and abating penalties. Additionally, under the current reportable transaction penalty structure, there is no mechanism to allow taxpayers to bring themselves into compliance once they discover their error after the due date or to otherwise voluntarily come forward. Finally, we note that some taxpayers are exposed to listed transactions indirectly via investments in partnerships. Such taxpayers frequently have no control over the activities of the partnerships in which they invest. And, investing taxpayers are only informed of listed transaction exposure once a year via Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.*, reporting that is frequently very complicated.

#### Conclusion/Recommendation

We recommend amending section 6707A to allow an exception to the penalty if there was reasonable cause for the taxpayer's failure to disclose and the taxpayer acted in good faith for all types of reportable transactions, and to allow for judicial review in cases where reasonable cause was denied. Moreover, we recommend amending section 6664 to provide a general reasonable cause exception to section 6662A, irrespective of whether the transaction was adequately disclosed or the level of assurance, for all types of reportable transactions.

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Proposal: Repeal IRC section 7122(c)(1) requirement to submit a 20% partial payment with a lump-sum offer in compromise

**Present Law**

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

**Description of Proposal**

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

**Analysis**

The efficient resolution of outstanding tax liabilities is necessary for effective tax administration and reduction of the tax gap. The IRS should have the opportunity to review offers and determine whether the acceptance of an offer is in the best interest of the government. The IRS should use an OIC as a tool to collect the proper amount of tax; however, the 20% requirement imposed under the current law has discouraged taxpayers from seeking opportunities to settle tax liabilities with the government.

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

Furthermore, one of the stated objectives of an OIC is to "provide the taxpayer a fresh start toward future voluntary compliance with all filing and payment requirements."<sup>13</sup> Requiring the 20% payment for submission with an offer hinders a significant segment of the population from returning to compliance.

Although proponents of the 20% partial payment amount under section 7122(c)(1) believe the partial payment amount is effective in eliminating the submission of frivolous offers, it appears that the 20% payment requirement is actually discouraging the submission of a significant number of legitimate offers.

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<sup>13</sup> [Internal Revenue Manual, Part 5, Chapter 8, section 1, 5.8.1.1\(3\), Objectives](#), dated April 20, 2021.

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According to the Taxpayer Advocate Service’s 2018 Annual Report to Congress, one of the most serious problems facing the IRS has to do with the Collection’s OIC program. Policy changes made by the IRS to the OIC program make it more difficult for taxpayers to submit acceptable offers. Among those changes, the report mentions the additional requirements, which increasingly cause offers to be returned as “not processable” and that the IRS will keep the payments sent with the OIC for returned applications for lack of filing compliance. “By not processing these OICs *and* keeping the payments, the IRS creates major obstacle to submitting a successful OIC.”<sup>14</sup>

Before the Coronavirus pandemic started, the IRS already reflected a trend of significant annual increases in the amounts of unpaid assessments and a decrease in the percentage of offers accepted.<sup>15</sup> Due to pandemic IRS closures, the existing unopened mail backlog problem, and the shortage of personnel, the total amount of uncollected taxes will substantially increase and there will be a decrease of the percentage of accepted offers.

Conclusion/Recommendation

Repeal of section 7122(c)(1) will provide taxpayers with an effective option for addressing a federal tax liability.

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<sup>14</sup> Nina Olson, National Taxpayer Advocate, “[Annual Report to Congress 2018, Most Serious Problems, Offer In Compromise: Policy Changes Made by the IRS to the Offer in Compromise Program Make It More Difficult for Taxpayers to Submit Acceptable Offers](#),” June 2018.

<sup>15</sup> IRS, “[SOI Tax Stats – Delinquent Collections Activities – IRS Data Book, Table 25](#),” 2020.

# **Partnerships**

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Proposal: Allow the transfer of any partnership section 704(d) suspended losses to his/her spouse when spousal transfers under section 1041(a) take place

**Present Law**

Section 1366(d)(2)(B) permits an S corporation shareholder to transfer any suspended losses to his/her spouse when a section 1041(a) exchange takes place between spouses or incident to a divorce. No such transfer between spouses or former spouses is permitted for the section 704(d) suspended losses of partners in partnerships.

**Description of Proposal**

Section 704(d)(3) should include a new subparagraph, section 704(d)(3)(C). Spouses engaged together in the operation of a partnership may transfer partnership units or interests to each other under section 1041(a) while married or incident to a divorce. When such a transfer occurs, the suspended loss associated with the partnership interest should also transfer to the transferee spouse.

The AICPA recommends amending section 704(d)(3) by adding new subparagraph (C) to read as follows:

(d)(3)(C) Exception. In the case of any transfer described in section 1041(a) of an interest in a partnership, any loss or deduction described in paragraph (2) with respect to such interest shall be treated as incurred by the partnership in the succeeding taxable year with respect to the transferee.

**Analysis**

Spouses and former spouses who transfer partnership interests between themselves find that they are in the same position in which spousal shareholders of an S corporation were prior to the addition of section 1366(d)(2)(B). That is, after the transfer, they find that suspended losses of the transferor are now trapped and forever unusable. The transferee spouse (or former spouse) who actually owns the partnership interest should have access to the suspended losses, regardless of who was entitled to this loss prior to the transfer of ownership interest. This recommendation furthers the tax policy goals of simplicity and equity.

**Conclusion/Recommendation**

Amend section 704(d)(3) by adding a new subparagraph to allow the transfer of any partnership section 704(d) suspended losses to his/her spouse when spousal transfers under section 1041(a) take place.

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Proposal: Clarify that spousal partnerships that are recognized under state law are eligible to elect Qualified Joint Venture (QJV) status under section 761(f).

**Present Law**

The Small Business and Work Opportunity Tax Act of 2007, P.L. 110-28 added section 761(f) to simplify the tax reporting requirements of a spousal partnership by treating it as two sole proprietorships. The only statutory requirements are that: (1) both spouses materially participate in the business, (2) they file a joint return, (3) they are the only members of the joint venture and (4) they elect to not have partnership treatment.

On its website, the IRS has published a definition of a QJV under section 761(f), which indicates that it “includes only businesses that are owned and operated by spouses as co-owners, and not in the name of a state-law entity (including a general or limited partnership or a limited liability company) ....” and also notes that “...mere joint ownership of property that is not a trade or business does not qualify for the election.”

**Description of Proposal**

The AICPA recommends clarifying the section 761(f) spousal joint venture election to cover state law general, limited partnerships, and limited liability companies. Amending section 761(f)(2) by adding a flush sentence after subparagraph (C) that reads:

The qualified joint venture shall not be disqualified from making the election of the subsection merely because the ownership interests are held through a state law entity such as a partnership or limited liability company.

clarifies this intended simplification provided for in The Small Business and Work Opportunity Tax Act of 2007 regarding spousal partnerships.

**Analysis**

Congressional clarification of section 761(f) is needed as the IRS administrative limitation on state law entities to elect spousal partnership status under section 761(f) excludes many, if not all, spousal partnerships which were the intended beneficiaries of this potential simplification. Generally, the Revised Uniform Partnership Act, the Revised Uniform Limited Partnership Act, or the Uniform Limited Liability Company Act provide the foundation of state law rules governing partnerships and limited liability companies, as modified on a state-by-state basis. The model Acts generally define a partnership as two persons engaged in an activity for profit and treats even a general partnership as a state law entity. This general definition would bring virtually all spousal business operations under state law jurisdiction and would thus disqualify them from electing QJV status.

To properly effectuate the simplification provided for in The Small Business and Work Opportunity Tax Act of 2007, section 761(f) must specifically allow spousal partnerships

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(including the limited liability company, but minimally the general partnership) to make this election.

**Conclusion/Recommendation**

Clarify the section 761(f) spousal joint venture election to cover state law general, limited partnerships, and limited liability companies.

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# **S Corporations**

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Proposal: Allow an offset to the built-in gains (BIG) tax for charitable contribution and foreign tax credit carryforwards from a C corporation year

**Present Law**

Generally, section 1371(b) prohibits the carryover of deductions and credits from a C corporation year to an S corporation year. However, section 1374(b)(2) and section 1374(b)(3)(B) provide exceptions to this general prohibition carryover rule for net operating loss, capital loss, and section 39 general business credit carryforwards, which are permitted to offset the net recognized built-in gain of an S corporation. Charitable contribution and foreign tax credit carryforwards are not permitted to offset net recognized built-in gain of an S corporation.

**Description of Proposal**

The AICPA recommends modifying section 1374(b)(2) and section 1374(b)(3)(B) to add charitable contribution and section 27 foreign and possessions tax credit carryforwards from a C corporation year to the above carryforwards to offset net recognized built-in gain of an S corporation. Alternatively, modifying section 39(b) to include the foreign tax and possession tax credits as permitted carryforward credits from a C corporation year to an S corporation year.

**Analysis**

The law should allow deductions and credits against the section 1374 BIG tax for charitable contribution and foreign and possessions tax credit carryforwards arising in a C year. All other permitted carryforward deductions and credits arising in a C corporation year may offset the corporate-level BIG tax of an S corporation since both the carryforwards and the BIG tax relates to a tax liability integrally related to the former C corporation. It appears that the foreign tax credits may have been inadvertently omitted due to the general business credit regime excluding it.

**Conclusion/Recommendation**

Amend section 1374(b) to allow an offset to the built-in gains (BIG) tax for charitable contribution and foreign tax credit carryforwards from a C corporation year.

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Proposal: Allow S corporations to have nonresident alien shareholders

**Present Law**

Section 1361(b)(1)(C) provides that a nonresident alien is not eligible as a shareholder of an S corporation. Regulation § 1.1361-1(m)(1)(ii)(D) and Reg. § 1.1361-11(m)(5)(iii) specify that a potential current beneficiary (PCB) of an electing small business trust (ESBT) must be an eligible shareholder. Nonresident aliens are allowed to be PCBs of an ESBT.

**Description of Proposal**

The AICPA recommends amending section 1361(b) to permit nonresident aliens as eligible shareholders of an S corporation. In conformity with that change, we also recommend amending section 1446 to require the S corporation to withhold and pay a withholding tax on effectively connected income allocable to the corporation's nonresident alien shareholders.

**Analysis**

Nonresident aliens are able to contribute capital to, and participate in, the benefits and obligations of an S corporation indirectly in instances where the S corporation is aware that a restructure of the S corporation's operations may permit nonresident shareholders through partnerships. The operating partnership(s) permit nonresident aliens to hold ownership interests and thus nonresident aliens indirectly receive pass-through items from the S corporation's operations. If nonresident aliens were permitted as eligible S corporation shareholders and subject to withholding similar to nonresident alien partners, there would be no revenue loss at the individual level. The smaller, struggling S corporations, particularly those in border states, should also have the freedom to raise capital from these individuals without expensive restructuring available to other S corporations.

**Conclusion/Recommendation**

Amend section 1361(b) to permit nonresident aliens as eligible shareholders of an S corporation.

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Proposal: Repeal section 1362(d)(3), which terminates an S election due to investment income that exceeds a certain threshold or alternatively, increase the passive investment income threshold of S corporations under section 1375(a)(2) from 25% to 60%

**Present Law**

Section 1375 imposes the highest corporate tax rate (currently 21%) on certain S corporations that have accumulated earnings and profits (AE&P) from a former C corporation year<sup>16</sup> on the royalties, rents, dividends, interest and annuities earned if this passive revenue<sup>17</sup> exceeds 25% of the S corporation's gross receipts. Eligible income of banks and bank holding companies, finance companies, interest from installment sales of inventory and dividends from certain C corporation stock is excluded. An S corporation may avoid the tax by distributing its AE&P before the close of the tax year.

The S election involuntary terminates under section 1362(d) for an S corporation with excess passive income for three consecutive years.

**Description of Proposal**

**Eliminating the termination event**

The AICPA recommends repealing section 1362(d)(3) due to the draconian penalty of involuntary terminating the S election due to excess passive investment income.

**Raising the passive investment income thresholds**

The AICPA also recommends amending section 1375(a)(2) and section 1375(b)(1)(A)(i) (as well as the section 1375 header), and (to the extent not repealed) section 1362(d)(3)(A)(i)(II) (as well as the section 1362(d)(3) header) to replace "25%" with "60%" each place it appears. This modification raises the excess net passive investment income tax threshold.

**Analysis**

The probable goal of the excess net passive investment income tax and termination of the S election is to penalize an S corporation for its failure to distribute the AE&P of a C corporation predecessor. Given this apparent goal, it is unclear what the connection is between those undistributed earnings and profits and the passive investment income of the S corporation. If the current regime is maintained, it should at least minimize the differential between a hypothetical, yet correlated tax on AE&P and the uncorrelated tax currently imposed on excess net passive investment income (PII). This eliminates significant uncertainty for S corporation operations. Modifying section 1362(d)(3) and section 1375 to replace "25%" with "60%" each time it appears provides parity by taxing an S corporation's passive investment income in an analogous fashion to the personal holding company tax regime on C corporations.

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<sup>16</sup> At the close of the tax year

<sup>17</sup> Net of allowable deductions.

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Encouraging distributions of AE&P appears the primary goal of section 1375 and section 1362(d)(3). However, a logical by-product of the excess passive income tax regime is discouraging S corporations from earning PII as excess PII triggers an involuntary S election termination. However, it is improbable that discouraging an S corporation from earning PII was the sole goal of enacting section 1362(d)(3) since the regime only applies to S corporations with AE&P. Accordingly, as a matter of fairness to all S corporations, section 1362(d)(3) should be repealed.

**Conclusion/Recommendation**

Repeal the section 1362(d)(3) termination event and raise the passive investment income threshold for S corporations.

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Proposal: Repeal section 1372

**Present Law**

Section 1372(a) provides that, for purposes of applying the provisions of subtitle A of the Code (sections 1 through 1563) which relate to employee fringe benefits, an S corporation is treated as a partnership and any 2% shareholder of the S corporation is taxed under Subchapter K.

Section 1372(b) defines a “2% shareholder” as any person who owns (or constructively owns under section 318) on any day during the taxable year of the S corporation: (1) more than 2% of the outstanding stock of the corporation, or (2) stock possessing more than 2% of the total combined voting power of all stock of the corporation.

Section 1372 has been a source of confusion and significant compliance burdens since its enactment by the Subchapter S Revision Act of 1982.<sup>18</sup> No regulations have been proposed or finalized under this provision, and the only published guidance is limited to the treatment of premiums paid for health insurance by S corporations on behalf of 2% shareholders, contributions to health savings accounts, and certain section 132 fringe benefits. No published guidance identifies what the IRS considers within the scope of the term “fringe benefit” under section 1372.

In the case of an individual who is an employee,<sup>19</sup> section 162(l) allows a deduction for the amount paid during the taxable year for insurance that constitutes medical care for the individual, the individual’s spouse and dependents, and any child of the individual who has not attained the age of 27. The deduction is an “above the line” deduction (i.e., allowable in calculating adjusted gross income).<sup>20</sup>

**Description of Proposal**

The AICPA recommends repealing section 1372, simplifying the compliance burden of small business taxpayers and their tax preparers without appreciably affecting tax revenues. Developments in other Code provisions have narrowed the (albeit uncertain) scope of section 1372 since its enactment in 1982.

**Analysis**

Rev. Rul. 91-26<sup>33</sup> provides guidance to both S corporations and partnerships on the treatment of premium payments made on behalf of 2% shareholders and partners which perform services for the entity. In the case of S corporation 2% shareholders, the IRS concluded that the premiums were generally deductible by the S corporation under section 162, and includable in the gross income of

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<sup>18</sup> Pub. L. No. 97-354, section 3.

<sup>19</sup> Under section 401(c)(1), the term “employee” includes a self-employed individual for purposes of section 401.

<sup>20</sup> The expense is treated as an amount allowable under section 162, which provides a deduction for the ordinary and necessary expenses of carrying on a trade or business. Section 62(a)(1) generally provides for a deduction, in calculating adjusted gross income, for allowed deductions attributable to a trade or business carried on by the taxpayer, other than the trade or business of being an employee.

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the shareholder-employee under section 61. Accordingly, the premiums are reflected as wages on the employee's Form W-2. However, the employee is entitled to deduct the cost of the premiums to the extent provided by section 162(l).<sup>21</sup>

Neither section 1372 nor any other authority defines the term "fringe benefit" for purposes of section 1372. However, several other Code provisions provide an exclusion from an individual taxpayer's gross income only if the individual is an employee and the benefit is employer provided. In addition to the exclusion of premiums paid for health insurance, these provisions include exclusions for group-term life insurance,<sup>35</sup> medical reimbursement (accident and health) plans,<sup>22</sup> and meals and lodging provided for the convenience of the employer.<sup>23</sup> The IRS has also concluded that section 1372(a) prevents a 2% shareholder from excluding contributions by an S corporation to a health savings account under section 106(d).<sup>24</sup>

In contrast, provisions for the exclusion of other fringe benefits are not contingent on the existence of an employer-employee relationship under the Code. For example, while a 2% shareholder may not qualify for the exclusion of qualified transportation fringe benefits,<sup>25</sup> these and other benefits may be excluded as working condition fringe benefits<sup>26</sup> or as *de minimis* fringe benefits.<sup>27</sup>

Moreover, the post-1982 enactment of successor versions of section 162(l) and the subsequent expansion of those provisions have nearly eliminated any disparate treatment of self-employed

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<sup>21</sup> In Ann. 92-16, 1992-5 I.R.B. 53, the Service clarified Rev. Proc. 91-26 by providing guidance on the treatment of such premiums for social security and Medicare tax purposes. In general, subject to compliance with the provisions of section 3121(a)(2)(B), such premiums are not treated as wages for purposes of these taxes, even though the premiums are treated as wages for income tax purposes.<sup>35</sup> Section 79(a).

<sup>22</sup> Section 105.

<sup>23</sup> Section 119.

<sup>24</sup> Notice 2005-8, 2005-4 I.R.B. 368.

<sup>25</sup> Section 132(a)(5) provides an exclusion for any fringe benefit which qualifies as a "qualified transportation fringe." Section 132(f)(1) provides that the term "qualified transportation fringe" includes several types of transportation-related benefits "provided by an employer to an employee." Section 132(f)(5)(E) provides that, for purposes of section 132(f), the term "employee" does not include an individual who is an employee within the meaning of section 401(c)(1). Regulation § 1.132-9(b), A-24(a), provides that an individual who is a 2% shareholder and a common law employee of an S corporation is not eligible for the exclusion of a qualified transportation fringe.

<sup>26</sup> Section 132(a)(3) provides an exclusion for any fringe benefit which qualifies as a "working condition fringe." Section 132(d) provides that the term "working condition fringe" means any property or services provided to an employee of the employer to the extent that, if the employee paid for such property or services, such payment is allowable as a deduction under section 162 or section 167. Regulation § 1.132-9(b), A24(b), provides that the working condition fringe exclusion is available for transit passes provided to individuals who are 2% shareholders.

<sup>27</sup> Section 132(a)(4) provides an exclusion for any fringe benefit which qualifies as a "de minimis fringe." Section 132(e) provides that the term "de minimis fringe" means any property or service the value of which is (after taking into account the frequency with which similar fringes are provided by the employer to the employer's employees) so small as to make accounting for it unreasonable or administratively impracticable. Regulation § 1.132-9(b), A-24(b) and (c), provides that the de minimis fringe exclusion is available for transit passes and commuter parking provided to individuals who are 2% shareholders. Such plans are generally described in section 401(a), and include pension, profit-sharing, and stock-bonus plans of an employer for the exclusive benefit of its employees or their beneficiaries. As noted above, for purposes of section 401, section 401(c)(1) provides that a self-employed individual and a partner in a partnership with earned income is treated as an employee. In addition, section 401(c)(4) provides that a partnership shall be treated as the employer of each partner who is an employee within the meaning of section 401(c)(1).

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individuals, partners, 2% shareholders, and other employees with respect to employer-provided medical insurance. As indicated above, the exclusion of certain fringe benefits does not depend on an employer-employee relationship and is consequently unaffected section 1372(a)'s application. It is also unclear whether section 1372(a) applies to incentive stock options or employee stock purchase plans.<sup>28</sup>

Conclusion/Recommendation

Repeal section 1372.

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<sup>28</sup> J. Eustice and J. Kuntz, *Federal Taxation of S Corporations* ¶ 11.04 (WG&L).

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Proposal: Treat the return of an S corporation as the return of any related qualified subchapter S subsidiary for purposes of any relevant statute of limitations

**Present Law**

In general, tax may be assessed at any time within three years after the return was filed (whether or not the return was filed on or after the prescribed date).<sup>29</sup> However, there is no statute of limitations if no return is filed.<sup>30</sup> If an S corporation files Form 1120-S, *U.S. Income Tax Return for an S-Corporation*, but does not qualify as an S corporation, the return filed by the corporation is treated as a return filed by the taxpayer for purposes of chapter 66 (relating to limitations).<sup>31</sup>

If an S corporation makes an election to treat a subsidiary as a qualified subchapter S subsidiary (“QSub”), the QSub is not treated as a separate corporation, and all of the items of income, deduction, and credit of the QSub are treated as items of the S corporation.<sup>32</sup> The QSub does not file its own tax return, but instead the S corporation includes all of the QSub’s items as its own. If the subsidiary does not qualify as a QSub for a particular taxable year, it is subject risk that the IRS may assess tax for that year against the subsidiary at any time because the subsidiary had never filed a tax return for that year.

**Description of Proposal**

The AICPA recommends modifying section 6012 and section 6037, as appropriate, to treat the return of the S corporation for any taxable year as the return of any QSub provided the S corporation has made a QSub election with respect to the subsidiary and treats the subsidiary as a QSub for that taxable year for purposes of IRC Chapter 66. This proposal would eliminate any uncertainty regarding the relevant statute of limitations determination under section 6501 on assessment in cases where a corporation did not qualify as a QSub.

**Analysis**

The general policy of the statute of limitations on tax assessment is that a requirement should exist for the tax collector to make a final determination of tax owed within a reasonable period of time after the return was filed, while records are still available, and while the personal knowledge and recollections of relevant individuals are still fresh and reliable. Where a tax return reasonably reflects the taxpayer’s own self-assessment of its items of income, deduction, and credit, it is reasonable to expect that the IRS should complete its assessment within the statutorily prescribed three years after that filing. That policy, however, does not (and should not) limit the IRS where no return is filed and no information regarding the taxpayer’s self-assessment has been provided to the IRS.

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<sup>29</sup> Section 6501(a).

<sup>30</sup> Section 6501(c)(3).

<sup>31</sup> Section 6037(a).

<sup>32</sup> Section 1361(b)(3)(A).

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In other cases where an incorrect basis for filing was used by a taxpayer but the taxpayer's information was otherwise provided to the IRS, the normal three-year limitations period will apply. For example, if a consolidated return is filed by a group for a taxable year but the tax liability of a corporation whose income is included in that return should have been included in a separate return, the filing date of the group's consolidated return is the relevant date for computing any limitations period.<sup>33</sup> Similarly, as indicated above, if a corporation files as an S corporation but it is later determined that the corporation should have filed as a C corporation, the Form 1120-S filing date is used for purposes of computing any limitations period. Therefore, unless another exception under section 6501(c) applies, the Service could only assess tax against the corporation within three years after the return is filed.

**Conclusion/Recommendation**

Modify section 6012 and section 6037 to treat the return of an S corporation as the return of any related qualified subchapter S subsidiary for purposes of any relevant statute of limitations.

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<sup>33</sup> Treas. Reg. § 1.1502-75(g)(1).

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# **Trust, Estate & Gift Tax**

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Proposal: Modify the deadline for estate basis reporting

Present Law

Section 2004 of the [Surface Transportation and Veterans Health Care Choice Improvement Act of 2015](#) provided rules for consistent basis reporting between estates and beneficiaries.

In July 2015, as part of the Act, Congress amended IRC section 1014 to provide for the consistent use of the value of property passing from a decedent's estate and the value subsequently used by the beneficiary to determine gain or loss upon the disposition of such property acquired from a taxable estate.

The Act also added section 6035, which requires the executor of any estate required to file a return under section 6018(a) to furnish to the Secretary and to each person acquiring an interest in property included in the decedent's gross estate for Federal estate tax purposes a statement identifying the value of each interest in such property as reported on such return and such other information with respect to such interest as the Secretary may prescribe. Section 6035(a)(3) states that the time for filing such statement is 30 days from the earlier of the date of the due date for filing the return (including extensions, if any) or the date the return was actually filed.

Section 6035(b) authorizes the Secretary to prescribe regulations necessary to carry out the provisions of section 6035(a), including applying these provisions to estates that are not otherwise required to file a return ([Form 706, United States Estate \(and Generation-Skipping Transfer\) Tax Return](#)).

Section 2004(c) of the Act adds statements under section 6035 to the list of information returns and payee statements subject to the penalties under section 6721 and section 6722, respectively. Specifically, the Act adds new paragraph (D) to section 6724(d)(1) to provide that the term *information return* means any statement that the executor is required to file with the Secretary under section 6035. The Act also adds new paragraph (II) to section 6724(d)(2) to provide that the term *payee statement* means any statement that the executor is required to furnish under section 6035 (other than a statement described in section 6724(d)(1)(D)).

Section 2004(d) of the Act states that the above rules shall apply to property with respect to which an estate tax return is filed after the date of enactment of the Act (July 31, 2015). IRS [Notice 2015-57](#) delayed until February 29, 2016, the due date, which otherwise would have begun August 30, 2015, and provided transition relief as well as time for IRS and Treasury to issue the needed guidance to taxpayers and practitioners to comply with that provision. IRS [Notice 2016-19](#), issued February 11, 2016, further extended the due date to March 31, 2016, pending issuance of proposed regulations. As the AICPA [requested](#), the March 31, 2016 due date was further extended to June 30, 2016 by [Notice 2016-27](#).

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**Description of Proposal**

We urge Congress to modify the due date for estate basis statements to require such reporting by February 15 following the end of a calendar year in which an estate distributes assets to a beneficiary, rather than 30 days after an estate files the Federal estate tax return.

Congress should revise the section 6035(a)(3) due date for providing statements to beneficiaries and the IRS to February 15 following the end of a calendar year in which the property is distributed to the beneficiaries in order to streamline the process and make the reporting more accurate and useful to the beneficiaries and the IRS.

**Analysis**

Our suggestion would:

- Continue the reporting of estate basis to beneficiaries and the IRS;
- Maintain the intent of the provision;
- Simplify and improve the administrative process;
- Result in more accurate reporting; and
- Provide more meaning to the information provided by the executor to beneficiaries and the IRS.

For many estates, the executor does not know *within thirty days after filing the estate tax return* which beneficiary will receive which asset. In fact, it is customary that many, if not most, executors do not fully distribute estate assets until after they have received the IRS closing letter to ensure that there are sufficient funds in the estate to meet its federal and state tax obligations.

Because the executor usually does not know which assets the estate will distribute to each beneficiary 30 days after the time the estate tax return is filed (before the executor has settled the estate), the information provided to each beneficiary at that time, due to the filing requirement, includes all the assets in the estate that the executor could possibly distribute to that beneficiary. The beneficiary may receive pages and pages listing almost all of the estate's assets. The beneficiary will need to keep these pages to determine the basis of the assets that the beneficiary actually receives, perhaps several years later. Each beneficiary also gains knowledge of all the assets in the estate, even though the beneficiary may receive a small share of those assets and is not entitled to know the extent of the estate's holdings. Such disclosure of information has the potential to cause family disputes and discord.

The beneficiary needs to know the basis of the assets that the beneficiary actually receives; the executor should provide that information contemporaneously with the distribution of the respective assets. This information would help the IRS as well. The proposed regulations and the instructions to [Form 8971, Information Regarding Beneficiaries Acquiring Property From a](#)

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*Decedent*, provide that executors may, but are not required to, file supplemental statements after the assets are distributed to specify the beneficiary who actually received the assets.

Another advantage of moving the due date is that the statements are more likely to reflect the final value of the assets for Federal estate tax purposes. Because the executor generally waits to distribute most of the assets until after the estate receives its IRS closing letter, the value of the assets on the statements will reflect any adjustments in value made during the estate tax audit. In these situations, moving the due date would eliminate the need to file the supplemental return required by section 6035(a)(3)(B) when the value of assets changes upon audit.

This legislative proposal would provide more administrable reporting deadlines for executors and provide more accurate and relevant information on basis to the beneficiaries and IRS because under the proposal the reporting is required after the property is actually distributed to a beneficiary. Because an annual post-distribution filing deadline will produce more accurate reporting, this reporting regime is preferable to the current system, despite the inconvenience of more frequent filings.

Our suggestion of a February 15<sup>th</sup> filing requirement has the following advantages:

- Post-distribution reporting of actual assets distributed (and not over-reporting of assets that the executor might distribute);
- Only one [Form 8971](#) filing per year (regardless of how often the executor makes distributions during that year);
- Executors would file Form 8971 the same time as any consolidated Form 1099 reporting (if any required by the estate executor or corporate trustee/fiduciary for interest, dividends, sales proceeds and basis for their accounts under management) and two weeks after the January 31<sup>st</sup> deadline for any Form 1099INT, *Interest Income*, filed by estate executors;
- Basis reporting to a beneficiary with sufficient time prior to the beneficiary's annual tax compliance (i.e., Form 1040, due April 15).

We considered the possibility of an annual Form 8971 filing based on an estate's fiscal year; however, we concluded that annual reporting based on a calendar year is preferable to fiscal year reporting because of the reasons below.

- If the requirement were to file Form 8971 with the estate's [Form 1041, U.S. Income Tax Return for Estates and Trusts](#):
  - The estate could obtain an extension to file Form 1041, resulting in the return due eight and a half months after the end of the fiscal year. If Form 8971 is due with Form 1041, the beneficiary might have to wait 19½ months after receiving a distribution of an asset before the basis of that asset is reported to him or her. For example, if a distribution is made in the first month of an estate's fiscal year, an additional 11 months exists until the fiscal year end, and potentially eight and a half

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months before Form 1041 and Form 8971 are filed. In the meantime, the beneficiary may have already sold the asset and needed the basis information to file properly his or her income tax return.

- If the requirement were to file Form 8971 within 30 days after the end of the estate's fiscal year:
  - The executor would provide basis information more timely than if it were filed with Form 1041, but the reporting would not align with the beneficiary's income tax reporting schedule and may arrive too late for the completion of the beneficiary's individual income tax return if the asset was sold shortly after the beneficiary received it.

**Conclusion/Recommendation**

We urge Congress to revise the section 6035(a)(3) due date for providing statements to beneficiaries and IRS to February 15 following the end of the calendar year in which specific property is distributed to the respective beneficiaries in order to streamline the process and make the reporting more accurate and useful to the beneficiaries and the IRS.

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Proposal: Allow administrative relief for late portability, inter vivos qualified terminable interest property, and qualified revocable trust elections

Present Law

**Section 9100 Relief**

The IRS has the authority to provide taxpayers relief from certain missed or late elections by granting extensions of time to make those elections. This relief, known as “section 9100 Relief,” requires the taxpayer to establish to the satisfaction of the IRS Commissioner that the taxpayer acted reasonably and in good faith, and the grant of relief will not prejudice the interests of the Government. Section 9100 Relief is available for elections, the timing of which is prescribed by regulation (Treas. Reg. § 301.9100-3(a)), rather than by statute.

**Portability Election**

Effective for decedents dying after 2010, a portability election is an election under IRC section 2010(c)(5)(A) to transfer a decedent’s unused exclusion amount (known as a deceased spousal unused exclusion (DSUE) amount) to the decedent’s surviving spouse. If a portability election has been made, the surviving spouse may use their own exclusion amount (\$11.7 million for deaths in 2021 less certain lifetime gifts) plus the DSUE amount.

Section 2010(c)(5)(A) provides that the portability election is made by the executor not later than the time prescribed for filing the estate tax return (determined with regard to extensions).

Because the time for making the portability election is prescribed by statute, we think that the IRS does not have the authority to grant relief for late elections if the estate is required to file a Federal estate tax return. The IRS has the authority to grant an extension of time to make the portability election only if the estate is not otherwise required to file an estate tax return because the estate is below the filing threshold. Estates that are above the filing threshold for the Federal estate tax return and that fail to make a timely portability election have no recourse to cure the problem and are disadvantaged because of the errors committed by their advisors.

**Qualified terminable interest property election**

Transfers of property interests that meet the requirements as qualified terminable interest property (QTIP) are eligible for the marital deduction for gift and estate tax purposes if the QTIP election is made. For QTIP transfers made when an individual dies in a year other than 2010, the QTIP election is made by the decedent’s executor on the Federal estate tax return. For an inter vivos QTIP transfer, the QTIP election is made on the Federal gift tax return for the calendar year in which the interest is transferred. A QTIP election, once made, is irrevocable.

Section 9100 relief has been available for failures to make a QTIP election on a Federal estate tax return for over two decades, since the deadline for making that election is prescribed by regulation (Treas. Reg. § 20.2056(b)-7(b)(4)(i)). For an inter vivos QTIP, section 2523(f)(4)(A) provides that the QTIP election is made on or before the date prescribed by section 6075(b) for filing a gift tax return with respect to the transfer. The statutory language of the gift tax and estate tax QTIP provisions is different. The IRS has determined that the deadline for making the gift tax QTIP election is statutory, and, therefore, section 9100 relief is not available. See [PLR 201109012](#) (March 4, 2011), [PLR 200314012](#) (April 4, 2003), and PLR 9641023 (July 10, 1996). The present

situation imposes a hardship on taxpayers as it provides no remedy – other than a malpractice action – for a taxpayer who loses the gift tax marital deduction due to an error on the part of the taxpayer’s advisor.

**Qualified revocable trust election**

Effective with respect to estates of decedents who die after August 5, 1997, an election is available to have certain revocable trusts treated and taxed as part of the decedent’s estate. If both the executor (if any) of an estate and the trustee of a qualified revocable trust (QRT) elect the treatment provided in section 645 (originally enacted as section 646), the trust is treated and taxed for income tax purposes as part of the estate (and not as a separate trust) during the election period. Section 645(c) provides that the election to treat a QRT as part of the decedent’s estate is made not later than the time prescribed for filing the income tax return for the first taxable year of the estate (determined with regard to extensions).

Because the time for making the election to treat the QRT as part of the estate is prescribed by statute, the IRS does not have the authority to grant relief for late elections. Estates of decedents that fail to make a timely election do not have recourse to cure the problem and are disadvantaged because of the errors committed by their tax advisors.

**Description of Proposal**

We urge the enactment of legislative provisions stating that the due dates for the portability election, inter vivos QTIP election, and the QRT election are treated as if not prescribed by statute, thus allowing the IRS to grant administrative relief for late portability, inter vivos QTIP, and QRT elections. Specifically, Congress should authorize the IRS to grant section 9100 relief for late portability elections, for certain late or defective lifetime (i.e., inter vivos) QTIP elections, and for late elections by QRTs to treat such trust as part of a decedent’s estate. Congress could accomplish this by revising the IRC to provide that the due dates for (1) the portability election, (2) the inter vivos QTIP election, and (3) the QRT election are treated as if not prescribed by statute. These proposals would make the same sort of statutory change in section 2010(c)(5)(A), section 2523(f)(4), and section 645(c) as the change made to IRC section 2642(g)(1)(B) by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) with respect to generation-skipping transfer (GST) exemption (and extended through 2012 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, and extended permanently by the American Taxpayer Relief Act of 2012). The provisions would apply to requests for relief pending on or filed after the date of enactment with respect to elections due before, on, or after such date. These proposed prospective effective dates are similar to the prospective effective date provision applicable to the generation-skipping transfer exemption relief in EGTRRA.

**Analysis**

The problems for late portability, inter vivos QTIP, and QRT elections are similar to the problem that existed with the allocation of GST exemption prior to EGTRRA. The time for making an allocation of GST exemption was fixed by statute, and numerous taxpayers were being penalized for the failures of their tax advisors and tax return preparers to properly make the allocation. EGTRRA added section 2642(g)(1)(B) of the Code, which states “[f]or purposes of determining

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whether to grant relief under this paragraph, the time for making the allocation (or election) is treated as if not expressly prescribed by statute.” That language opened up the possibility of section 9100 relief for missed allocations of GST exemption. Given that statutory authority, the IRS has granted 9100 relief in hundreds of private letter rulings.

This proposal would make the same type of statutory change in section 2010(c)(5)(A), section 2523(f)(4), and section 645(c) as was made in section 2642(g)(1)(B) in order to not penalize taxpayers for the errors of their lawyers or accountants in failing to make the portability election on a timely filed Federal estate tax return, the QTIP election on a timely filed Federal gift tax return, or a QRT election to treat the trust as part of an estate on the estate’s first Federal income tax return.

We note that legislation to provide administrative relief for inter vivos QTIP elections was introduced previously and was reported by the Senate. Specifically, in the 109<sup>th</sup> Congress, on June 28, 2006, [S. 1321](#), the Telephone Excise Tax Repeal Act of 2005, as reported by the Senate, included section 713, Administrative Relief for Certain Late Qualified Terminable Interest Property Elections (see Report [109-336](#) and [JCX-28-06](#)). In addition, on July 25, 2006, [H.R. 5884](#) was introduced in the House of Representatives to authorize the Secretary of the Treasury to extend the date for making a gift tax QTIP election.

In addition, we point out that a QTIP election does not forgive estate or gift tax; it merely defers imposition of the tax until the death of the donee spouse. Therefore, this provision would have minimal cost (estimated in 2006 at \$2 million over 10 years per [JCX-28-06](#)). Similarly, the QRT election does not forgive tax, it just treats the trust during the election period as part of the estate for income tax purposes, rather than as a separate trust; therefore, we expect this proposal as well would have minimal cost. The portability election provides the same tax consequences as are available to taxpayers with proper estate planning.

#### Conclusion/Recommendation

We urge the enactment of legislative provisions stating that the due dates for the portability election, inter vivos QTIP election, and the QRT election are treated as if not prescribed by statute, thus allowing the IRS to grant administrative relief for late portability, inter vivos QTIP, and QRT elections.

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Proposal: Treat consistently all federal tax payments of trusts and estates

**Present Law**

Currently, the ability of a trust or estate to allocate its tax payments to its beneficiaries is different for estimated federal tax payments, backup withholding, and regular withholding, and the different treatment becomes confusing and unnecessarily complex to taxpayers and tax practitioners. In some instances, a fiduciary may allocate estimated tax payments to the beneficiaries, but only if an election to do so is made within 65 days after the close of the trust or estate's tax year. Backup withholding follows its corresponding income, and the beneficiary's share is reported to the beneficiary on the Schedule K-1 (Form 1041), *Beneficiary's Share of Income, Deductions, Credits, etc.*, which is filed with the Form 1041. A trust or estate may not allocate regular withholding to the beneficiary but is required to report regular withholding itself even if the corresponding income is reported by the beneficiary.

Specifically, for estimated tax payments, a trust or, for its final tax year, a decedent's estate may elect under section 643(g) to allocate any part of its estimated tax payments to beneficiaries. The fiduciary makes this election by filing Form 1041-T, *Allocation of Estimated Tax Payments to Beneficiaries*, by the 65<sup>th</sup> day (i.e., generally March 5 for calendar year taxpayers) after the close of the tax year. Absent a timely election, the trust or estate must report the estimated tax payments on its [Form 1041](#) and cannot allocate them to beneficiaries on Schedule K-1 (Form 1041).

For backup withholding, the tax credit under section 31(c) for payments subject to section 3406 (backup withholding) is allocated between the trust or estate and its beneficiaries on the basis of their respective shares of the payment, which is subject to backup withholding under section 643(d). Schedule K-1 (Form 1041) is used to report the beneficiaries' share of the backup withholding.

For regular withholding, the trust or estate may not allocate the credit under section 31(a) for amounts withheld as tax under chapter 24 (regular withholding) to a beneficiary. See [Chief Counsel Advice 200644018](#) (Dec. 25, 2005), in which the IRS stated that neither section 643(d) nor section 643(g) is relevant to the treatment of the withholding credit under section 31(a), and neither Form 1041-T nor any other form or schedule is available to allocate this credit, except in two situations. Those situations involve (1) a trust that is a grantor trust, in which case the credit appears on the grantor's income tax return, and (2) the recipient of income in respect of a decedent, who is entitled to any section 31 credit associated with the income taxed to the recipient. Also, the [instructions to Form 1041](#) state that withheld income tax (other than backup withholding) cannot pass through to beneficiaries on either Schedule K-1 or Form 1041-T.

**Description of Proposal**

Congress should enact legislation that would permit consistent treatment of all federal tax payments of trusts and estates, including estimated tax payments, backup withholding and regular withholding. This proposal would provide tax simplification and consistency. Specifically, we propose that the fiduciary of a trust or estate have permission to allocate estimated tax payments, including payments made with extension requests, to the trust's or estate's beneficiaries on

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Schedule K-1 (Form 1041) attached to a timely filed Form 1041 (including extensions) and that regular withholding is treated the same as the current treatment of backup withholding. This proposal would allow the estate or trust to allocate estimated tax payments (including any tax payment made with an extension request) to the beneficiary on the Schedule K-1, which is the same way that backup and regular withholding is reported to the beneficiaries. Having all such taxes attributed to the beneficiaries reported on the Schedule K-1 is much less confusing and reduces complexity to the fiduciaries.

With respect to regular withholding, the title of section 643(d) could change to “Coordination with withholding” and section 643(d)(1) could have an amendment to include a reference to section 31(a) in order for it to read: “... (1) by allocating between the estate or trust and its beneficiaries any credit allowable under section 31(a) or 31(c) (on the basis of their respective shares of any such payment taken into account under this subchapter)....”

With respect to estimated tax payments and extension payments, we suggest that Congress add estates to the general rule of section 643(g)(1) with the result that section 643(g)(3) is repealed and that Congress amend section 643(g)(1) and (2) to read as follows:

- (g) Certain payments of tax treated as paid by beneficiary.
  - (1) In general. In the case of trust or estate—
    - (A) The trustee or fiduciary of the estate may elect to treat any portion of a payment of estimated tax (including a tax payment with an extension request) made by such trust or estate for any taxable year of the trust or estate as a payment made by a beneficiary of such trust or estate,
    - (B) Any amount so treated shall be treated as paid or credited to the beneficiary on the last day of such taxable year of the trust or estate, and
    - (C) For purposes of subtitle F, the amount so treated—
      - (i) Shall not be treated as a payment of tax made by the trust or estate, but
      - (ii) Shall be treated as a payment of estimated tax made by such beneficiary on the fifteenth day of the first month following the close of the trust or estate’s taxable year.
  - (2) Time for making election. An election under paragraph (1) shall be made on the tax return of the trust or estate filed on or before its due date (including extensions of time actually granted) and in such manner as the Secretary may prescribe.

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Adding estates to the general rule will allow the estate to treat tax payments as paid by estate beneficiaries in years other than just the estate's last tax year if the executor so chooses. These proposals will simplify processing for the IRS as well as taxpayers. We think that any revenue cost for this proposal is negligible as it deals with allocating tax payments only between taxpayers.

### Analysis

There are many professional fiduciaries and trust companies facing the present law inconsistency in the reporting treatment of the various types of tax payments. In addition, trusts and probate estates frequently are administered by family members or other individuals, for whom this inconsistent treatment causes confusion and unnecessary complexity. With regard to the election for estimated tax payments, fiduciaries frequently miss making this election because of its due date. Fiduciaries often are unable to determine whether federal taxes have been overpaid by the 65<sup>th</sup> day of the next year, especially when Forms 1099 (the information returns reporting various types of income) are not available to the trust or estate until the 46<sup>th</sup> day of the next year and many Schedules K-1 (the information returns reporting income from partnerships, S corporations and trusts) are not available to the trust or estate until much later in the following year, well past the 65-day period.

A related issue arises with respect to federal tax payments submitted with a fiduciary's request for an extension of time to file the trust or estate's income tax return. It is not possible to allocate any of those payments to the beneficiaries, rather they are applied only to a later year's tax or refunded to the fiduciary. In addition, returns may be extended based on prior year information before it is known that the return will be final. Currently, trusts may remain open because of a partnership investment that distributes income to partners but the final Schedule K-1 is received late and there is nothing further to distribute.

The treatment of regular withholding and estimated payments becomes most critical in the final year of the trust or estate. If the fiduciary misses the 65-day period for making the election for estimated tax payments, then those payments are refunded to the fiduciary. Regular withholding payments are always refunded to the fiduciary. Since the refund is made after the close of the trust or estate's final year, the fiduciary may already have been discharged and is no longer able to act on behalf of the entity. The fiduciary also may have closed all financial accounts in connection with the final distribution of assets and therefore has no way to cash the check or make a further distribution.

### Conclusion/Recommendation

We continue to encourage Congress to pass legislation that simplifies the tax compliance burden of taxpayers. To further this mission, we request that Congress enact legislation that would permit consistent treatment of all federal tax payments of trusts and estates, including estimated tax payments, backup withholding and regular withholding. We urge Congress to enact this tax simplification and consistency proposal.

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Proposal: Amend section 67(e) to simplify the law and allow estates and nongrantor trusts to fully deduct the cost of complying with fiduciary duties in administering estates and trusts<sup>34</sup>

**Present Law**

Prior to 2018, the law denied a deduction for the cost of complying with many fiduciary duties to the extent that their aggregate cost does not exceed 2% of the taxpayer's adjusted gross income (AGI). This rule is known as the "2% floor." For tax years 2018 through the 2025, these expenses are not deductible at all. After 2025, the law prior to 2018 returns.

By way of background, Congress enacted section 67(a) in 1986 to limit deductions for miscellaneous itemized deductions to those in excess of 2% of AGI. Congress's purpose was to reduce recordkeeping for numerous small expenditures and eliminate deductions for many, essentially personal expenditures claimed in error.<sup>35</sup> Because estates and nongrantor trusts<sup>53</sup> are taxed in the same manner as individuals, Congress provided an exception to the 2% floor in section 67(e) for fiduciary administrative costs that would not have been incurred "if the property were not held in such trust or estate."

Because of the statute's unusual wording, there have been several judicial battles over its meaning. In 2008, the U.S. Supreme Court held in *Knight v. CIR*, 552 U.S. 181, 128 S. Ct. 782 (2008), that the statute allows a full deduction for "only those costs that it would be uncommon (or unusual, or unlikely) for such a hypothetical individual to incur." To make that determination, the Court held that the trustee must "predict" whether a hypothetical person with the trust property would have incurred the cost. Unfortunately, this interpretation imposes significant uncertainty, complexity, recordkeeping and enforcement burdens on both the trustee and the government. In short, it raises more questions than it answers.

We have worked together with the American Bankers Association, the American Bar Association, the American College of Estate and Trust Counsel and other groups to provide the IRS and Treasury input on [July 27, 2007 proposed regulations](#). On September 7, 2011, the IRS withdrew those regulations and issued a replacement set of [proposed regulations](#) attempting to implement the Supreme Court's decision. On May 9, 2013, the IRS issued the [final regulations](#). The final regulations require trusts and estates to unbundle trustees' fees and other single commission fees and to separate between costs that are commonly incurred by individuals and those that are not. The IRS and Treasury are unsuccessful in drafting regulations that are clear and administrable, without subjecting many administrative costs to the 2% floor (or to complete disallowance in 2018 through 2025). This treatment limits the exemption under section 67(e). Expressing similar frustration over section 67(e), Chief Justice Roberts commented:

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<sup>34</sup> The AICPA submitted a similar proposal on [September 8, 2008](#) to the 110<sup>th</sup> Congress.

<sup>35</sup> [Sen. Rep. No. 99-313](#), 1986-3 C.B. Vol. 3, p. 78; [House Rep. No. 99-426](#), 1986-3 C.B. Vol. 2, p. 109. A nongrantor trust is a trust that is treated as a separate taxable entity from its grantor or beneficiary. By contrast, a grantor trust is one whose grantor or beneficiary is treated as the owner of all or part of the trust property for income tax purposes.

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While Congress's decision to phrase the pertinent inquiry in terms of a prediction about a hypothetical situation inevitably entails some uncertainty, that is no excuse for judicial amendment of the statute.

**Description of Proposal**

The solution, in our view, is to amend the statute, specifically section 67(e), to simplify the law and allow estates and nongrantor trusts to fully deduct the cost of complying with fiduciary duties in administering estates and trusts.

We think the proposed amendment below would simplify the statute, would modernize it for the prudent investor rule,<sup>36</sup> make it easier to administer, and provide a consistent definition of AGI for estates and nongrantor trusts throughout the IRC.

As amended, the statute would provide:

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

**Analysis**

We support this measure for the following reasons:

1. The present statute is overly complex and burdensome. The trustee must predict whether an ordinary individual with the same property would have incurred the same cost or a portion thereof, under the Supreme Court's reading of the statute. The trustee must then separate its fees into the portion an individual would have incurred (subject to the 2% floor or to disallowance in 2018 through 2025) and the portion that is fully deductible. The regulations indicate "any reasonable method" is used for the determination. Such recordkeeping complexity is contrary to sound tax policy.
2. A legislative change would eliminate uncertainty, inconsistencies and errors arising from the requirement to predict what individuals commonly do. Because section 67(e) requires the extraordinarily difficult task of determining whether individuals would commonly incur a particular expense that the trust or estate incurred, it results in uncertainty, inconsistent treatment from trust to trust, errors of judgment, and potential penalties on both the trustee and tax preparers.

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<sup>36</sup> The prudent investor rule requires a trustee to invest trust funds as a prudent investor would for the account of another. Prior to the Uniform Prudent Investor Act of 1992, trustees were only required to follow the prudent man rule, which required the trustee to invest trust funds as he would for himself.

3. The present statute requires extensive recordkeeping. The Supreme Court's interpretation of section 67(e) requires the trustee to keep additional records to determine whether and how its expenses are different from those incurred by hypothetical individuals with the same property. This additional recordkeeping is contrary to Congress's original purpose for section 67, which was to simplify recordkeeping and limit individuals from deducting personal expenses (i.e., safe deposit box fees, investment magazines, home office expenses, etc.).
4. The present statute is out of date. The present statute was enacted eight years before the [Prudent Investor Act \(1994\)](#) was adopted by nearly every state. The Prudent Investor Act raised the investment standard from the "prudent man" to the more demanding "prudent investor" rule, requiring many trustees to obtain specialized expertise to fulfill their fiduciary duties. This is an especially burdensome requirement for family member trustees. Thus, the IRC denies a full deduction for costs incurred to comply with the Act merely because individual investors sometimes incur the same costs.
5. The present statute penalizes compliance with fiduciary duties. The present statute penalizes trustees for incurring costs to carry out their mandatory fiduciary duties. Trustees who hire professional advisors to comply with their duty to invest prudently are denied some or all of their deductions. However, if they forgo the professional advice, they risk a breach of fiduciary duty. Such tension should not exist between the IRC and other regulatory acts.
6. Trusts are small taxpayers. According to IRS Statistics of Income for 2014, over 93% of all trusts report less than \$100,000 of total income, including capital gains.<sup>37</sup> These trusts are often maintained for minors, disabled individuals, and the elderly. This \$100,000 threshold is significantly below the amount generally used to define "wealthy taxpayers" for whom benefits are limited. The IRC should reflect that estates and trusts are generally small taxpayers burdened with mandatory duties that require extra costs to administer.
7. For years other than 2018 through 2025, the cost of compliance does not justify the tax collected. As section 67(e) is presently interpreted, trusts and estates must determine on an item-by-item basis which costs would not be customarily incurred by a hypothetical individual in order to determine the costs not subject to the 2% floor. In order to avoid the cost, complexity, and recordkeeping required to determine which costs would not commonly be incurred by a hypothetical individual, many small trusts and estates might simply subject all their costs to the 2% floor, forfeiting their right to the full deduction because they cannot justify the compliance cost. Large trusts and estates may decide to incur the extra cost of recordkeeping in order to obtain a full deduction. The additional compliance cost for both the government and fiduciaries is likely significant compared to the incremental revenue. Sound tax policy should not limit the availability of legitimate tax deductions to only those who can afford the cost to comply.

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<sup>37</sup> Table 1. [Fiduciary Income Tax Returns, Income Source, Deductions, and Tax Liability, by Tax Status and Size of Total Income, Filing Year 2014.](#)

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8. The proposed change is simple. The bill proposes to simply delete the phrase at the end of section 67(e)(1) – “and would not have been incurred if the property were not held in such trust or estate.” Such change would allow a full deduction for all costs “incurred in connection with the administration of the trust or estate.” It is administrable, fair, and consistent with Congress’s intent to simplify recordkeeping. It would also eliminate the tension between the Prudent Investor Act’s mandate to invest prudently and the IRC’s denial of a full deduction for the costs of complying with that Act.
9. Trustees are heavily scrutinized on how they invest property entrusted to them compared to individuals who are free to manage their own property. Trustees must comply with the Uniform Trust Code, the Uniform Prudent Investor Act, the Uniform Principal and Income Act, and numerous other federal and state laws. These laws require them to have loyalty and impartiality, to diversify, to contain costs and to consider numerous other circumstances unique to a trust. Trusts and estates were not the original target of section 67(e) when Congress sought to reduce recordkeeping and deductions for personal expenses.
10. The proposed change would provide a single definition of AGI for an estate or trust in the IRC. The IRC contains two different definitions of AGI for an estate or trust. Section 67(e) provides that AGI is determined after deducting costs “paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate.” However, section 165(h)(4)(C) provides that AGI is determined after deducting “costs paid or incurred in connection with the administration of the estate or trust.” These two distinctly different definitions of AGI serve no purpose. The IRC needs simplification to provide a single definition of AGI for estates and trusts, which is identified in the definition contained in section 165(h)(4)(C).

**Conclusion/Recommendation**

Congress should amend section 67(e) to simplify the law and allow estates and nongrantor trusts to fully deduct the cost of complying with fiduciary duties in administering estates and trusts.

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Proposal: Exempt trusts with charitable deductions only from partnerships and limited liability companies (LLCs) from the information return filing requirement of section 6034(a)

**Present Law**

Section 6034(b)(1) provides that every trust that is not a split-interest trust described in section 4947(a)(2) but that is claiming a deduction under section 642(c) for the taxable year shall furnish the information with respect to the taxable year as the Secretary may by forms or regulations prescribe, including:

1. The amount of the deduction taken under section 642(c) within the year;
2. The amount paid out within the year which represents the amount for which deductions under section 642(c) have been taken in prior years;
3. The amount for which the deductions have been taken in prior years but which has not been paid out at the beginning of the year;
4. The amount paid out of principal in the current and prior years for the purposes described in section 642(c);
5. The total income of the trust within the year and the expenses attributable thereto; and
6. A balance sheet showing the assets, liabilities and net worth of the trust as of the beginning of the year.

Section 6034(b)(2)(A) provides an exception to the reporting requirement of section 6034(b)(1) for a trust for any taxable year if all the income for the year, determined under the applicable principles of the law of trusts, is required to be distributed currently to beneficiaries.

Under section 6652(c)(2)(A), a penalty is imposed for failure to file the information return required by section 6034(b). The penalty is \$10 a day with a maximum of \$5,000.

Trusts use Form 1041-A, *U.S. Information Return Trust Accumulation of Charitable Amounts*, to satisfy their reporting obligation under section 6034(b). According to the instructions, the trustee must file Form 1041-A for a trust that claims a charitable deduction or other deduction under section 642(c) unless an exception applies. The instructions provide exceptions for a trust that is required to distribute currently to the beneficiaries all the income for the tax year determined under section 643(b) and the related regulations<sup>38</sup>; a charitable trust described in section 4947(a)(1)<sup>39</sup>; and for tax years beginning after 2006, a split-interest trust described in section 4947(a)(2).<sup>40</sup> Section 642(c)(1) provides that a trust is allowed a deduction in computing its taxable income for any amount of the gross income, without limitation, that pursuant to the terms of the governing

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<sup>38</sup> See section 6034(b)(2)(A).

<sup>39</sup> See section 6034(b)(2)(B).

<sup>40</sup> See section 6034(a).

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instrument is, during the taxable year, paid for a purpose specified in section 170(c). For a trust to claim a charitable deduction under section 642(c) for amounts of gross income that it contributes for charitable purposes, generally the governing instrument of the trust must give the trustee the authority to make charitable contributions.

**Description of Proposal**

We urge Congress to enact this tax simplification proposal to exempt from complying with the information reporting requirements of the IRC section 6034(b)(1) trusts whose only charitable deductions are passed through to them from a partnership or LLC.

Specifically, we suggest that an additional exception (C) is added to section 6034(b)(2) to read as follows:

(2) Exceptions. Paragraph (1) shall not apply to a trust for any taxable year if – ...

(A) the trust's only deductions under section 642(c) are those attributable to charitable contributions taken into account by the trust under section 702(a)(4)

**Analysis**

Often trusts invest in partnerships or LLCs that make charitable contributions. If the partnership makes a charitable contribution from its gross income, that income is never available to the trust. For federal tax purposes, however, the trust must take into account its distributive share of the partnership's income, gain, loss, and deductions, and credits. These items include the amount of income given to charity and the corresponding deduction for that contribution. The IRS has recognized the trust's ability to claim a charitable deduction in this situation despite the fact that the trust's governing instrument does not authorize the trustee to make charitable contributions. See Rev. Rul. 2004-5, 2004-3 I.R.B. 295.

For many trusts that claim a charitable deduction under section 642(c), the contribution is made by partnerships or LLC in which the trust owns an interest, and no contributions are actually made by the trust. In these situations, we recommend that Congress exempt these trusts from the information reporting requirements of section 6034(b) and therefore not require them to file Form 1041-A. Such trusts are not accumulating any income that they may distribute to a charity in the future. The current charitable deductions are based solely on the current income of a flow-through entity, which contributes it directly to charity, and are not from any prior year's accumulation of income by the trusts.

As discussed above, the trusts themselves never received the amounts that were given to charity and never made any direct charitable contributions. Under these circumstances, being required to file Form 1041-A places an unnecessary burden on these trusts and does not yield any additional useful information for the IRS. Moreover, trustees and preparers frequently are unaware of this filing requirement if the trust itself normally does not make any charitable contributions but in some years has charitable contributions passed through to it from their partnership or LLC

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investments. For these trusts, the failure to file penalty can easily run to its maximum \$5,000 amount, an amount that frequently is much greater than the amount of the claimed charitable deduction. For those trustees who are aware of this filing requirement, they sometimes choose to forego claiming the deduction rather than having to file an additional tax return. The creation of an exception is needed for these trusts because charitable deductions passed through to trusts from partnerships or LLCs do not appear to fall within the scope and purpose of the information reporting requirement of section 6034(b).

**Conclusion/Recommendation**

We urge Congress to enact this tax simplification proposal to exempt from complying with the information reporting requirements of the IRC section 6034(b)(1) trusts whose only charitable deductions are passed through to them from a partnership or LLC.

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Proposal: Subject estates, certain qualified revocable trusts, and qualified disability trusts to the income tax and net investment income tax in the same manner as married persons filing separate returns

**Present Law**

Historically, estates and trusts were taxed at the highest income tax rates/brackets applicable to individual taxpayers –those rates/brackets pertaining to married persons filing separate returns. However, the Tax Reform Act of 1986 compressed the income tax rate brackets for trusts and estates. The Revenue Reconciliation Acts of 1990 and 1993 further compressed the rate brackets for these entities.

The General Explanation of the Tax Reform Act of 1986, prepared by the Joint Committee on Taxation (May 4, 1987, at page 1245) explained Congress' reasons for the initial compression of tax rates for trusts and estates. According to the report, “the prior rules ... permit reduction of taxation through the creation of entities that are taxed separately from the beneficiaries or the grantor of the trust or estate. This result arises because any retained income of the trust or estate was taxed to the trust or estate under a separate set of rate brackets ... from those of its grantor and beneficiaries.”<sup>41</sup> According to the report, Congress believed that it should eliminate or significantly reduce the benefits that result from the ability to split income between a trust or estate and its beneficiaries, and Congress accomplished this result by reducing the amount of income that a trust or estate may accumulate before it was taxed at the highest bracket.<sup>42</sup>

While the change in income tax rates was primarily aimed at trusts, estates were also subjected to the higher rates imposed on trusts. As a result, for the tax year 2021, the top tax rate of 37% applies to an individual who is married and filing separately only if his or her taxable income exceeds \$314,151. However, if that individual dies in 2021, his or her estate is subject to the top income tax rate of 37% on income in excess of \$13,050.

The net investment income tax places an additional burden on estates. Beginning in 2013, section 1411 imposes a tax of 3.8% on the lesser of net investment income or the excess of modified adjusted gross income over a threshold amount. For an individual who is married and filing separately, the threshold amount is \$125,000. Therefore, the net investment income tax would apply only if that individual has a modified adjusted gross income in excess of \$125,000. However, if that individual dies in 2021, his or her estate is subject to the 3.8% net investment income tax if the estate’s adjusted gross income exceeds \$13,050.

Certain trusts established for the benefit of disabled individuals have received special tax treatment since 2001. For years before 2018, section 642(b)(2)(C)(i) provides that qualified disability trusts may claim a personal exemption in the amount that is based on the personal exemption for individuals under section 151(d) (\$4,050 for 2017), rather than the \$300 or \$100 personal exemption allowed for regular trusts. Beginning in 2018 when the personal exemption is zero,

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<sup>41</sup> [The General Explanation of the Tax Reform Act of 1986](#), prepared by the Joint Committee on Taxation (May 4, 1987, at page 1245).

<sup>42</sup> *Ibid.*

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section 642(b)(2)(C)(iii) provides that the exemption amount is \$4,150 indexed for inflation (\$4,300 for 2021). This provision applies to taxable disability trusts described in 42 U.S.C. section 1396p(c)(2)(B)(iv) (relating to the treatment, for purposes of determining eligibility for medical assistance under the Social Security Act, of assets transferred to a trust established solely for the benefit of a disabled individual under 65 years of age). The Commissioner of Social Security must determine that all the beneficiaries of the trust are considered disabled for some portion of the year. A trust does not fail to meet this requirement merely because the corpus of the trust may revert to a person who is not disabled after the trust ceases to have any beneficiary who is disabled. While qualified disability trusts are entitled to an exemption considerably higher than the amount allowed to a regular trust, qualified disability trusts are subject to income tax and the tax on net investment income at the same rates as regular trusts.

**Description of Proposal**

Congress should restore the income tax rate/bracket schedule for estates to the pre-1986 approach, in which estates have the same income tax rate/bracket schedule as that applicable to the highest income tax rate/bracket schedule for individuals (i.e., the married filing separate income tax rate/bracket schedule). In addition, Congress should make the estate's threshold for imposition of the section 1411 net investment income tax the same as for married individuals filing separately (i.e., \$125,000). Congress also should treat qualified disability trusts described in section 642(b)(2)(C) as subject to income tax and the tax on net investment income as if the qualified disability trust were a married individual filing a separate return.

The proposal would subject estates and qualified revocable trusts for which the election under section 645 is made (collectively referred to as "estates" in this letter) and qualified disability trusts described in section 642(b)(2)(C) to income tax and the net investment income tax in the same manner as a married person filing a separate tax return.

We propose taxing estates in the same manner as a married person filing a separate tax return for income tax and net investment income tax purposes. This proposal would restore estates to the federal tax position they were in historically from 1954-1986. In addition, Congress should subject qualified disability trusts established for the benefit of disabled individuals to income tax and the net investment income tax in the same manner as a married person filing a separate tax return.

**Analysis**

Congress should adjust the income tax and net investment income tax rates/brackets applicable to estates. In order for an individual (taxed at the highest level as married filing separately) to reach the highest income tax rate of 37% in 2021, he or she would need to report taxable income in excess of \$314,151. As a result of this threshold, so-called lower to middle class individuals may never pay tax on any of their taxable income at that rate. However, once an individual dies, the individual's estate is subject to the income tax rate of 37% on its annual taxable income in excess of \$13,050. A married individual filing separately with taxable income of \$13,050 in 2021 would have a top income tax rate of 12%. Similarly, with respect to the section 1411 net investment income tax, no tax would apply on the individual's net investment income unless (in the case of a married individual filing a separate return) modified adjusted gross income exceeds \$125,000.

Therefore, many individuals will never reach the \$200,000 single, \$250,000 married filing jointly, and \$125,000 married filing separately thresholds and never pay the net investment income tax during their lifetimes, but because of the tax inequalities applicable to estates, this net investment income tax will almost certainly apply to their estates after their deaths. For purposes of these tax rates, Congress should treat estates as if they were a continuation of the deceased individual and tax them at the highest applicable individual rate.

An estate serves a unique role as being the successor to an individual for a limited period of time during which it winds up the affairs of the individual and then distributes the assets to the individual's heirs. The fiduciary of the estate is responsible for collecting all the assets of the decedent, paying off the decedent's creditors, filing federal and state estate tax returns, if necessary, and finally distributing the remaining assets to the beneficiaries. Unlike trusts, a person has to die in order to create the estate, and one individual cannot create multiple estates.

Unlike trusts that now can exist in perpetuity in some states, an estate is in existence for only a limited period of time. Most probate courts strive to expedite the collection and disposition of assets, frequently requiring explanations for any delay in distributing the assets and closing the estate. In addition, prolonging the administration of an estate is not an option, and it will not be considered as an estate for purposes of the IRC if the estate is unnecessarily kept open. Treasury Reg. §1.641(b)-3 provides that the executor cannot unduly prolong the period of administration of an estate. If the administration of the estate is unreasonably prolonged, the estate is considered terminated for federal income tax purposes after the expiration of a reasonable period for the performance by the executor of all the duties of administration. For qualified revocable trusts that the trustee elects to treat and tax as part of the estate under section 645, the statute itself provides a termination date for such treatment. Under section 645(b), the trustee can treat the qualified revocable trust as part of the estate for no longer than two years after the date of the decedent's death if the filing of a federal estate tax return is not required. If the filing of a federal estate tax return is required, the trustee can no longer consider the qualified revocable trust as part of the estate after six months after the date of the final determination of the estate tax liability.

The only way an estate could eliminate exposing the estate's income to the high income tax rates of section 1(e) and to the net investment income tax is by making distributions of current income to the estate's beneficiaries in order for the lower individual tax rates to apply. There are, however, numerous non-tax reasons that can serve to limit or prohibit the estate's fiduciary from making current distributions to beneficiaries. For example, an executor of an estate may not have the ability to distribute to beneficiaries because of the following reasons: (1) in some situations, the executor faces challenges in probating the will quickly; (2) the executor needs to retain the assets to pay specific bequests and debts (including income and estate taxes); (3) state law prohibits the executor from making distributions until after the claims period for debts expires (imposing personal liability on the executor) and some states require court approval prior to making any distributions; (4) executors of smaller estates frequently do not understand their fiduciary income tax filing responsibility and the income tax consequences of not distributing income before the end of the tax year or within the 65 day period following the close of the tax year; and (5) pending litigation or will contests delay the estate's closing. In addition to needing court approval for distributions, estates often cannot pay some necessary expenses (such as executor and attorney fees) until there is court approval. This additional judicial hurdle pushes most of the

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estate's income tax deductions into the final fiduciary return. Estates generally pay expenses and distribute assets to beneficiaries as soon as possible because all parties are anxious to complete the process and to close the estate. The federal tax laws should not penalize the estate and its beneficiaries by imposing very low thresholds before the highest income tax rate and the net investment income tax apply to the estate's temporarily retained income.

Because of their unique role as successor to an individual and because death is not viewed as an income tax planning option, estates are treated differently and more favorably than trusts in several important areas of the IRC. Estates are permitted to adopt a fiscal year, while trusts are required to use the calendar year under section 644(a). All estates are permitted as shareholders of an S corporation under section 1361(b)(1)(B), while only certain trusts described in section 1361(c)(2) are permitted S corporation shareholders. Estates are permitted a charitable deduction for amounts of gross income that pursuant to the terms of the governing instrument are permanently set aside for charitable purposes under section 642(c)(2). Since 1969, the IRC has not permitted this set-aside deduction for trusts. Rather, trusts are allowed a charitable deduction only if gross income is paid for a charitable purpose during the taxable year. Section 469(i) allows an individual to deduct up to \$25,000 of losses from rental real estate activities in which the individual actively participates. Under section 469(i)(4), this deduction is also permitted to the individual's estate for taxable years ending less than 2 years after the date of the individual's death. The throwback rules (sections 665-668, which taxed beneficiaries of trusts on distributions of accumulated income) were applicable only to trusts and not estates before they were repealed for domestic trusts in 1997. Because trusts and estates are not always treated the same for federal income tax purposes, there is no policy reason for Congress to treat them the same for purposes of the income tax rate schedule and the net investment income tax. Just as estates receive more favorable treatment than trusts in the cited situations above, allowing estates more favorable tax rates than trusts is justified because of the unique nature of estates.

Qualified disability trusts are frequently established by a parent or grandparent for the benefit of a disabled child. Often these trusts are funded at the death of the parent or grandparent. The assets are placed in trust because the child is not capable of handling the set aside funds personally. Congress concluded in 2001 that these trusts deserved the same treatment as individuals for purposes of the amount of the personal exemption. Congress should similarly treat these qualified disability trusts as individuals for purposes of the federal income tax rates and the net investment income tax. If all the income from the trust was distributed to the disabled individual, the individual – not the trust – would pay the income tax on the trust's income. It is very likely that the individual, who is taxed at the lower individual rates, would pay substantially less income tax on the trust's income than the trust would pay if no distributions were made. It is also very likely that the individual would owe no section 1411 tax on the net investment income because the individual's adjusted gross income is below the threshold amount. However, trustees make discretionary distributions from these trusts based on the needs of the disabled individuals and not to lower taxes. Because these trusts serve to manage funds for beneficiaries who are not capable of managing funds for themselves, Congress should treat these qualified disability trusts in the same manner as married individuals filing separately for purposes of the income tax rates and the section 1411 tax on net investment income.

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Conclusion/Recommendations

Congress should restore the income tax rate/bracket schedule for estates to the pre-1986 approach, in which estates have the same income tax rate/bracket schedule as that applicable to the highest income tax rate/bracket schedule for individuals (i.e., the married filing separate income tax rate/bracket schedule). In addition, Congress should make the estate's threshold for imposition of the section 1411 net investment income tax the same as for married individuals filing separately (i.e., \$125,000). Congress also should treat qualified disability trusts described in section 642(b)(2)(C) as subject to income tax and the tax on net investment income as if the qualified disability trust were a married individual filing a separate return.

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Proposal: Require Form 1099 reporting of interest and dividends paid to charitable remainder trusts and private foundations

**Present Law**

Section 6042 defines the conditions under which persons that pay dividends must report the payment of such dividends and identifying the person to whom such dividends were paid. This information return is [Form 1099-DIV](#), *Dividends and Distributions*. Section 6042(b)(2)(B) excludes from the definition of a reportable dividend “any distribution or payment . . . to any person described in section 6049(b)(4),” except to the extent otherwise provided in the regulations.

Similarly, section 6049 defines the conditions under which persons that pay interest must report the payment of such interest and identifying the person to whom such interest was paid. This information return is Form 1099-INT. Section 6049(b)(2)(B)(i) excludes from the definition of interest any amounts paid to a “person” described in section 6049(b)(4), except to the extent otherwise provided in the regulations.

A person described in section 6049(b)(4) includes trusts exempt from tax under section 664(c), i.e., charitable remainder trusts (section 6049(b)(4)(L)(i)) and private foundations (section 6049(b)(4)(B)). Thus, persons who pay dividends or interest to charitable remainder trusts and private foundations are not required to file Form 1099-DIV or Form 1099-INT with respect to those payments.

Under section 664(c)(1), a charitable remainder annuity trust or charitable unitrust (together “charitable remainder trusts”) and under section 501(a), a private foundation is exempt from the tax imposed by Subtitle A of the Code (i.e., income tax). However, the annuity or unitrust beneficiaries of a charitable remainder trust are generally taxed on the distributions they receive from the charitable remainder trust or private foundation. Under section 664(b), the character of those distributions is determined by assigning the trust’s income to one of three categories – ordinary income, capital gains, and other (tax-exempt) income. Reg. § 1.6641(d)(1)(i)(b) provides that income within each category is further assigned to a class within the category based on the tax rate applicable to that type of income. For example, non-qualified dividends are assigned to higher tax rate class than qualified dividends, as defined in section 1(h)(11).

The distributions from a charitable remainder trust and private foundations are treated as coming first from ordinary income, second from capital gains, third from other (tax-exempt) income, and finally from corpus. Within each category of income, distributions are treated as coming from income subject to the highest tax rate until the category is exhausted. For example, distributions are treated as carrying out non-qualified dividends before any qualified dividends are treated as distributed.

**Description of Proposal**

Congress should repeal section 6049(b)(4)(L)(i) to remove the exemption for reporting income payments to charitable remainder trusts and private foundations. Congress would then include

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charitable remainder trusts and private foundations among the recipients of interest and dividend payments to whom Form 1099-DIV and Form 1099-INT are issued.

### Analysis

Under current law, an investment firm is not required to issue tax reporting information to a charitable remainder trust. Accordingly, the trustee of the charitable remainder trust or private foundation is left to make tax character determinations without the benefit of the information that the investment firm has in its possession. For a private foundation, this information is only needed for the excise tax based on investment income. The balance of the analysis is for charitable remainder trusts. Without accurate information, the trustee may report too little or too much income of a given tax rate class to the annuity or unitrust beneficiaries, thereby causing the beneficiary to under-report or over-report income of a given type. Such under-reporting or over-reporting has the consequence of causing the beneficiary to overpay or underpay his or her individual income tax liability. In short, this proposal is essential to the fair and efficient administration of the tax system as it applies to charitable remainder trusts and their income beneficiaries.

This proposal will assist trustees of charitable remainder trusts to comply with the requirements of section 664(b) and the regulations thereunder. A trustee of a charitable remainder trust must maintain a set of records that assigns the income of the trust to the three categories and to tax-rate classes within each category for the purpose of reporting the character of distributions to annuity or unitrust beneficiaries. A trustee reports the tax character of the trust's distributions by issuing to each beneficiary a Schedule K-1 (Form 1041).

Many trustees of charitable remainder trusts and private foundations are individuals as opposed to corporate trustees. Consequently, many trustees invest the trust or foundation corpus in investment accounts at brokerage firms and mutual fund firms. Those firms are in the best position to know the proper tax classification of the income from securities in the portfolios they manage. A primary example of such a tax classification is the distinction between non-qualified ordinary dividends and qualified dividends described in section 1(h)(11).

Furthermore, the proposed reporting requirements will not trigger a significant administrative burden on the brokerage firms or mutual fund firms. These firms already comply with Form 1099 tax reporting for thousands of individuals and other trust or private foundation clients.

### Conclusion/Recommendation

We urge Congress to require information reporting of interest and dividends paid to charitable remainder trusts and private foundations in order to assist the trustees of these trusts in performing their duties

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Proposal: Modify Form 3520-A, *Annual Information Return of Foreign Trust With a U.S. Owner*, due date from March 15<sup>th</sup> to April 15<sup>th</sup>

Present Law

The [Form 3520-A](#) is due by the 15<sup>th</sup> day of the third month after the end of the trust's tax year (i.e., March 15<sup>th</sup> for a calendar year trust). An automatic six month extension is allowed by filing [Form 7004](#), *Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns*, by the due date (i.e., September 15<sup>th</sup> for a calendar year trust).

The original tax due date, for [Form 1041](#), is the 15<sup>th</sup> day of the fourth month following the close of the tax year (i.e., April 15<sup>th</sup> for calendar year taxpayers). Starting in 2017, the extended due date for Form 1041 is five and a half months after the original due date (i.e., September 30<sup>th</sup> for calendar year taxpayers).

Description of Proposal

Congress should change the Form 3520-A deadline to the April 15<sup>th</sup> due date of Form 1041. The current automatic extension of six months should remain in place.

Congress should instruct the Secretary of the Treasury or his delegate to expeditiously modify the appropriate regulations to provide that the due date of Form 3520-A, which is currently prescribed under Administrative authority, is changed from March 15<sup>th</sup> to April 15<sup>th</sup> (with a maximum six month extension to October 15<sup>th</sup>). We urge Congress to instruct the modification of the regulations to conform the original due date for Forms 3520-A to April 15<sup>th</sup> for calendar year end taxpayers (the 15<sup>th</sup> day of the fourth month for other taxpayers).

Suggested legislative language is:

“The due date of Form 3520-A, Annual Information Return of a Foreign Trust with a U.S. Owner, shall be the 15th day of the fourth month after the close of the trust’s tax year with a maximum extension of a 6-month period ending after the date prescribed for filing the return.”

Analysis

Foreign trusts are required to file Form 3520-A to report the annual information of a foreign trust with at least one U.S. owner. The form provides information about a number of parties, namely the foreign trust, its U.S. beneficiaries, and any U.S. person who is treated as an owner of any portion of the foreign trust under the grantor trust rules (sections 671 through 679).<sup>43</sup>

By changing the deadline for Form 3520-A to April 15<sup>th</sup>, Congress would align the due date with the general due date for trust income tax returns (i.e., Form 1041). For consistency purposes, Congress should provide that all tax returns for trusts, including the foreign trust information return, are due the 15<sup>th</sup> day of the fourth month after the trust year end (i.e., April 15<sup>th</sup>). Moreover,

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<sup>43</sup> See [instructions](#) to Form 3520-A.

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by keeping the current six-month automatic extension for Form 3520-A, it would provide taxpayers an additional two weeks past the extended deadline for Forms 1041. These additional two weeks would align the due date of Form 3520-A to the extended due date of individuals. Given that beneficiaries of trusts may report information from the Form 3520-A on an individual's income tax return due to the grantor trust rules found in Subchapter J of the Code, the additional two weeks provides additional time to ensure accuracy and consistency for reporting the taxpayer's reportable income.

**Conclusion/Recommendation**

We urge Congress to instruct the modification of the regulations to conform the original due date for Forms 3520-A to April 15<sup>th</sup> for calendar year end taxpayers (the 15<sup>th</sup> day of the fourth month for other taxpayers).

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Proposal: Provide an increase in the Alternative Minimum Tax (AMT) exemption and phaseout threshold for estates and trusts

**Present Law**

The Alternative Minimum Tax (AMT) was created by the Tax Reform Act of 1969 (P.L. 91-172) to prevent high-income taxpayers from avoiding income tax. This parallel income tax system requires high-income taxpayers to calculate their tax bill twice: once under the ordinary income tax system and again under the AMT. The taxpayer then needs to pay the higher of the two taxes.

The Tax Cuts and Jobs Act (P.L. 115-97), enacted in 2017, provides an increase in the AMT exemption and phaseout threshold for individuals and repeals the AMT for corporations. However, it does not mention any increase in the AMT exemption or phaseout threshold nor any repeal of AMT for estates and trusts.

Under prior law, for the 2017 tax year, the AMT exemption for single filers was \$54,300, began to phase out at \$120,700 of Alternative Minimum Taxable Income (AMTI) and was completely phased out at \$337,900; the AMT exemption for joint filers was \$84,500, began to phase out at \$160,900 of AMTI and was completely phased out at \$498,900. The AMT rate of 26% increased to 28% when AMTI exceeded \$191,500 for all individual taxpayers (\$95,750 for married filing separately).

Under the new law, the AMT exemption for single filers increases to \$73,600, begins to phase out at \$523,600 of AMTI and is completely phased out at \$818,000; the AMT exemption for joint filers increases to \$114,600, begins to phase out at \$1,047,200 of AMTI and is completely phased out at \$1,505,600. These changes are scheduled to sunset after 2025.

IRC section 55 allows an index for inflation each year for the exemption and phaseout threshold for individuals, estates and trusts. Additionally, on an annual basis, the IRS adjusts more than 40 tax provisions for inflation. The indexing for inflation is to prevent what is called “bracket creep,” when people are pushed into higher income tax brackets or have reduced value from credits or deductions due to inflation, instead of any increase in real income.

The increases for individuals under the new law mentioned above include more than an index for inflation. The increase in exemption is approximately 36% for both single filers and joint filers. The increase in the phaseout threshold is approximately 334% for single filers and 551% for joint filers.

For income tax purposes, both estates and trusts file a Form 1041 and must calculate and report AMT on Form 1041 Schedule I, AMT – Estates and Trusts. For estates and trusts in 2017, the threshold for the 28% AMT tax bracket was \$187,800. The AMT exemption was \$24,100, began to phaseout at \$80,450 of AMTI and was completely phased out at \$176,850. For 2021, under IRC section 55, these amounts are indexed for inflation and are as follows: \$199,900 for the threshold for the 28% AMT tax bracket, \$25,700 for the AMT exemption, \$85,650 of AMTI for the beginning of the phaseout threshold, and \$188,450 for completely phased out.

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**Description of Proposal**

Congress should provide an increase for the AMT exemption and phaseout threshold for estates and trusts.

**Analysis**

The Tax Cuts and Jobs Act eliminates the AMT for corporations and provides AMT relief for individuals. Estates and trusts are the only taxpayers who were not afforded any AMT relief in the Act. Congress should provide some AMT relief to estates and trusts because AMT relief was given to all other taxpayers. Therefore, Congress should increase the AMT exemption and phaseout applicable to estates and trusts.

**Conclusion/Recommendation**

Congress should increase the AMT exemption and phaseout threshold for estates and trusts.

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Proposal: Allow individual and fiduciary beneficiaries to roll-over retirement benefits within 60-days once per year similar to spouse beneficiaries

**Present Law**

The Internal Revenue Code allows rollover contributions of individual retirement account or annuity distributions to another eligible retirement plan within 60 days after receipt once per year.<sup>44</sup> In addition, a surviving spouse of a qualified plan also has a rollover option.<sup>45</sup> However, these tax provisions are currently not available to non-spouse beneficiaries, including trust beneficiaries.<sup>46</sup>

**Description of Proposal**

Congress should allow individual and fiduciary beneficiaries to roll-over retirement benefits within 60-days once per year similar to spouse beneficiaries.

We propose amending the statute to remove the “Denial of Rollover Treatment for Inherited Accounts” provision. By removing this limitation, all beneficiaries would have the ability to avoid errors and make appropriate changes as required.

**Analysis**

At the death of an IRA owner or qualified plan participant, it is necessary for the named beneficiary to have retirement benefits transferred to a new account. Generally, this would be an inherited IRA. The retirement benefit transfer is not the only duty that the decedent’s representative must handle as a result of the death, and it is not uncommon that mistakes are made in moving benefits to the beneficiaries. This situation is especially difficult when a trust is named as the IRA beneficiary because the trustee must first have benefits transferred to an inherited IRA for the trust, then comply with trust agreement provisions to distribute benefits in separate inherited IRAs for each trust beneficiary or establish new inherited IRAs for sub-trusts. Efforts to short cut the transfer from the decedent to the ultimate beneficiaries often result in pushback from custodians.

Pre-SECURE Act regulations do not require custodians to assist IRA beneficiaries with compliance after an inheritance. This situation contributes to the errors made in trying to comply with the decedent’s wishes in allocating retirement benefits to loved ones. Often, the IRA investments chosen by the decedent are not appropriate for the younger beneficiary, requiring additional considerations when investing the account. Allowing a once-per-year rollover would allow individual or fiduciary beneficiaries to correct mistakes that lead to unwanted tax results.

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<sup>44</sup> IRC section 408(d)(3).

<sup>45</sup> IRC section 402(c)(9).

<sup>46</sup> IRC section 408(d)(3)(C).

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**Conclusion/Recommendation**

Congress should allow individual and fiduciary beneficiaries to roll-over retirement benefits within 60-days once per year similar to spouse beneficiaries.

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Proposal: Adjust for inflation the \$100,000 Form 3520, *Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts*, reporting threshold for foreign gifts received by a U.S person and the \$13,000 estate tax credit for deceased nonresidents to file Form 706-NA, *United States Estate (and Generation-Skipping Transfer) Tax Return (Estate of nonresident not a citizen of the U.S.)*

**Present Law**

Section 6039F(a) states that if the value of the aggregate foreign gifts received by a U.S. person in a taxable year exceeds \$10,000, the U.S. person must report the information regarding each foreign gift received in the year as prescribed by the Secretary. Section 6039F(d) requires a cost-of-living adjustment to the \$10,000 amount for any taxable year beginning after December 31, 1996. Section 6039F(e) grants the Treasury Secretary the authority to prescribe regulations to carry out the purposes of this section.

IRS Notice 97-34 states:

For purposes of determining whether the receipt of a gift from a foreign person is reportable, Treasury and the Service have determined that different reporting thresholds are warranted for gifts received from nonresident alien individuals, foreign estates, foreign partnerships, and foreign corporations. Accordingly, it is expected that Form 3520 will apply the following reporting thresholds and requirements:

1. Gifts from foreign individuals and foreign estates.

*A U.S. person is required to report the receipt of gifts from a nonresident alien or foreign estate only if the aggregate amount of gifts from that nonresident alien or foreign estate exceeds \$100,000 during the taxable year. Once the \$100,000 threshold has been met, it is expected that Form 3520 will require the donee to separately identify each gift in excess of \$5,000 but will not require the identification of the donor. (Emphasis added.)<sup>47</sup>*

Section 2102 provides a credit against tax relating to gift tax and tax on prior transfers. Specifically, section 2102(b) provides a credit of \$13,000 in general, and for nonresidents that are not a citizen of the United States a credit of the greater of \$13,000 or that proportion of \$46,800 which the value of that part of the decedent's gross estate which at the time of his death is situated in the United States bears to the value of his entire gross estate wherever situated. These credit amounts were enacted in 1988. If indexed for inflation, the \$13,000 would be \$30,000 in 2021.

Section 6018(a)(2) requires a nonresident who is not a citizen of the United States and has a gross estate situated in the United States greater than \$60,000 to file an estate tax return.

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<sup>47</sup> IRB 1997-25, Section VI. U.S. Recipients of Foreign Gifts, B. Reporting Thresholds.

Description of Proposal

Congress should enact legislation raising the reporting threshold for foreign gifts to nonresident individual U.S. persons and the estate tax credit for nonresidents who are not citizens of the United States, taking into account inflation since the most recent year the thresholds were modified or enacted. The reporting threshold should continue to be adjusted for inflation in subsequent years. This measure would reduce burdensome reporting requirements. Specifically, we propose that Congress raise the reporting threshold for the credit in section 2102(b) to be indexed for inflation and then reference the amount in section 2102(b) as the threshold for filing the Form 706-NA, including the filing threshold for deceased nonresidents who are not citizens of the United States. We recommend indexing the reporting and filing threshold to keep pace with inflation beginning with the most recent year the thresholds were enacted and continuing in subsequent years.

The sections 2012(b) (providing two possible versions), 6018(a)(2), 6039F(a), and 6039F(a) red-line suggested edits are (inserted text in *italics*):

**2102(b) Unified credit (1) In General**

A credit of \$13,000 *indexed for inflation from 1988 and annually indexed for inflation thereafter* shall be allowed against the tax imposed by section 2101. (2) Residents of possessions of the United States. In the case of a decedent who is considered to be a “nonresident not a citizen of the United States” under section 2209, the credit under this subsection shall be the greater of-

- (A) \$13,000 *indexed for inflation from 1988 and annually indexed for inflation thereafter*, or
- (B) that proportion of \$13,000 *indexed for inflation from 1988 and annually indexed for inflation*, which the value of that part of the decedent’s gross estate which at the time of his death is situated in the United States bears to the value of his entire gross estate wherever situated.

or

**2102(b) Unified credit (1) In General**

A credit of \$13,000-\$30,000 *and annually indexed for inflation* shall be allowed against the tax imposed by section 2101. (2) Residents of possessions of the United States. In the case of a decedent who is considered to be a “nonresident not a citizen of the United States” under section 2209, the credit under this subsection shall be the greater of-

- (A) \$13,000-\$30,000, *and annually indexed for inflation*, or
- (B) that proportion of \$46,800-\$105,600, *and annually indexed for inflation*, which the value of that part of the decedent’s gross estate which at the time of his death is situated in the United States bears to the value of his entire gross estate wherever situated.

**6018(a)(2) NONRESIDENTS NOT CITIZENS OF THE UNITED STATES**

In the case of the estate of every nonresident not a citizen of the United States if that part of the gross estate which is situated in the United States exceeds \$60,000 *the section 2102(b) gross estate equivalent amount*, the executor shall make a return with respect to the estate tax imposed by subtitle B.

#### **6039F(a) IN GENERAL**

If the value of the aggregate foreign gifts received by *an individual who is* a United States person (other than an organization described in section 501(c) and exempt from tax under section 501(a)) during any taxable year exceeds **\$100,000 and that threshold is indexed for inflation from 1974 and annually**, such United States person shall furnish (at such time and in such manner as the Secretary shall prescribe) such information as the Secretary may prescribe regarding each foreign gift received during such year. *If the value of the aggregate foreign gifts received by a United States person (other than an individual or other than an organization described in section 501(c) and exempt from tax under section 501(a)) during any taxable year exceeds \$10,000 and that threshold is indexed for inflation from 1974 and annually, such United States person shall furnish (at such time and in such manner as the Secretary shall prescribe) such information as the Secretary may prescribe regarding each foreign gift received during such year.*

#### **6039F(d) COST-OF-LIVING ADJUSTMENT**

In the case of any taxable year beginning after December 31, ~~1996~~**2021**, the \$10,000 amount under subsection (a) shall be increased **to \$100,000 for individuals and increased for all taxpayers** by an amount equal to the product of such amount and the cost-of-living adjustment for such taxable year under section 1(f)(3), except that subparagraph (A)(ii) thereof shall be applied by substituting “~~2020~~**1995**” for “2016”.

#### Analysis

IRS Notice 97-34 increased the reporting threshold for foreign gifts from \$10,000 to \$100,000. The Notice was issued under the authority granted by section 6039F(d) and section 6039F(e), to increase the reporting threshold as part of the ability to carry out the purposes of the statute. There have not been any legislative changes or additional increases since Notice 97-34 was issued. The amounts set forth in section 6039F(a) and section 6039F(d) should be changed to \$100,000 for individuals, which is the same amount as IRS provided in Notice 97-34, and that amount should be indexed for inflation since 1974 and annually, and the \$10,000 should continue to be indexed for inflation since 1974 and annually for all taxpayers others than individuals.

The estate tax return filing threshold for deceased nonresidents has not been modified or increased by Congress since section 2102(b) and section 6018(a)(2) were enacted. This lack of increase in the threshold has led to an extreme disparity between the exemption for a non-resident, non-citizen (NRNC) and a US resident of \$11,640,000 (\$11,700,000 vs. \$60,000) for 2021. In addition, this lack of increase in the threshold leads to NRNCs who have modest estates (such a small stock portfolio) to owe US estate tax even if there is no other connection to the US. This lack of increase in the threshold also leads to additional expense from an already modest estate in preparing the transfer certificate and Form 706-NA in order to transfer the stock to the heirs.

Congress should index the reporting and filing threshold for inflation to keep pace with the changing value of the dollar and reduce burdensome filing requirements for taxpayers that were not intended to be part of the scope of the original legislation.

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**Conclusion/Recommendation**

We encourage Congress to enact legislation raising the reporting threshold for the credit against tax relating to gift tax and tax on prior transfers and the estate filing threshold for nonresidents who are not citizens of the United States and foreign gifts to U.S. persons, taking into account inflation since the most recent year the thresholds were modified or enacted. We would request that the reporting threshold continue to be adjusted for inflation in subsequent years. This measure would reduce burdensome reporting requirements.

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Proposal: Provide that the statute of limitations with respect to the inclusion ratio for generation-skipping transfers begins with the reporting of the initial transfer on Form 709, *United States Gift (and Generation-Skipping Transfer) Tax Return*

**Present Law**

In general, section 6501(a) states that the amount of tax imposed shall be assessed within three years after a return is filed or three years after the due date of the return, whichever is later. There are exceptions that may extend the assessment period.

Section 6019 requires that an individual who makes any transfer by gift and is not excepted, shall make a return for such year with respect to the gift tax imposed by subtitle B.

Per Reg § 25.6019-1(a), transfers by gift with certain exceptions, must file a gift tax return, Form 709, for that calendar year.

Generation-skipping transfers are a transfer of income or principal to a beneficiary assigned to a generation at least two generations below the transferor's generation. Section 2611(a) defines generation-skipping transfers as either a (1) taxable distribution, (2) taxable termination, or (3) a direct skip.

In 1995, the Treasury issued final generation-skipping transfer tax regulations. Reg. § 26.2662-1(b)(1) and Reg. § 26.2662-1(b)(2) detail the filing requirements for taxable distributions and taxable terminations. IRS Form 706-GS(D), *Generation-Skipping Transfer Tax Return for Distributions*, or 706-GS(T), *Generation-Skipping Transfer Tax Return For Terminations*, must be filed when there is a taxable distribution and Form 706(GS)(T) must be filed when there is a taxable termination.

Reg. § 26.2642-5 covers the Finality of Inclusion Ratio. Reg. § 26.2642-5(b) states that for taxable distributions and terminations, the inclusion ratio is final on the later of (1) the expiration of the period for assessment with respect to the first GST tax return filed using that inclusion ratio or (2) the expiration of the period for assessment of Federal estate tax with respect to the estate of the transferor. If an estate tax return is not required to be filed, the period for assessment is determined as if a return were required to be filed and was timely filed.

**Description of Proposal**

Congress should enact legislation allowing for the statute of limitations with respect to the inclusion ratio for generation skipping transfers to begin for all generation-skipping transfers, including taxable terminations and taxable distributions, when the initial transfer is reported on IRS Form 709.

Congress should revise Reg § 26.2642-5 that requires the statute of limitations to start with the filing of either Form 706-GS(D) or 706-GS(T) for taxable distributions and terminations, instead allowing for the statute of limitations to begin when the initial transfer is reported on Form 709.

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**Analysis**

The current law causes unnecessary complexity and adds an additional burden to administrators of estates as they must keep track or uncover information on generation-skipping transfers that occurred many years in the past but did not have the statute of limitations initiated as IRS Form 706-GS(D) or IRS Form 706-GS(T) had not been filed yet or was not filed at all. This situation leads to the use of estimates and incorrect data for the filing of estate tax returns.

For example, if a Form 709 was filed that claimed a \$5 million GST allocation to a \$5 million gift to a trust, the trust would have an inclusion ratio of 0 and be fully exempt. If it is later discovered that the full \$5 million GST exemption was not available at the time the Form 709 was filed due to prior unreported gifts to life insurance trusts that may have inadvertently had automatic allocation of GST, the trust would not be fully exempt. But this may not be discovered until many years after the initial gift to the trust - most likely at the donor's death. This situation allows for uncertainty to remain for many years after a return was filed in good faith and causes administrative complexity to resolve the issue.

By starting the statute of limitations with the filing of Form 709 that reports the initial transfer, there would be certainty to the amounts used on subsequent tax filings. The proposal would finalize the inclusion ratio, removing uncertainty in the future for estate administrators.

**Conclusion/Recommendation**

We recommend that Congress enact legislation allowing for the statute of limitations with respect to the inclusion ratio for generation skipping transfers begin when the initial transfer is reported on Form 709.

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Proposal: Modernize section 642(h) to include carryover items that are not currently addressed and may have not existed at the time legislation was originally enacted

**Present Law**

When a trust or estate terminates it may have the following deductions: net operating loss under section 172; capital loss under section 1212; and deductions in excess of gross income not part of a net operating loss or capital loss. IRC section 642(h) outlines the treatment for these deductions upon the termination of a trust or estate.

Generally, when trusts or estates that terminate have deductions in excess of income, they do not pass through to beneficiaries. There are a few exceptions that are addressed by section 642(h). Per 642(h)(1), a net operating loss carryover under section 172 or a capital loss carryover under section 1212 that remain after termination will carry forward for the beneficiary who receives the property that generated the loss carryforward and allowed as deductions to the beneficiary in the year of termination. Section 642(h)(2) allows for deductions, other than net operating losses and capital losses, in excess of gross income for terminating trusts and estates to be allowed as a deduction to beneficiaries succeeding the property of the estate or trust in the year of termination.

**Description of Proposal**

Congress should modernize section 642(h) to provide clear guidance on the treatment of various carryover losses and credits for terminating trusts and estates.

Specifically, section 642(h) should be modernized to include carryover items that are not specifically addressed and may not have existed at the time legislation was enacted. Examples of carryforward items that may be addressed by expanding section 642(h) include but are not limited to the following:

- Losses that are suspended due to at-risk limitations under section 465
- Losses that are suspended due to passive activity rules under section 469
- Losses that are suspended due to depletion rules under section 613
- Investment interest expense
- Excess business interest expense limited under section 163(j)
- Qualified Business Income loss carryovers under section 199A
- Foreign Tax Credits
- Alternative Minimum Tax Credits

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**Analysis**

Under current law, fiduciaries and estate administrators of terminating trusts and estates are provided guidance on treatment of only a handful of carryover items. Section 642(h) does not specifically address different losses and credits that a terminating trust or estate may incur. Without proper guidance, fiduciaries and estate administrators may err on treatment of carryforward and credit items. As many of these items did not exist at the time that section 642(h) was enacted, it is not clear there was an intent to exclude the beneficiary from being able to take advantage of deductions that the trust was not able to fully utilize.

As an example, if there are losses suspended under section 613 and the asset that generated the loss is then distributed out to the beneficiary upon the trust's termination, it would seem that the loss should follow the asset.

We note that the disposition of passive activity losses may be covered by section 469(j)(12) for “normal” trust terminations. However, there are some other code sections that reference section 642(h) (such as when an electing small business trust (ESBT) terminates), and it is not clear that section 469(j)(12) would apply if the assets stay in the trust. In that situation, it would be helpful for section 642(h) to reference passive activity losses so it is clear that suspended losses continue in the non-ESBT.

**Conclusion/Recommendation**

We recommend that Congress enact legislation allowing for the statute of limitations with respect to the inclusion ratio for generation skipping transfers begin when the initial transfer is reported on Form 709.

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Proposal: Allow estates and trusts to elect section 179 expensing by repealing section 179(d)(4)

**Present Law**

Generally, section 179 allows the immediate deduction of certain depreciable business assets. The statute provides limitations on the amount of the deduction, type of property qualified, and taxpayers eligible to use the deduction, as well as a prohibition against use to create a loss. This section has largely been disappeared from use due to the availability of bonus depreciation under section 168(k) that has very few restrictions.

Bonus depreciation is scheduled to sunset after 2026. Should this occur, the section 179 expensing election will return as the primary small business depreciation benefit. Partnerships and S corporations are eligible under section 179 but are disallowed from allocating the expense to an estate or ineligible trust. Estates and trusts are ineligible to elect section 179 expensing.<sup>48</sup> Bonus depreciation, by contrast, is fully available to estates and trusts of all types.

Section 179(d)(4) is complicated by the fact that all “trusts” are not considered to be trusts for purposes of section 179(d)(4) because other statutes provide that the trust itself is not considered the owner of the asset in trust. Grantor trusts are a common example.<sup>49</sup> Consequently, some partners and S corporation shareholders are eligible to receive the potential section 179 expensing election benefit while the partners and S shareholders who are estates or ineligible trusts may not.

**Description of Proposal**

The AICPA recommends repealing section 179(d)(4).

**Analysis**

A good principle for fair tax administration is to periodically revalidate underlying assumptions. Changes in commerce, societal norms, other statutes, regulations, and case law can be a reason to revisit an underlying assumption. This approach is supported by a legal maxim that where the reason for a law ceases, the law itself ceases.<sup>50</sup>

First enacted in 1958, section 179 provided a \$10,000 immediate expensing election for estates but excluded trusts. In 1981, estates became ineligible to elect section 179 expenses. The legislative history is silent regarding this change to estates. Enacted in 2002, section 168(k) provided for 30% bonus depreciation and estates and trusts were eligible taxpayers to claim this deduction. Gradually, the bonus depreciation percentage increased to 100%, and no restrictions were placed on estates and trusts. Repealing section 179(d)(4) properly aligns the section 179 expensing and section 168(k) bonus depreciation elections.

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<sup>48</sup> Section 179(d)(4).

<sup>49</sup> See section 671-section 679.

<sup>50</sup> *Cessante ratione legis, cessat et ipsa lex.*

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For example, uncertainty exists regarding the non-expensed portion of a newly purchased asset. Regulation § 1.179-1(f)(3) attempts to provide a solution by allowing partnerships and S corporations to depreciate the portion of property otherwise expensed. However, the regulation does not provide any authority to allocate this depreciation to those partners and S corporation shareholders who did not receive the allocated deduction. In addition, the receipt of a nondeductible expense item decreases the trust's basis without an offsetting tax benefit.

Partnerships and trusts must have accurate, timely information as to what type of trust is an owner of their organization. Changes in the type of trust during the year will change the section 179 deduction allocation and computation of depreciation on the portion of cost basis allocable to the estate and trust owners. Unknown changes in trust status affecting the section 179 eligibility of partners increases the administrative burden exponentially for partnerships subject to the centralized partnership audit regime due to the complex administrative adjustment request (AAR) process.

Partnerships may address this disparate allocation treatment if the partnership agreement provides for special allocations. However, the ability of an S corporation to adequately address the disparity is much more questionable and may introduce a prohibited second class of stock.

The interplay between section 179(d)(4) and the deduction allocation rules for partnerships and S corporations introduces unneeded complication, especially for small businesses who benefit from the current section 168(k) bonus depreciation rules.

Conclusion/Recommendation

Congress should repeal section 179(d)(4) to allow estates and trusts to elect section 179 expensing.

# **Corporations & Shareholders**

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Proposal: Provide small business relief by creating a *de minimis* threshold for applying the section 382 loss limitation rules

**Present Law**

Section 382 limits a loss corporation's ability to use its tax net operating losses (NOLs) and tax attribute carryforwards following an ownership change. Loss corporations that undergo an ownership change may also have limitations placed on their ability to utilize certain future losses that arise if the company is in a net unrealized built-in loss position at the time of the ownership change under section 382(h). Section 382(h)(3)(B)(i) provides that a loss corporation with a net unrealized built-in gain or net unrealized built-in loss that is not greater than the lesser of i) 15% of the fair market value of the assets or ii) \$10,000,000 does not have a net unrealized built-in gain or built-in loss.

Congress enacted section 382 to prevent the trafficking of tax attributes where one corporation acquired all of the stock, or a controlling interest, in a corporation with NOLs in hopes of using such losses to offset future taxable income generated by the acquiring or target corporations. To prevent such abuse, Congress enacted section 382 to police such transactions by causing a limitation upon the amount of future taxable income that could offset NOL carryforwards or certain losses recognized after an ownership change that existed immediately before the acquisition.

**Description of Proposal**

Create a *de minimis* threshold for loss corporations' NOLs, section 163(j) carryforwards, and the application of section 383 to create parity with the *de minimis* rule already applicable for net unrealized built-in losses contained in section 382(h)(3)(B)(i) and provide them with relief from the myriad of complex section 382 rules.

**Analysis**

Section 382 provides a complex set of rules that limits a loss corporation's ability to use its operating losses and tax attribute carryforwards. All taxpayers, both large public companies and small loss corporations, are faced with the same complex set of rules. Many loss corporations generally need to consult with a tax advisor with specialized knowledge of the section 382 rules. In many cases, for small businesses in particular, the cost of hiring such an advisor to apply the complex section 382 rules outweighs the value of applying the tax loss to offset future taxable income. The complexity and consequences of section 382 has led some companies with tax attributes down a road that does not appear to be in concert with what Congress intended when section 382 was enacted.

Extending the existing *de minimis* threshold to NOLs, section 163(j) carryforwards, and the application of section 383 would eliminate some of the burden and provide simplification to more small loss corporations.

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**Conclusion/Recommendation**

Create a *de minimis* threshold for loss corporations' NOLs, section 163(j) carryforwards, and the application of section 383 to create parity with the *de minimis* rule already applicable for net unrealized built-in losses contained in section 382(h)(3)(B)(i) and provide them with relief from the myriad of complex section 382 rules.

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Proposal: Provide clarification regarding what it means to be “under the jurisdiction of the court” versus “in bankruptcy” under section 382(l)(5)(A)

**Present Law**

Section 382(l)(5)(A) creates an exception to the application of the general section 382(a) limitation rules<sup>51</sup> for a corporation that undergoes an ownership change triggered by the issuance of stock to creditors in connection with certain bankruptcy proceedings (commonly referred to as the “bankruptcy exception”).

Two statutory requirements must be satisfied in order to qualify for the section 382(l)(5)(A) bankruptcy exception:

1. Pursuant to section 382(l)(5)(A)(i), the loss corporation must be *“under the jurisdiction”* of the court in a title 11 or similar case immediately before such ownership change, and
2. Pursuant to section 382(l)(5)(A)(ii), historic shareholders and “qualified creditors” of the loss corporation must own at least 50% of the loss corporation (or stock of a controlling corporation if also *“in bankruptcy”*) following the ownership change. (Emphasis added).

However, it is unclear what constitutes being “under the jurisdiction of the court” and “in bankruptcy” and whether there is a difference between being “under the jurisdiction of the court” (as referenced in section 382(l)(5)(A)(i)) versus being “in bankruptcy” (as referenced in section 382(l)(5)(A)(ii)).

**Description of the Proposal**

Provide clarification under section 382(l)(5)(A) as to when a corporation is considered to be under the jurisdiction of the court and to be in bankruptcy, and whether there is a difference between a corporation being “under the jurisdiction of the court” (as referenced in section 382(l)(5)(A)(i)) versus being “in bankruptcy” (as referenced in section 382(l)(5)(A)(ii)).

**Analysis**

Pursuant to section 382(l)(5)(F), the meaning of a “title 11 or similar case” is determined under section 368(a)(3)(A) and includes Chapter 11 bankruptcy cases, as well as receiverships, foreclosures, and similar proceedings in a federal or state court.

Legislative history expressly provides that the section 382(l)(5)(A) bankruptcy exception is only available if a stock-for-debt exchange, reorganization, or other transaction resulting in an ownership change is ordered by the court or is pursuant a plan approved by the court.<sup>52</sup> This stated

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<sup>51</sup> As noted above, section 382 limits a corporation’s ability to use NOLs and certain other tax attributes (e.g., built-in losses, capital loss carryovers, tax credit carryovers, section 163(j) disallowed interest carryovers) following an “ownership change” (as defined by section 382(g)).

<sup>52</sup><sup>52</sup> See 1986 Conference Report, at II-192. See also 1986 Bluebook, at p. 322.

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legislative intent was subsequently restated and codified in Reg. Sec. 1.382-9(a), which provides that “section 382(l)(5) . . . may apply to an ownership change which occurs in a title 11 or similar case (as defined in section 368(a)(3)(A)) if the transaction resulting in the ownership change is ordered by the court or is pursuant to a plan approved by the court.”

One example of the current certainty involves consolidated groups in which certain members may be non-debtors but still be part of an overall reorganization plan and, thereby, subject to the court-approved/confirmed bankruptcy plan. As a result, there is some uncertainty as to whether the entire consolidated group or just the debtors are “under the jurisdiction of the court” (section 382(l)(5)(A)(i)). Additionally, even if the non-debtors are under the jurisdiction of the court, there is further uncertainty as to whether those entities are “in bankruptcy” (as referenced in section 382(l)(5)(A)(ii)). Linguistically, being “under the jurisdiction of the court” is potentially broader than being “in bankruptcy”. The difference in language between sections 382(l)(5)(A)(i) and 382(l)(5)(A)(ii) creates confusion relative to the applicability of the section 382(l)(5)(A) bankruptcy exception in situations.

This issue arises frequently in several contexts where stock of non-debtor members is utilized as part of a court-approved reorganization plan, including (without limitation): issuance of stock of a newly formed subsidiary that becomes the new loss corporation’s parent and issuance of common parent company stock in connection with a court-approved/confirmed plan in situations where consolidated subsidiaries are debtors in the Chapter 11 proceedings but the common parent company is not actually a Chapter 11 debtor.

Providing clarification regarding the meaning of “under the jurisdiction of the court” (section 382(l)(5)(A)(i)) and “in bankruptcy” (section 382(l)(5)(A)(ii)) would eliminate confusion, simplify administration, and ensure consistent application of the section 382 bankruptcy provisions to common fact patterns that arise in consolidated group contexts.

**Conclusion/Recommendation**

Provide clarification under section 382(l)(5)(A) as to when a corporation is considered to be under the jurisdiction of the court and to be in bankruptcy, and whether there is a difference between a corporation being "under the jurisdiction of the court" (as referenced in section 382(l)(5)(A)(i)) versus being "in bankruptcy" (as referenced in section 382(l)(5)(A)(ii)).

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Proposal: Provide small businesses relief by creating a *de minimis* threshold for applying the section 384 loss limitation rules

**Present Law**

Section 384 limits the use of certain preacquisition losses and other tax attributes when a corporation acquires control of another corporation or acquires the assets of another corporation in an A, C, or D reorganization. If one of the corporations has a net unrealized built-in gain, then any income attributable to the unrealized built-in gain cannot offset preacquisition losses of the other corporation to the extent that such gain is recognized within the five-year period after the date of the acquisition. Section 384(c)(8), by reference to section 382(h)(3)(B)(i), provides that a corporation with a net unrealized built-in gain or net unrealized built-in loss that is not greater than the lesser of i) 15% of the fair market value of the assets or ii) \$10,000,000 does not have a net unrealized built-in gain or built-in loss.

Similar to the purpose of section 382 to prevent the trafficking of tax attributes, section 384 was intended to address certain abusive transactions, namely those involving burnt-out leasing tax shelters. Congress enacted section 384 to prevent a loss corporation from using its losses or other attributes to shelter built-in gains of another corporation that are recognized within the statutory period. Section 384 applies concurrently with section 382, subjecting a transaction to the complex loss limitation rules of section 382 in addition to those under section 384.

**Description of Proposal**

Create a *de minimis* threshold for preacquisition losses under section 384 to create parity with the *de minimis* rule already applicable section 382(h)(3)(B)(i) through section 384(c)(8) and provide relief from the burdensome compliance with section 384.

**Analysis**

Section 384 limits an acquiring corporation's ability to use preacquisition losses and tax attributes of its own or of a target corporation against gains subsequently recognized on sales of the other corporation's assets to the extent of unrealized appreciation in the assets at the time of the acquisition. The restriction applies to all taxpayers, whether a large public company or a small corporation, and generally requires the costly assistance of a specialized tax advisor. Furthermore, section 384's application extends well beyond the shelter transactions with which Congress was originally concerned.

Extending a *de minimis* threshold to preacquisition losses would reduce the burdens of section 384 compliance for many small corporations. Such a change could be designed so that it would not lead to an increase of the type of abusive transactions Congress was concerned upon enactment. In addition, the change is consistent with the proposed change above related to section 382.

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**Conclusion/Recommendation**

Create a *de minimis* threshold for preacquisition losses under section 384 to create parity with the *de minimis* rule already applicable section 382(h)(3)(B)(i) through section 384(c)(8) and provide relief from the burdensome compliance with section 384.

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Proposal: Treat disallowed interest carryforwards as attributes subject to section 108(b)(2)

**Present Law**

Under the TCJA taxpayers are allowed to carryover disallowed interest deductions indefinitely.<sup>53</sup> However, it is not clear if disallowed interest carryforwards under section 163(j) constitute an attribute that is subject to reduction under section 108(b).

**Description of the Proposal**

Disallowed interest carryforwards should be attributes subject to section 108(b)(2).

**Analysis**

Generally, income from the cancellation of indebtedness (CODI) is included in gross income under section 61(a)(11). However, section 108(a) permits certain taxpayers to exclude CODI from gross income to the extent of their insolvency or bankruptcy (“excluded CODI”).<sup>54</sup> In exchange for avoiding CODI, section 108(b) requires that taxpayers reduce specified tax attributes to the extent of the excluded CODI. In particular, section 108(b)(2) provides that the following attributes are reduced in the following order:

- Any NOL for the year of the discharge and any NOL carryover to such year;
- Any carryover to or from the taxable year of a discharge of an amount allocable for purposes of determining the amount allowable as a general business credit under section 38;
- The amount of minimum tax credit available under section 53(b) as of the beginning of the taxable year immediately following the taxable year of the discharge;
- Any net capital loss for the taxable year of the discharge, and any capital loss carryover to such taxable year under section 1212;
- The basis of the property of the taxpayer;
- Any passive activity loss or credit carryover of the taxpayer under section 469(b) from the taxable year of the discharge; and
- Any carryover to or from the taxable year of the discharge for purpose of determining the amount of the credit allowable as a foreign tax credit under section 27.

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<sup>53</sup> Section 163(j)(2).

<sup>54</sup> Section 108(a)(1) and (3).

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The legislative history to section 108(b)(2) explains:

In developing the rules of the bill, the committee recognized that the basis-reduction mechanism of present law fails to effectuate the Congressional intent of deferring, but eventually collecting tax on, ordinary income realized from debt discharge.

Thus, present law permits both solvent and insolvent taxpayers to apply the amount of their discharged debt to reduce the basis of non-depreciable assets that may never be sold, such as stock in a subsidiary corporation or the land on which the company operates its business, thereby avoiding completely, rather than deferring, the tax consequences of debt discharge. . .<sup>55</sup>

Accordingly, the rules of the bill are intended to carry out the Congressional intent of deferring, but eventually collecting within a reasonable period, tax on ordinary income realized from debt discharge. Thus, in the case of a bankrupt or insolvent debtor, the debt discharge amount is applied to reduce the taxpayer's NOL and certain other tax attributes, unless the taxpayer elects to apply the amount first to reduce basis in depreciable assets.<sup>56</sup>

The legislative history also provides for the following:

Any amount of debt discharge which is left after attribute reduction under these rules is disregarded (i.e., does not result in income or have other tax consequences).<sup>57</sup>

Over time, Congress has added attributes and removed attributes from the list in section 108(b)(2).<sup>58</sup> The TCJA did not add disallowed interest carryforwards to the list of attributes in section 108(b)(2).<sup>59</sup>

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<sup>55</sup> Under the law at the time, “a debtor which would otherwise be required to report current income from debt cancellation under the preceding rules instead may elect to reduce the basis of its assets . . .” H.R. Rep. No. 96-833, at 7 (Mar. 19, 1980) (House Report accompanying the Bankruptcy Tax Act of 1980 (P.L. 96-589)).

<sup>56</sup> H.R. Rep. No. 96-833, at 9 (Mar. 19, 1980).

<sup>57</sup> S. Rep. No. 96-1035, at 13 (Nov. 23, 1980) (Senate Report accompanying the Bankruptcy Tax Act of 1980 (P.L. 96-589)).

<sup>58</sup> See e.g., P.L. 103-66 (adding the minimum tax credit under section 53 to the list of attributes available for reduction under section 108(b)(2) as well as the passive activity loss under section 469(b)); P.L. 98-369 (removing credit carryovers under former section 38 (relating to investment in certain depreciable property), former section 40 (relating to expenses of work incentive programs), former section 44B (relating to credit for employment of certain new employees), former section 44E (relating to alcohol used as a fuel) and former section 44F (relating to credit for increasing research activities)).

<sup>59</sup> In contrast, the TCJA added disallowed interest carryforwards to the list of attributes in section 381(c). Section 381(c)(20). Similar to section 108(b)(2), section 381(c) sets forth a list of tax attributes (including NOLs), each of which carry over to the acquiring corporation in a liquidation qualifying under section 332 or an acquisitive asset reorganization under section 368. Section 381(a).

The TCJA also amended the definition of pre-change loss in section 382 to include disallowed interest carryforwards. Generally, section 382 can limit a taxpayer's ability to use NOLs incurred before an ownership change (“pre-change losses”) following an ownership change. Section 382(d)(3). Prior to the enactment of the TCJA, pre-change losses were limited to NOLs incurred before the ownership change.

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Because the carryforward of disallowed business interest is treated similar to the carryforward of NOL, it would be appropriate to treat disallowed business interest similar to NOL for purposes of section 108(b). The statute currently does not expressly include disallowed interest carryforwards in the list of attributes subject to reduction under section 108(b)(2). In addition, the legislative history to section 108(b)(2) indicates that the list of attributes in section 108(b)(2) is an exclusive list, and once exhausted, remaining excluded CODI is discharged without additional cost.

Therefore, it seems that disallowed business interest carryforward may not be subject to reduction under section 108(b) without a statutory amendment. Including disallowed interest carryforwards in section 108(b)(2) reflects sound tax policy, which can be consistently applied by taxpayers and practitioners. It is also consistent with the purpose of section 108(a) and (b)(2) (i.e., to defer CODI while subsequently collecting tax on an equivalent amount of income by reducing attributes that would reduce taxable income in subsequent years).

Conclusion/Recommendation

Disallowd interest carryforwards should be attributes subject to section 108(b)(2).

# **Tax Methods & Periods**

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Proposal: Modify the enhanced deduction rules for charitable contributions of inventory

**Present Law**

Section 170(b)(2) provides that, except for qualified conservation contributions by corporate farmers and ranchers and contributions of food inventory under section 170(e)(3)(C), the total charitable contribution deduction for any taxable year shall not exceed 10% of a corporation's taxable income ("the 10% taxable income limitation").

Under section 170(d)(2), if a corporation is unable to deduct charitable contributions in the taxable year the contributions are made due to the 10% taxable income limitation, the corporation is permitted to deduct the excess amount during the five succeeding tax years ("five-year carryover period"), subject to additional limitations.

Under section 170(e)(1)(A), the charitable contribution deduction for ordinary income property is equal to the fair market value of the property at the time of the contribution reduced by the amount of gain which would not have been long-term capital gain if the property contributed had been sold by the taxpayer at its fair market value (determined at the time of contribution).

Section 170(e)(3) provides a special rule for qualified contributions of inventory and other property. Under section 170(e)(3), a qualified contribution is "a charitable contribution described in paragraph (1) or (2) of section 1221(a) by a corporation (other than an S corporation) to an organization which is described in section 501(c)(3) and is exempt under section 501(a) (other than a private foundation, as defined in section 509(a), that is not an operating foundation, as defined in section 4942(j)(3)), but only if –

1. The use of the property by the donee is related to the purpose or function constituting the basis for its exemption under section 501 and the property is to be used by the donee solely for the care of the ill, needy, or infants;
2. The property is not transferred by the donee in exchange for money, other property, or services;
3. The taxpayer receives from the donee a written statement representing that its use and disposition of the property will be in accordance with the provisions of (1) and (2); and
4. In cases where the donated property is subject to regulation under the Federal Food, Drug, and Cosmetic Act, as amended, such property must fully satisfy the applicable requirements of such Act and related regulations promulgated thereunder on the date of transfer and for one hundred and eighty days prior thereto."

Section 170(e)(3)(B) provides that "the reduction under paragraph (1)(A) for any qualified contribution (as defined in subparagraph (A)) shall be no greater than the sum of --

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1. One-half of the amount computed under paragraph (1)(A) (computed without regard to this paragraph), and
2. The amount (if any) by which the charitable contribution deduction under this section for any qualified contribution (computed by taking into account clause (1) but without regard to this clause) exceeds twice the basis of such property.”

Section 170(e)(3)(C) contains similar rules for the charitable contributions of food inventory.

**Description of Proposal**

Modify section 170(e)(3) to provide that a corporation making a qualified charitable contribution of inventory and food inventory shall include the basis of the contributed inventory in cost of goods sold, for the year of contribution, so that only the enhanced deduction is treated as a charitable contribution subject to the 10% taxable income limitation under section 170(b)(2) or the 15% taxable income limitation under section 170(e)(3)(C)(ii)(I).

**Analysis**

Under section 170(e)(3), a corporation making a qualified charitable contribution of inventory may claim a deduction equal to the fair market value reduced by one-half of the gain which would not have been long-term capital gain if the property contributed had been sold by the corporation at its fair market value (determined at the time of contribution). However, the total charitable contribution deduction may not exceed twice the basis of the contributed property. In other words, if the fair market value of the contributed inventory at the time of the contribution exceeds the basis of the inventory, the amount of the charitable contribution deduction is equal to the basis of the inventory plus 50% of the profit, not to exceed twice the basis of the inventory. The profit is the amount realized if the corporation had sold the inventory at its fair market value at the time of contribution.

The amount of the deduction in excess of basis is commonly referred to as “the enhanced deduction.” Under present law, the entire amount (basis plus the enhanced deduction) is treated as a charitable contribution, and the basis of the inventory is not included in cost of goods sold (see Reg. § 1.170A-4A(c)(3)). As a result of applying the 10% taxable income limitation in section 170(b)(2), some corporations are unable to claim the enhanced deduction and are unable to recover the basis of the contributed inventory in the year of the contribution. Accordingly, a corporation subject to the 10% taxable income limitation may opt to dispose of the inventory instead of contributing the inventory to charity. Such disposition would allow the corporation to obtain a current recovery of the basis through cost of goods sold instead of deferring the deduction to future years.

The IRS recognized this dilemma and issued Notice 2008-90, giving corporations the option to either claim the enhanced deduction under section 170(e)(3) or apply the rules under section 170(e)(1). Under section 170(e)(1), the basis of inventory contributed to charity generally is included in cost of goods sold instead of being treated as a charitable contribution deduction, but there is no enhanced deduction. Therefore, if a corporation making a qualified charitable

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contribution of inventory under section 170(e)(3) is subject to the 10% taxable income limitation, the corporation could elect to apply the rules under section 170(e)(1) to recover the basis of the contributed inventory in the year of contribution. However, a corporation electing to apply the rules under section 170(e)(1) would forfeit the enhanced deduction. The same issues apply to the charitable contribution of food inventory, as enhanced by the Protecting Americans from Tax Hikes of 2015. As a result, this option removes the incentive designed by Congress to encourage charitable contributions of inventory when it enacted section 170(e)(3).

Modifying section 170(e)(3) is even more important in light of the substantial increase in charitable contributions of inventory in response to COVID-19.

Conclusion/Recommendation

Modify section 170(e)(3) to provide that a corporation making a qualified charitable contribution of inventory and food inventory shall include the basis of the contributed inventory in cost of goods sold, for the year of contribution, so that only the enhanced deduction is treated as a charitable contribution subject to the 10% taxable income limitation under section 170(b)(2) or the 15% taxable income limitation under section 170(e)(3)(C)(ii)(I).

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Proposal: Repeal the anti-churning rules of section 197(f)(9)

**Present Law**

Enacted in 1993, section 197 permits the amortization of certain acquired intangibles (such as goodwill and going concern value). These intangibles were not amortizable prior to the enactment of section 197. Referred to as the anti-churning rules, section 197(f)(9), was enacted to prevent related taxpayers from converting previously non-amortizable intangibles into intangibles subject to the allowance for amortization by buying and selling intangible assets amongst themselves. Pursuant to the anti-churning rules, an intangible is excluded from the definition of amortizable section 197 intangibles if:

1. The intangible was held or used at any time on or after July 25, 1991, and on or before August 10, 1993 (“the transition period”), by the taxpayer or a related person;
2. The taxpayer acquired the intangible from a person who held it at any time during the transition period, and as part of the transaction, the user of the intangible does not change; or
3. The taxpayer grants the right to use the intangible to a person (or a person related to that person) who held or used the intangible at any time during the transition period.

**Description of the Proposal**

Repeal of the anti-churning rules under section 197(f)(9) in their entirety.

**Analysis**

Congress enacted the anti-churning rules to prevent taxpayers from transacting with related taxpayers to convert non-amortizable intangibles into amortizable intangibles. Most intangibles that exist today did not exist when section 197 was enacted almost 30 years ago. Therefore, applying the rules to the current economic environment is outdated and unfitting. In addition, the anti-churning rules are complex and require taxpayers to perform a burdensome analysis to determine if non-amortizable intangibles existed during the transition period. Furthermore, the anti-churning rules treat taxpayers who possessed intangibles during the transition period distinctly different from taxpayers that did not hold intangibles until after the enactment of section 197.

**Conclusion/Recommendation**

Repeal of the anti-churning rules under section 197(f)(9) in their entirety.

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Proposal: Amend section 451(b) by providing that gross income taken into account under section 451(b)(1)(A) related to the sale of a good is reduced for book costs incurred to produce such good

**Present Law**

An accrual method taxpayer with an applicable financial statement or other specified financial statement that is subject to the all events test must include sales, gross receipts, and other items of income in gross income no later than the taxable year in which such income is taken into account as revenue in its applicable financial statement or another financial statement under rules specified by the Secretary.

**Description of the Proposal**

Amend section 451(b) by providing that gross income taken into account under section 451(b)(1)(A) related to the sale of a good is reduced for book costs incurred to produce such good.

**Analysis**

We specifically recommend the following:

**CERTAIN SPECIAL RULES FOR TAXABLE YEAR OF INCLUSION**

- (a) Cost Allowance for the Sale of Goods. – Section 451 is amended by redesignating paragraphs (3), (4), and (5) of subsection (b) as paragraphs (4), (5), and (6) of subsection (b), and inserting after paragraph (2) of subsection (b) the following new paragraph:
  - (3) Costs incurred related to the future sale of goods
    - (A) In general. – In the case of a taxpayer that is a producer of inventory (as defined in section 263A), and is required to recognize gross income for such inventory as a result of paragraph (1)(A) before tax ownership of the inventory transfers to the purchaser, such taxpayer shall reduce the amount of gross income recognized by the amount of costs incurred in its applicable financial statement for the sale of such good.
    - (B) Applicability to agreements for the sale of multiple units. – In the case of a taxpayer that produces property and enters into an agreement to produce multiple units, such taxpayer shall take into account costs incurred in its applicable financial statement related to the agreement in total, but in no case shall the amount of revenue reduced by this paragraph be reduced below zero.
    - (C) Limitation on reduction of gross income. – This subparagraph shall not apply to gross income required to be recognized as a result of the all events test, as defined in paragraph (1)(C).
    - (D) Coordination with deduction requirements under this Chapter. In general. -- No cost shall be allowed under this paragraph unless otherwise deductible under this

Chapter. Any adjustments required under this subparagraph shall be taken into account through adjustments to deductions from total income after taking into account the gross income reduction allowed under this paragraph.

(E) Coordination with section 471 and section 263A. – In the case of any costs incurred and otherwise deductible under this Chapter, such costs shall be exempt from section 471 and section 263A.

(b) Coordination with section 481. – Any change in method of accounting made pursuant to subsection (b) of section 451 shall be treated for purposes of section 481 as initiated by the taxpayer and made with the consent of the Secretary.

TCJA modified the all events test for income recognition to require an accrual method taxpayer with an applicable financial statement or other specified financial statement that is subject to the all events test to include sales, gross receipts, and other items of income in gross income no later than the taxable year in which such income is taken into account as revenue in its applicable financial statement or another financial statement under rules specified by the Secretary. Under the modifications, an accrual method taxpayer with an applicable financial statement or other specified financial statement includes sales, gross receipts, and other items of income in gross income upon the earlier of when the all events test is met or when the taxpayer includes such item in revenue in an applicable financial statement or other specified financial statement (i.e., upon the earlier of when due, paid, earned, or included in an applicable or other specified financial statement).<sup>60</sup>

Generally effective around the same period as TCJA, generally accepted accounting principles or international financial reporting standards required companies to adopt new financial accounting standards for the recognition of revenue (the New Standards). Under these New Standards, companies are to recognize revenue based upon a transfer of control model, rather than when revenue is realized or realizable and earned.

In conjunction, the TCJA modifications to section 451(b) and the New Standards may require a taxpayer to accelerate the recognition of revenue for the sale of a good, or goods, even before benefits and burdens of ownership transfer to the customer, the entity has a right to invoice, or has been paid in advance for the good, or a portion of the good. However, with limited exception, a taxpayer is not entitled to offset such revenue with costs incurred for the good being sold until benefits and burdens of ownership transfers to the customer.

The acceleration of such revenue without a cost offset is a punishing consequence of TCJA's modifications to income recognition. The Conference Report to TCJA includes an example of accelerating an unbilled receivable for partially performed services and a taxpayer was already allowed to deduct costs to provide services as costs were incurred. Allowing a cost offset for the sale of a good for which revenue is recognized over time in the applicable financial statement, places service providers and certain producers of property on equal footing.

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<sup>60</sup> Joint Committee on Taxation General Explanation of P. L. 115-97 (page 161).

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**Conclusion/Recommendation**

Amend section 451(b) by providing that gross income taken into account under section 451(b)(1)(A) related to the sale of a good is reduced for book costs incurred to produce such good.

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Proposal: Modify the definition of “tax shelter” for purposes of section 448 to exclude syndicates

**Present Law**

Section 448(a)(3) provides that “in the case of a tax shelter, taxable income shall not be computed under the cash receipts and disbursements method of accounting.”

Section 461(i)(3) defines a tax shelter as “(A) any enterprise (other than a C corporation) if at any time interests in such enterprise have been offered for sale in any offering required to be registered with any Federal or State agency having the authority to regulate the offering of securities for sale, (B) any syndicate (within the meaning of section 1256(e)(3)(B)), and (C) any tax shelter (as defined in section 6662(d)(2)(C)(ii)).”

Section 461(i)(4) provides that in the case of the trade or business of farming (as defined in section 464(e)), in determining whether an entity is a tax shelter, the definition of farming syndicate in section 461(k) is substituted for section 461(i)(3)(A) and (B).

Section 1256(e)(3)(B) defines a syndicate as “any partnership or other entity (other than a corporation which is not an S corporation) if more than 35 percent of the losses of such entity during the taxable year are allocable to limited partners or limited entrepreneurs.” Section 1256(e)(3)(C)(i) provides that an interest in an entity is not treated as held by a limited partner or a limited entrepreneur for any period if during such period such interest is held by an individual who actively participates at all times during such period in the management of such entity. Subsequent clauses provide additional exceptions to the limited partner and limited entrepreneur status, including (v), authority for the Secretary to determine (by regulations or otherwise) that an interest should be treated as held by an individual who actively participates in the management of an entity, and that such entity and such interest are not used (or to be used) for tax-avoidance purposes.

Section 461(k)(2) does not provide the same authority for the Secretary as provided in section 1256(e)(3)(B)(v).

**Description of the Proposal**

An exemption should be provided for taxpayers meeting the gross receipts test of section 448(c) from syndicate status solely for purposes of determining eligibility for the small business taxpayer accounting methods. Exercising authority under section 1256(e)(3)(C)(v), Treasury and the IRS should deem owners of a small business entity as a holding by an individual who actively participates in the management of the entity. The guidance should deem these small business entity owners as active participants in management and should deem tiered structures that meet the gross receipts test as active participants in management, considering aggregation and attribution of gross receipts.

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Analysis

Congress granted Treasury the authority, in section 1256(e)(3)(C)(v), to address situations in which tax-avoidance is not an issue as follows: “If the Secretary determines (by regulations or otherwise) that such interest should be treated as held by an individual who actively participates in the management of such entity, and that such entity and such interest are not used (or to be used) for tax-avoidance purposes.” Modernizing the definition of tax shelter would simplify the tax system for many small businesses and provide equity among business entity forms. The IRS has not exercised this authority. The authority to address situations in which tax avoidance is not an issue does not apply to a farm syndicate described in section 461(k).

Conclusion/Recommendation

An exemption should be provided for taxpayers meeting the gross receipts test of section 448(c) from syndicate status solely for purposes of determining eligibility for the small business taxpayer accounting methods. Section 448(c) should include a provision that deems small business entity owners as active participants in management and should deem tiered structures that meet the gross receipts test as active participants in management, considering aggregation and attribution of gross receipts. The provision should apply for subsections 461(i) and (k).

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Proposal: Modify the section 471(c) rule for small taxpayers and allow them to follow book method

**Present Law**

The regulations under Section 471(c) do not interpret the statute to allow eligible small businesses to strictly follow the book method for inventory with no tax adjustments to costs capitalized to ending inventory. Such small businesses must make adjustments similar to Section 263A for book/tax differences on costs capitalized into inventory under the book method.

**Description of the Proposal**

Change Section 471(c) to allow eligible small businesses to strictly follow the book method for inventory with no tax adjustments to costs capitalized to ending inventory. Such small businesses must take into account all book/tax differences on costs capitalized into inventory under the book method as adjustments to the otherwise deductible costs for the current year as if the costs had not been capitalized into inventory under the book method.

**Analysis**

Section 471(c) provides that the requirement to maintain inventories under section 471(a) does not apply to a taxpayer that meets the gross receipts test under section 448, and that the taxpayer's method of accounting for inventory will not be treated as failing to clearly reflect income if the taxpayer either treats the inventory as non-incidental materials and supplies or if the taxpayer's method conforms to the method used in the taxpayer's applicable financial statements (AFS) or the taxpayer's books and records (together herein referred to as the "book method"), as applicable. The final regulations under section 471(c) make the ability to follow the book method overly complex for small businesses, which appears to be contrary to Congressional intent to simplify and reduce administrative burdens for small businesses. Reg. § 1.471-1(b)(5) and 1.471-1(b)(6) would require that a small business using one of the two book methods to make adjustments to its inventory costs similar to the types of adjustments that must be made under section 263A for book/tax differences in costs. That is, under the final regulations, small businesses are not allowed to actually follow their book method for inventory. Such businesses must make adjustments to the ending inventory for book/tax differences on costs capitalized for book purposes, but do not have the simplified methods under section 263A to perform such adjustments. The additional burden created by the final regulations is inconsistent with the intent of Congress to provide simplification for eligible small business taxpayers. Therefore, the statute should be clarified to allow eligible small businesses to strictly follow the book method for inventory, but that such businesses must take into account all book/tax differences, such as any disallowance under section 274, for which the underlying cost was capitalized into inventory under the book method as an adjustment to the otherwise deductible costs for the current year as if the costs had not been capitalized into inventory under the book method. Such simplification would be aligned with Congressional intent to provide simplification to eligible small businesses.

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**Conclusion/Recommendation**

Change Section 471(c) to allow eligible small businesses to strictly follow the book method for inventory with no tax adjustments to costs capitalized to ending inventory. Such small businesses must take into account all book/tax differences on costs capitalized into inventory under the book method as adjustments to the otherwise deductible costs for the current year as if the costs had not been capitalized into inventory under the book method.

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Proposal: Where research and experimental (R&E) activities are performed under a contract research arrangement, require only the taxpayer who has ownership over the intellectual property (IP) created from R&E activities to treat such costs as specified R&E expenditures under section 174

Present Law

For tax years beginning before January 1, 2022, section 174(a) provides that a taxpayer shall be allowed a deduction for R&E expenditures paid or incurred during the taxable year in connection with his trade or business. Section 174(b) provides that, at the election of the taxpayer, R&E expenditures which are paid or incurred by the taxpayer in connection with his trade or business, not treated as expenses under section 174(a), and chargeable to capital account but not chargeable to property of a character which is subject to the allowance under section 167 (relating to allowance for depreciation, etc.) or section 611 (relating to allowance for depletion), may be treated as deferred expenses. In computing taxable income, such deferred expenses shall be allowed as a deduction ratably over a period of not less than 60 months as may be selected by the taxpayer (beginning with the month in which the taxpayer first realizes benefits from such expenditures). Reg. § 1.174-1 provides that R&E expenditures which are neither treated as expenses nor deferred and amortized under section 174 must be charged to capital account.

Section 174 does not define the term “research and experimental expenditures.” However, Reg. § 1.174-2(a)(1) defines R&E expenditures as expenditures incurred in connection with the taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense and includes all such costs incident to the development or improvement of a product. For purposes of Reg. § 1.174-2, the term “product” includes any pilot model, process, formula, invention, technique, patent, or similar property, and includes products to be used by the taxpayer in its trade or business as well as products to be held for sale, lease, or license.

Regulation § 1.174-2(a)(10) provides that section 174 applies not only to costs paid or incurred by the taxpayer for R&E undertaken directly by him but also to expenditures paid or incurred for R&E carried on in his behalf by another person or organization (such as a research institute, foundation, engineering company, or similar contractor).

Section 174 was amended by section 13206 of the TCJA, which modifies the treatment of R&E expenditures paid or incurred in taxable years beginning after December 31, 2021. Amended section 174(a) provides that in the case of a taxpayer's specified R&E expenditures, no deduction shall be allowed for such expenditures except as provided under section 174(a)(2). Under amended section 174(a)(2), the taxpayer shall charge specified R&E expenditures to capital account and be allowed an amortization deduction of such expenditures ratably over the 5-year period (15-year period in the case of any specified R&E expenditures which are attributable to foreign research (within the meaning of section 41(d)(4)(F))) beginning with the midpoint of the taxable year in which such expenditures are paid or incurred.

Similar to Reg. § 1.174-2(a)(1), section 174(b) provides that the term “specified research or experimental expenditures” means, with respect to any taxable year, research or experimental

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expenditures which are paid or incurred by the taxpayer during such taxable year in connection with the taxpayer's trade or business.

**Description of the Proposal**

In an arrangement where R&E activities are performed pursuant to a contract, require only the taxpayer who has ownership over the IP created from R&E activities to treat such costs as specified R&E expenditures under section 174.

**Analysis**

Section 174 as it applies to tax years beginning before January 1, 2022 gives taxpayers various options for treating its R&E expenditures. Section 174 as it applies to tax years beginning after December 31, 2021 removes any flexibility by providing that taxpayers must charge research and experimental expenditures to a capital account and amortize the costs over 5 (in the case of domestic research) or 15 years (in the case of foreign research) under section 174(a)(2). With the flexibility no longer available to taxpayers, amended section 174 could result in the requirement for both parties subject to a contract research arrangement to recover their costs over time under section 174(a)(2). In addition, absent a rule requiring only one party to recover R&E expenditures under section 174(a)(2), the contract researcher will often be required to recognize income for the services provided to the other party under section 451 principles and will be required to recognize the related costs over 5 or 15 years under section 174(a)(2). This distortive mismatch in timing of recognizing income and related costs will create situations in which taxpayers will not have the cash available to cover their tax liabilities. Furthermore, requiring a contract researcher to capitalize R&E under section 174 would be inconsistent with historic capitalization principles under section 263(a) in that the contract researcher would not have a capitalizable intangible asset if it does not own the underlying IP.

For these reasons, costs incurred by a contract researcher that does not own the IP developed from the research should be treated as ordinary and necessary business expenses under section 162 rather than specified R&E expenditures under section 174.

**Conclusion/Recommendation**

In an arrangement where R&E activities are performed pursuant to a contract, require only the taxpayer who has ownership over the IP created from R&E activities to treat such costs as specified R&E expenditures under section 174.

# **International Tax**

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Proposal: Clarify the limited nature of section 958(b)(4) repeal

**Present Law**

Public Law No. 115-97 (the “TCJA”) completely repealed section 958(b)(4), which prevented “downward attribution” under section 318(a)(3) from a foreign person to a U.S. person. Due to downward attribution and the repeal of section 958(b)(4), certain foreign corporations are now treated as Controlled Foreign Corporations (CFCs). In effect, lower-tier U.S. entities may now be deemed to own and control other foreign entities in the structure, causing several problems. These problems include additional compliance burdens, an expansion of entities subject to the CFC rules (and, by extension, an expansion of entities subject to the Specified Foreign Corporation (SFC) rules under section 965) and income inclusions by certain ultimate U.S. investors.

The repeal of section 958(b)(4) applies retroactively to a foreign corporation’s last taxable year beginning before January 1, 2018 and each subsequent taxable year. It also applies to taxable years of U.S. shareholders in which or with which the taxable years of those foreign corporations end.

**Description of Proposal**

Provide legislation to clarify the exclusion of a foreign corporation, which is considered a CFC solely as a result of the “downward attribution” rules of section 318(a)(3), from the definition of a CFC for any U.S. shareholder not considered a related party (within the meaning of section 954(d)(3)) with respect to the domestic corporation to which ownership was attributed.

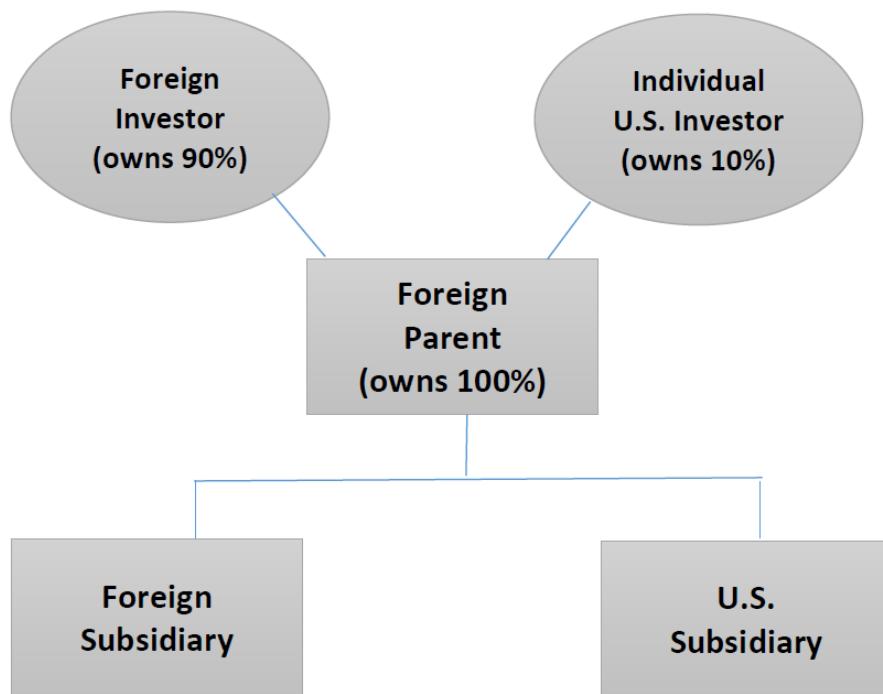
**Analysis**

The treatment of these entities as CFCs is inconsistent with the intent of Congress when it repealed section 958(b)(4). According to page 633 of the [Joint Explanatory Statement of the Committee of the Conference](#) (Conference Report) for the TCJA relating to the repeal of section 958(b)(4), “the Senate Finance Committee explanation states that the provision is not intended to cause a foreign corporation to be treated as a controlled foreign corporation with respect to a U.S. shareholder as a result of attribution of ownership under section 318(a)(3) to a U.S. person that is not a related person (within the meaning of section 954(d)(3)) to such U.S. shareholder as a result of the repeal of section 958(b)(4).” The Report further states that the “conference agreement follows the Senate amendment.”

The Conference Report also provides that “in adopting this provision, the conferees intend to render ineffective certain transactions that are used to [sic] as a means of avoiding the subpart F provisions. One such transaction involves effectuating ‘de-control’ of a foreign subsidiary, by taking advantage of the section 958(b)(4) rule that effectively turns off the constructive stock ownership rules of 318(a)(3) when to do otherwise would result in a U.S. person being treated as owning stock owned by a foreign person. Such a transaction converts former CFCs to non-CFCs, despite continuous ownership by U.S. shareholders.”

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The application of our recommendation is illustrated by the following example and diagram:



As a result of the changes enacted as part of the TCJA, U.S. Subsidiary is treated as owning 100% of the stock in Foreign Subsidiary, converting Foreign Subsidiary from a non-CFC, under prior TCJA-law, into a CFC. Unless the related party exclusion described by the Conference Report is applied, Foreign Subsidiary would, as a new “constructive” CFC, become subject to additional information reporting. The Individual U.S. investor may now be required to include Foreign Subsidiary’s gross income under sections 951, 965, 951A, among others. Absent the repeal of section 958(b)(4), the Individual U.S. Investor would not have been subject to the various rules applicable under the CFC regime.

Interpreting the plain language of the relevant code sections does not provide the intended result of the TCJA, resulting in an increasing number of taxpayers falling under the definition of a U.S. shareholder of a CFC than anticipated by Congress. As a result, Individual U.S. Investor in our example is subject to all of the provisions applicable to U.S. Shareholders of a CFC (including subpart F inclusions and GILTI, as well as increased disclosure compliance) on an ongoing basis.

#### Conclusion/Recommendation

Clarify the law to follow Congressional intent.

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Proposal: Permit taxpayers with outstanding section 965(h) installments to obtain a refund for overpayments of tax, notwithstanding any future installment amounts of section 965 transition tax liability<sup>61</sup>

Present Law

Under section 965, Treasury and the IRS reached a conclusion in the question and answer ([Q&A 13 and 14](#)) for the 2017 filing years. These FAQs were posted to the IRS website on April 13, 2019, later explained in an IRS Chief Counsel Memorandum ([PMTA 2018-16](#) or “PMTA”), and most recently re-affirmed in [Q&A 4](#) of a new set of IRS FAQs issued in response to the CARES Act, posted to the IRS website on April 23, 2020. Allowing taxpayers to obtain a refund for losses incurred during this tumultuous economic period, regardless of whether they have outstanding section 965(h) installments, is necessary for fair and sound administration of the tax system.

Description of Proposal

Congress should enact legislation similar to that provided for in section 2208 of the original version of the CARES Act legislation introduced in the Senate on March 19, 2020, which provides as follows:

(a) IN GENERAL.—Section 965(h) of the Internal Revenue Code of 1986 is amended by adding at the end the following new paragraph:

“(7) INSTALLMENTS NOT TO PREVENT CREDIT OR REFUND OF OVERPAYMENTS OR INCREASE ESTIMATED TAXES.—If an election is made under paragraph (1) to pay the net tax liability under this section in installments—

“(A) no installment of such net tax liability shall—

“(i) in the case of a request for credit or refund, be taken into account as a liability for purposes of determining whether an overpayment exists for purposes of section 6402 before the date on which such installment is due, or

“(ii) for purposes of sections 6425, 6654, and 6655, be treated as a tax imposed by section 1, section 11, or subchapter L of chapter 1, and

“(B) the first sentence of section 6403 shall not apply with respect to any such installment.”

(b) LIMITATION ON PAYMENT OF INTEREST.—In the case of the portion of any overpayment which exists by reason of the application of section 965(h)(7) of the Internal Revenue Code of 1986 (as added by this section)—

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<sup>61</sup> AICPA Letter, [“Overpayments, Section 965\(h\) Transition Tax Installments, and Net Operating Loss Carryback Relief under the CARES Act,”](#) October 20, 2020.

(1) if credit or refund of such portion is made on or before the date which is 45 days after the date of the enactment of this Act, no interest shall be allowed or paid under section 6611 of such Code with respect to such portion; and

(2) if credit or refund of such portion is made after the date which is 45 days after the date of the enactment of this Act, no interest shall be allowed or paid under section 6611 of such Code with respect to such portion for any period before the date of the enactment of this Act.

(c) **EFFECTIVE DATE.**—The amendment made by subsection (a) shall take effect as if included in section 14103 of Public Law 115–97.

### Analysis

The AICPA remains concerned about the negative effect of the decision of Treasury and the IRS for certain taxpayers regarding the application of overpayments of tax unrelated to the section 965 transition tax or the installment payments under section 965(h). This concern has been amplified by the recent crisis caused by the COVID-19.

Many businesses are experiencing significant reductions in revenues and cash flow as a result of the COVID-19 crisis. Without cash reserves, the reduction in revenues may force many businesses to either look for additional funding in a difficult market or to reduce their expenses, including through layoffs or reduction of wages. Indeed, we have already seen dramatic layoffs and increases in unemployment claims since the Coronavirus affected the U.S.<sup>62</sup>

United States businesses with foreign subsidiaries may have incurred a section 965 transition tax liability following the enactment of the TCJA. These businesses, which may now experience constrained revenues, may have elected to pay the section 965 transition tax liability in eight annual installments under section 965(h). Some of the central purposes of the CARES Act are to provide relief for businesses and their employees and to help stabilize the U.S. economy.<sup>63</sup>

We understand that the intent and purpose of the CARES Act provision granting relief through a temporary carryback period for NOL deductions extends to U.S. businesses and employers with payments in installments of the transition tax liability under section 965(h). However, such businesses and employers may face severe constraints in obtaining the benefits of that extended NOL carryback period because of Q&A 14. Due to the Treasury and IRS interpretation, many

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<sup>62</sup> According to the Bureau of Labor Statistics (BLS) [Employment Situation Summary for September 2020](#), “In September, the unemployment rate declined by 0.5 percentage point to 7.9%, and the number of unemployed persons fell by 1.0 million to 12.6 million.” The unemployment rate was 3.5% in February and jumped quickly to nearly 15% in April as U.S. employers laid off more than 20 million people due to the coronavirus pandemic.

<sup>63</sup> See [Senate Majority Leader Mitch McConnell’s remarks on the Senate Floor regarding the CARES Act](#) (March 19, 2020); [U.S. Senate Committee on Finance Press Release on Tax Policies for Phase 3 Coronavirus Response](#) (March 19, 2020) (providing that the provision reversing the Q&A 14 guidance of Treasury and the IRS “corrects an error in the TCJA, allows companies to recover the overpayment of taxes paid on the toll charge to help with liquidity during the current crisis.”); [Chairman of the U.S. House Ways and Means Committee Richard Neal’s Floor Remarks on the Coronavirus Response Legislation](#) (March 27, 2020).

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U.S. businesses that generated positive taxable income prior to the COVID-19 pandemic but are now experiencing losses and revenue constraints could not obtain a refund by carrying back the losses to prior year periods as long as they have future section 965 transition tax installments that remain unpaid.

**Conclusion/Recommendation**

Congress should enact legislation to permit taxpayers with outstanding section 965(h) installments to obtain a refund for overpayments of tax, notwithstanding any future installment amounts of section 965 transition tax liability.

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Proposal: Consolidate the reporting of foreign assets under Title 31 and Title 26 into a single report

**Present Law**

Under Title 31 of the U.S. Code (the Bank Secrecy Act, or BSA) – Reports of Foreign Bank Accounts 31 C.F.R § 1040.350 and §5314, U.S. citizens, resident aliens and certain entities with aggregated balances in accounts held outside the U.S. that exceed a \$10,000 statutory threshold are required to report on FinCEN Form 114, *Report of Foreign Bank and Financial Accounts* (“FBAR”) specified details on these accounts. Simultaneously, these same taxpayers are also required under 26 USC § 6038D to report nearly identical information on Form 8938 *Statement of Specified Foreign Financial Assets*, yet subject to different reporting rules and thresholds. This duplicative reporting is cumbersome for taxpayers who struggle to discern nuances in the separate statutes, heightened risk for penalties for unintended noncompliance, and inefficient tax administration, both in processing duplicated information as well as responding to penalty abatement requests that could be reduced with a single consolidated report.

**Description of Proposal**

Congress should enact legislation to consolidate FBAR and Form 8938 reporting requirements into a single compliance form, with an original (not extended) due date of October 15<sup>th</sup>, encompassing the data requirements included in both current Forms 8938 and the FBAR.

**Analysis**

The AICPA appreciates the history of cooperation with the Service and elected officials in matters relating to foreign asset reporting and understands the need for information reporting of offshore assets. Our membership advocates, however, simplification of regulations to streamline this reporting from the inefficient duplicative process into a single consolidated report. Form 8938 clearly represents a modernization of vital information gathering for foreign assets, yet the FBAR still remains with outdated and inconsistent rules. The data needed from taxpayers should be consolidated into a single Form 8938 that may be signed and submitted irrespective of income tax filing requirements, and the FBAR can be eliminated.

One of the most striking disparities in reporting is the differences in reporting thresholds between the two forms. Form 8938 under 26 U.S.C. § 6038D (enacted as a part of the HIRE Act) applies a \$50,000 filing requirement (and higher, depending on residency and filing status). In contrast, the FBAR under 31 C.F.R. § 103.27(c) applies a remarkably smaller threshold of only \$10,000 for identical information. This threshold was set in 1970 and has never been indexed for inflation. Given the rate of inflation since 1970 on most commonly available inflation calculators, this amount equates to over \$65,000 in today’s dollars. The \$50,000 threshold of the Form 8938 is more appropriate for modern foreign asset reporting, to align with the intended scope these laws first considered. This \$50,000 threshold should be indexed for inflation as further explained below.

Curiously, however, the penalty for noncompliance of an FBAR is indexed for inflation, setting the penalty for non-willful violations now higher than the reporting threshold. 31 C.F.R. 5321(a)(5) authorizes the Secretary to assess penalties for violations of section 5314. In 2015, §

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701 of the Inflation Adjustment Act authorized agencies to annually adjust for inflation Civil Monetary Penalties (CMP) assessed beginning in 2017. The current CMP for those assessed after January 28, 2021 is up to \$13,640. Bearing in mind that the FBAR reporting threshold is an aggregate of high values in accounts at *any* point in time, and not a report of actual wealth, it is possible that the penalty for non-willful filing violations exceeds the amount ever held abroad by a taxpayer. Consider a common example of holding \$6,000 in a foreign time deposit, which expires in a given year and is rolled to a new time deposit that bears a new account number. The aggregate of the high values in each of the two accounts – each having had \$6,000 in them – is \$12,000 and above the reporting threshold. Yet, should the account holder have misunderstood the aggregation rules and failed to report an FBAR for that year, the penalty assessed would be \$13,640 – well in excess of the cash actually held abroad. By contrast, the current penalty for failure to file a Form 8938 is set at \$10,000, a fraction of the \$50,000 reporting threshold and is not indexed for inflation. We recommend that any indexing for inflation, if necessary, to apply to the penalties, also apply to the reporting threshold to maintain a logical parity between the two values.

Further confusion in reporting lies in identifying which entities must file which form, if at all, and which assets are reportable on which form. As the forms are very similar and much of the same information must be reported twice, slight differences remain which, if interpreted incorrectly, lead to costly penalty assessment. Requiring two different forms with different reporting thresholds and different sets of rules adds unnecessary confusion for taxpayers.

- a. Individuals and entities who may not have an income tax filing requirement (such as disregarded tax entities or children), and as such do not have a requirement to report assets on a Form 8938, still must file a separate FBAR.
  - o For example, consider a U.S. citizen who operates a business through a single-member LLC in both the U.S. and Canada, and holds bank accounts in Canada for its Canadian customers. She must report the FBAR under the tax ID of the LLC and not under her Social Security Number. In contrast, however, she would still include the foreign accounts on her Form 8938 for the year, as an account in which she has an interest. Aside from reporting identical information twice, to two separate agencies of the same Treasury Department, this confusing difference may lead to an unreported FBAR by the LLC (*i.e.* having been reported under the SSN of the taxpayer).
  - o Children may not have an income tax filing obligation, though they may still be beneficiaries of financial assets abroad. Often this is the result of an inheritances or gifts to which they and their parents may not even be aware. The Form 8938 would not be required in this instance where the children do not have sufficient income to necessitate an income tax return filing, though the additional step to submit the FBAR may well be missed.

In both of these cases, it is very easy for the taxpayer to confuse the income tax filing requirement with the FBAR requirement and make a potentially costly mistake of missing the FBAR filing altogether.

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- b. The definition of a “foreign account” varies between the forms, as well. The FBAR form includes accounts of a U.S. bank that are held at a *branch* that is outside the U.S. With the increase in digital banking, there is often not a branch *anywhere*. Therefore, it is confusing to discern where the “branch” in question is located. By contrast, Form 8938 requires the bank itself be a foreign financial institution, which is a much clearer determination for the taxpayer to make.
- c. Accounts held indirectly are reportable on the FBAR – these may include accounts through stock ownership in a Controlled Foreign Corporation (CFC) or a foreign partnership. Form 8938, however, recognizes these assets have already been reported on Forms 5471, *Information Return of U.S. Persons With Respect To Certain Foreign Corporations*, or Form 8865, *Return of U.S. Persons With Respect to Certain Foreign Partnerships*, and exempts duplicative filing.

Lastly, consolidating the reporting into a single form simplifies and reduces the quantity of forms subject to civil monetary penalties. Though the Secretary has authority to consider and abate penalty assessment in cases for which reasonable cause can be shown, it is an unnecessarily stressful and costly step for the taxpayer to hire qualified representation to petition for abatement, as the “reasonable cause” bar is set extraordinarily high. The taxpayer must then wait months for a reply from the IRS. The Service, in turn, must address these penalty abatement requests while citing significant understaffing problems, most recently in Commissioner Rettig’s testimony before the House Ways and Means Committee on Thursday March 18, 2021. In this hearing, the Committee sought means for which Congress could assist the Service in its significant backlogs and staffing challenges. This proposal to consolidate duplicative work offers some of that desperately needed relief. Any concerns with 26 U.S.C. § 6013 disclosure over transmission of similar information to other Governmental agencies could be drafted into legislation.

**Conclusion/Recommendation**

We recommend that Congress eliminate the FBAR by consolidating foreign asset reporting into a single Form 8938 that bears an original (not extended) due date of October 15<sup>th</sup> that may be submitted separate from an income tax return when none is required. This will eliminate costly and duplicative reporting, reduce confusion and taxpayer risk for error that results in unnecessary penalties, and streamline tax administration.

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Proposal: For purposes of assessing penalties related to international information reporting, grant an automatic 6 month extension time to file international informational returns without requiring the filing of Form 7004, *Application for Automatic Extension of Time To File Certain Business Income Tax, Information, and Other Returns* or Form 4868, *Application for Automatic Extension of Time To File U.S. Individual Income Tax Return*.

**Present Law**

By filing a properly completed Form 7004, a taxpayer currently receives an automatic extension of time to file certain business income tax, information, and other returns. For calendar year taxpayers, this extension is generally granted to six months from the original due date. International information returns, including Forms 5471,<sup>64</sup> 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*,<sup>65</sup> and 8865,<sup>66</sup> are filed with their associated U.S. federal income tax returns. Thus, international informational return deadlines are extended automatically via the Form 7004 extension when their associated U.S. federal income tax return (e.g., Form 1120, *U.S. Corporation Income Tax Return*, and Form 1065, *U.S. Return of Partnership Income*), is extended. Individuals filing Form 4868 similarly receive an automatic six-month extension of their income and informational tax return filings.

While no tax is directly due with the filing of these returns, the failure to timely file these returns can result in significant penalties, as well as extend the statute of limitation on assessment for the taxpayer's entire return under section 6501(c)(8). For example, the minimum penalty for delinquent Forms 5471 and 8865 is \$10,000 per form. The penalty for a late Form 5472 is \$25,000 per form. The IRS applies penalties for Forms 5471 and 5472 automatically when they are received with late-filed income tax returns. As a result, taxpayers may face significant penalties for a simple administrative oversight, such as not filing an "automatic" extension.

**Description of Proposal**

Grant an automatic six-month filing extension without requiring Form 7004 or Form 4868 for international information tax returns, thereby providing prospective penalty relief for failure to timely file penalties.<sup>67</sup>

**Analysis**

An automatic extension of international informational return filing deadlines when no payment is due would facilitate taxpayer compliance and demonstrate Treasury's interest in streamlining

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<sup>64</sup> Certain U.S. persons who are officers, directors, or shareholders in certain foreign corporations file Form 5471 and schedules to satisfy the reporting requirements of sections 6038 and 6046, and the related regulations.

<sup>65</sup> Corporations file Form 5472 to provide information required under sections 6038A and 6038C when reportable transactions occur with a foreign or domestic related party.

<sup>66</sup> A U.S. person files Form 8865 to report the information required under (1) Section 6038 (reporting with respect to controlled foreign partnerships); (2) Section 6038B (reporting of transfers to foreign partnerships); and, (3) Section 6046A (reporting of acquisitions, dispositions, and changes in foreign partnership interests).

<sup>67</sup> Note that this proposal solely requests extension of the filing deadline for the purpose of failure to timely file international information return penalties and would leave other penalties intact.

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processes by eliminating unnecessary filings. The existence of the “automatic” extension under Form 7004 for these filings indicates that Treasury has already concluded that it does not need to evaluate the reasons why such an extension is necessary. Notably, certain foreign and domestic corporations and certain partnerships are already entitled to an automatic extension to file *and pay* without filing Form 7004.<sup>68</sup> Entities entitled to that automatic extension include those that maintain books and records outside the U.S. and/or principally have non-U.S. income.<sup>69</sup> The same reasoning — presumably the increased complexity of those returns and the often-distributed nature of the underlying data required — applies to entities and individuals required to file international information returns.

Moreover, while international information return filing deadlines are currently extendable by extension of their associated Forms 1120 (series), 1065, and 1040 (series) via Form 7004 or Form 4868, the penalties for failure to obtain that extension are significant and largely automatic for the international information returns. Thus, if a taxpayer fails to file Form 7004 to extend its original income tax return compliance deadline but is unaware that it will need to file an international information return in a given tax year, it will automatically be penalized even if it ultimately files a return in a time (*i.e.*, by September or October) that Treasury has determined is acceptable under the current tax system.

For example, a foreign corporation may be looking to invest in the U.S. It does so, but is unfamiliar with the tax rules, and, although it sought advice, late filed its U.S. federal income tax return. If the return had ten Forms 5472 attached to the late filed return, the taxpayer would immediately receive a penalty notice for \$250,000. This occurs even though the taxpayer may have filed within what would have been the extended due date had they filed Form 7004, and otherwise owed no federal income tax with the return. Systematically assessing penalties against the taxpayer in this scenario does not enhance voluntary compliance because the taxpayer voluntarily submitted the returns.

Finally, this proposal is in accord with automatic extensions such as the FBAR extension from April 15 to October 15 without filing a form.

#### Conclusion/Recommendation

Congress should enact legislation to provide an automatic extension of international information return filings for six months from their original due date without requiring filing of an extension form. This will provide prospective penalty relief for failure to timely file.

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<sup>68</sup> Instructions for Form 7004 regarding Line 4.

<sup>69</sup> *Id.*

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Proposal: Clarify that the section 78 gross up is not necessary when foreign taxes are properly attributable to PTEP distributions

**Present Law**

The TCJA repealed section 902, modified section 960, and generally changed the system for determining the deemed paid credit to a “properly attributable” standard – that is, taxes are deemed paid by a U.S. shareholder of a CFC only to the extent that those taxes are properly attributable to certain subpart F income, GILTI, or PTEP. If a CFC makes a distribution of PTEP to another CFC or to a U.S. shareholder, section 960(b) generally treats the recipient corporation as having paid the taxes that are properly attributable to the distribution. Section 78, as amended by the TCJA, generally provides that an amount equal to the taxes deemed paid under sections 960(a), 960(b), and 960(d) for the taxable year will be treated (except for sections 245 and 245A purposes) as a dividend received by such domestic corporation from the foreign corporation.<sup>70</sup>

The purpose of section 78 is to ensure that a U.S. shareholder cannot effectively both deduct and credit the foreign taxes deemed paid by the U.S. shareholder.<sup>71</sup> Requiring a gross-up with respect to taxes deemed paid under section 960(a) and (d) is consistent with this purpose. Failure to require a gross-up for taxes deemed paid under sections 960(a) and (d) would have the effect of first allowing the foreign taxes paid by the CFC as a deduction (because Subpart F income and GILTI inclusions are net of expenses, including taxes)<sup>72</sup> and then, allowing a portion of such foreign taxes paid by the CFC as a tax credit of the U.S. shareholder against its U.S. tax.

**Description of Proposal**

Legislation is needed to clarify that the section 78 gross up is not necessary when foreign taxes are properly attributable to PTEP distributions. The reference to section 960(b) in section 78, to the extent it is interpreted as resulting in a dividend that is included in the gross income of the recipient domestic corporation, does not serve any clear purpose and effectively creates non-economic income.

**Analysis**

In December 2018, the Joint Committee on Taxation issued an explanation of the TCJA in which it noted that section 78 may require a technical correction to remove the reference to section 960(b) indicating that deemed paid taxes related to the distribution of PTEP to a U.S. shareholder should not be grossed-up.<sup>73</sup> About one year after the TCJA was signed into law, the House Ways and Means Committee released a discussion draft of technical and clerical corrections (the “Technical

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<sup>70</sup> See also Staff of the Jt. Comm. on Technical Explanation of the House Ways and Means Committee Chairman's discussion draft of the “Tax Technical and Clerical Corrections Act.”, at 16 (JCX-1-19) (Jan. 2, 2019).

<sup>71</sup> See T.D. 9882, 84 Fed. Reg. 69022, 69048 (Dec. 17, 2019); Notice of Proposed Rulemaking (“NPRM”), 83 Fed. Reg. 63200, 29319 (Dec. 7, 2018).

<sup>72</sup> Specifically, under sections 954(b)(5) and 951A(c)(2)(ii), the creditable foreign tax reduces the foreign corporation’s foreign base company income (which includes FPHCI) and tested income, respectively.

<sup>73</sup> See Joint Committee on Taxation, *General Explanation of Public Law No. 115–97* (JCS-1-18), at 394 n.1784 (December 2018) (the “JCT Technical Explanation”).

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Corrections Discussion Draft") "that are needed to properly reflect the original Congressional intent or that provide clarifications consistent with such intent."<sup>74</sup> The Technical Corrections Discussion Draft proposed to strike the reference to section 960(b) in section 78 "to clarify that foreign tax credits taken by reason of withholding tax imposed on a distribution of PTEP do not result in an additional section 78 gross-up."<sup>75</sup>

In addition, in the preamble to the final foreign tax credit regulations released on December 17, 2019,<sup>76</sup> the IRS and Treasury acknowledged that requiring a section 78 gross-up with respect to taxes deemed paid on distributions of PTEP under section 960(b) does not serve the purpose of section 78:

Section 960(b) addresses taxes deemed paid on distributions of previously taxed earnings and profits. Before the TCJA, section 78 did not reference former section 960(a)(3), which at the time addressed taxes deemed paid on distributions of previously taxed earnings and profits. This is consistent with the purpose of the section 78 dividend, which is to ensure that a U.S. shareholder cannot effectively both deduct and credit the foreign taxes paid by a foreign subsidiary that are deemed paid by the U.S. shareholder. However, there is no deduction taken into account by the U.S. shareholder for U.S. tax purposes with respect to taxes deemed paid under either former section 960(a)(3) or section 960(b) that would need to be reversed by section 78.<sup>77</sup>

#### Conclusion/Recommendation

Section 78, as amended by the TCJA, references section 960(b); however, there is no policy justification for this rule. Specifically, PTEP distributions are excluded from the gross income of a U.S. shareholder. Consequently, there is no deduction available to a U.S. shareholder for U.S. tax purposes with respect to taxes deemed paid under section 960(b) that would need to be grossed-up by section 78.

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<sup>74</sup> Tax Technical and Clerical Corrections Act, Discussion Draft, 115th Cong. 2nd Sess. (Jan. 2, 2019).

<sup>75</sup> See Tax Technical and Clerical Corrections Act, Discussion Draft, 115th Cong. 2nd Sess., § 14301 (Jan. 2, 2019); see also Staff of the Jt. Comm. on Technical Explanation of the House Ways and Means Committee Chairman's discussion draft of the "Tax Technical and Clerical Corrections Act.", at 16 (JCX-1-19) (Jan. 2, 2019).

<sup>76</sup> T.D. 9882, 84 Fed. Reg. 69022 (Dec. 17, 2019). The proposed foreign tax credit regulations were published on December 7, 2018 (the "2018 Proposed FTC Regulations"). See NPRM, 83 Fed. Reg. 63200 (Dec. 7, 2018). Treas. Reg. § 1.78-1 was finalized before the issuance of the 2019 Final FTC Regulations, as part of the Treasury Decision published in the Federal register on June 21, 2019. See T.D. 9866, 84 Fed. Reg. 29288 (June 21, 2019).

<sup>77</sup> T.D. 9882, 84 Fed. Reg. 69022, 69048 (Dec. 17, 2019) (internal citations omitted).